

**AN ANALYSIS OF THE POSSIBLE FISCAL CONSEQUENCES OF A
CONTROLLED FOREIGN COMPANY BEING DECLARED RESIDENT IN SOUTH
AFRICA– MAY SARS HAVE ITS CAKE AND EAT IT?**

By

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A dissertation presented for the approval of Senate in fulfilment of part of the requirements for the degree Master of Laws in Tax Law in approved courses and a minor dissertation. The other part of the requirements for this qualification was the completion of a programme of courses.

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Word count: 13 424

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A INTRODUCTION

The issue considered in this paper proceeds from the basis of a hypothetical income tax assessment issued by SARS against a hypothetical taxpayer.

The circumstances under which the hypothetical assessment is raised are as follows: suppose that Company A, a South African resident, owns 100% of the participation rights in Company B (the hypothetical taxpayer), a resident of Luxembourg. Company A has failed to qualify for any of the internal “exemptions”¹ contained in section 9D of the Income Tax Act, 58 of 1962 (“the Act”), and has thus been taxed with reference to the profits of Company B for the past ten years.

In the eleventh year, SARS audits Company B and determines that its effective place of management has, in fact, been in South Africa all along and that it is therefore resident in South Africa in terms of paragraph (b) of the definition of “resident” contained in section 1 of the Act.

Upon the determination that Company B is resident in South Africa, SARS proceeds to raise assessments against Company B in relation to the taxable income it earned during its current and former years of assessment (i.e. income tax assessments are raised for the full 11-year audit period) (referred to herein below as the “hypothetical assessment”).

The purpose of this paper is thus to investigate the fiscal consequences that do (and, it will be argued, do not) arise subsequent to a controlled foreign company (“CFC”) having been declared resident of the Republic of South Africa, in circumstances where a South African resident taxpayer had historically been taxed with reference to the profits of that CFC in terms of section 9D.

It is clear from the example that the same income now being taxed in the hands of Company B subsequent to its South African residency would already have been taxed in the hands of Company A by application of section 9D. The inequity of this result is undeniable. Should

¹ In other words, none of the provisions contained in section 9D which serve to exclude the taxing provision thereof have been satisfied.

assessments be raised against Company B in the manner suggested it would amount to economic double taxation.

This paper seeks to argue that it would not be competent for SARS to raise assessments against a “newly resident” taxpayer in the circumstances described above. The argument against the competency of such assessments is threefold:

- i. Firstly, I deal with the question as to what constitutes an “assessment” and demonstrate, with reference to case law, that an assessment amounts to a decision taken by SARS to tax certain income, and is not therefor something confined to the piece of paper on which that decision to tax may be communicated. On this basis it will be argued that, as SARS had already taken a decision to tax the income referred to in the example above in the hands of the South African resident taxpayer on strength of section 9D, it will be precluded from assessing the same income later in the hands of the hypothetical, newly resident taxpayer (which had previously been the CFC in relation to which section 9D was applied), as to do so would amount to economic double taxation;
- ii. Secondly, I will attempt to develop the principle dealt with under the first argument with reference to the judgment of Corbett JA, as he then was, in the case of *Commissioner for Inland Revenue v Louw*.² In *Louw* it was held that where SARS elects to invoke the anti-avoidance provisions of section 103 of the Act and raise assessments in the hands of an individual taxpayer in circumstances where the income in question had already been taxed in the hands of a corporate taxpayer “equity demands” that SARS should, in applying section 103, either make an allowance for the tax already paid by the corporate taxpayer or re-open the corporate taxpayer’s assessments and make a fitting adjustment;
- iii. Thirdly, I will investigate the meaning of the concept of “place of effective management” as a test for tax residency and attempt to demonstrate that SARS’ understanding of the concept, as articulated in its Interpretation Notes on the topic, has undergone a volte face change from the first issue of the Interpretation Note to the second. On this basis it will be argued that any non-resident entities who were not drawn

² 1983 (3) SA 551 (A).

into South African tax residency on the basis of their place of effective management during the term of validity of the first issue of SARS Interpretation Note 6, will be able to resist attempts by SARS to do so now on the basis of a “practice generally prevailing” argument as contemplated in section 99(d)(i) of the Tax Administration Act, 28 of 2011 (“the Tax Administration Act”).

Before turning to discuss the arguments outlined above I deal first, by way of background, with section 9D of the Act and briefly consider its provenance, purpose and application.

B A BRIEF OVERVIEW OF TAXING CONTROLLED FOREIGN COMPANIES

The concept of taxing controlled foreign companies accompanied the advent of residence-based taxation in South Africa.³ This change brought with it the imperative to tax “South African owned foreign companies” as it was clear that South African tax residents would otherwise be able to avoid or defer liability by shifting their profits to foreign entities, which profits would then only be susceptible to South African taxation once repatriated as distributions.⁴ The taxing scope of the section does not, however, extend to a controlled foreign company which conducts a so-called “foreign business establishment” (i.e. one that earns active income through its own operations as opposed to a passive entity which merely receives South African profits).⁵

Section 9D of the Act was thus conceived as an anti-avoidance mechanism designed to prevent the deferral or avoidance of tax via South African owned foreign companies. It provides for the assessment to tax of South African residents on the basis of the profits earned by their

³ Section 9D was first inserted into the Act in 1998 when South Africa’s system changed to a ‘source-plus’ system which extended the reach of the fiscus to tax foreign sourced passive income. Section 9D in its present form and complexity, however, was introduced when South Africa’s system was changed to be residency based. The change to the tax system was introduced by way of the Revenue Laws amendment Act, 59 of 2000 and was effective from 2001. See National Treasury’s contemporaneous detailed explanation to section 9D of the Act which can be accessed at:

<http://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf> referred to hereinafter as “The Treasury Explanation” (last accessed 15 June 2017).

⁴ The Treasury Explanation page 1.

⁵ Section 9D(9)(b) of the Act.

foreign owned companies (as though earned by the South African resident itself), which profits would then attract no liability for South African tax when actually repatriated.⁶

Conceptually it was important that the implementation of section 9D did not amount to a form of “treaty override” and it is for this purpose that the profits of the CFC fell to be taxed in the hands of the South African resident as opposed to the foreign resident itself. The rationale being that, in this way, the same resident would not be taxed twice in contravention of the provisions of any treaty that might be in place.⁷

It bears mention that, from inception, Treasury appreciated the fact that the assessment to tax of a resident on foreign profits would result in economic double taxation in the absence of relief in the form of foreign tax credits.⁸

There are various provisions contained in section 9D which serve to exclude the operation of the taxing provisions thereof under narrowly defined circumstances, which may result in a taxpayer falling in and out of the purview of the section from year to year.

Section 9D of the Act is a complex legislative provision and a detailed exposition thereof is unnecessary for present purposes as the premise of this paper proceeds on the most simplistic application thereof, namely, that a South African resident is taxed with reference to the profits of a controlled foreign company.

The next section contains the first argument against the competency of issuing the hypothetical assessment and is concerned with the concept of assessment.

C THE FIRST ARGUMENT: WHAT CONSTITUTES AN ASSESSMENT?

The word “assessment” is defined in section 1 of the Tax Administration Act as follows:

⁶ *Ibid.*

⁷ The Treasury Explanation page 2.

⁸ *Ibid.*

“assessment” means the determination of the amount of a tax liability or refund, by way of self-assessment by the taxpayer or assessment by SARS.

Chapter 8 of the Tax Administration Act establishes the different types of assessments that can be raised, how such assessments must be raised, recorded or withdrawn as well as matters related thereto.

Provision is made for original assessments,⁹ additional assessments,¹⁰ reduced assessments,¹¹ jeopardy assessments¹² and estimated assessments.¹³ Section 100 of the Tax Administration Act describes the process in terms of which assessments become final with reference to any objections or appeals¹⁴ that may be raised by the taxpayer.

In essence section 100 provides for three circumstances under which an assessment becomes final: first, where no objection has been received thereto or where an objection has been withdrawn, second, where no notice of appeal is filed pursuant to a decision being made on an objection and, third, where a dispute has been settled or where an appeal has been determined by the tax board, the tax court or any higher court and there is no right to further appeal.

Chapter 8 of the Tax Administration Act also specifies the period of limitations for the issuance of assessments, this section is dealt with separately below.

What is relevant for the present inquiry is the question as to what actually constitutes an assessment; is it the notice of assessment itself or the determination made by SARS which that notice reflects? To answer this question regard must be had to the meaning that has been attributed to the concept of an assessment by the courts.

9 Section 91 of the Tax Administration Act.

10 Section 92 of the Tax Administration Act.

11 Section 93 of the Tax Administration Act.

12 Section 94 of the Tax Administration Act.

13 Section 95 of the Tax Administration Act.

14 Chapter 9 of the Tax Administration Act – Dispute Resolution.

**C 1 – COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE v
BRUMMERIA RENAISSANCE (PTY) LTD & OTHERS
("BRUMMERIA")¹⁵**

During the relevant years of assessment the respondent companies were property developers who developed retirement villages. The respondents concluded contracts with prospective occupants of units still to be built.¹⁶

These contracts were to the effect that the prospective occupants granted interest-free loans to the respondents, which loans were applied to finance the construction of particular units in the retirement village. To evidence the loan, the prospective occupants were issued with debentures, the title deeds of the relevant units were endorsed accordingly and covering bonds were registered over the units to secure the debt.¹⁷

The prospective occupants did not take transfer of ownership of the units but were instead granted lifelong occupation thereof while ownership remained vested in the respondents. It was a term of the contracts that the respondents would repay the loans so extended upon cancellation of the agreements or upon the occupant's death.¹⁸

The contracts thus provided that the interest-free loans advanced to the respondents constituted the consideration in return for which lifelong occupation was granted.

SARS issued assessments against the respondents and, pursuant to objections, issued revised assessments and, subsequently, further revised assessments. In terms of the further revised assessments SARS assessed the respondents to income tax on amounts equal to the value of their rights to utilise the interest-free loans.¹⁹

¹⁵ 2007 (6) SA 601 (SCA).

¹⁶ *Brummeria* at [2] – [3].

¹⁷ *Ibid.*

¹⁸ *Ibid.*

¹⁹ *Brummeria* at [5].

An appeal to the tax court by the respondents having been upheld, SARS brought a further appeal to the Supreme Court of Appeal. In the SCA, the first respondent retained its argument that the interest-free loans did not amount to taxable receipts in its hands, but also argued that SARS was precluded from raising revised assessments on the basis that the period of limitations for doing so had prescribed.²⁰

More specifically, the first respondent submitted that SARS had changed the basis of its assessment in issuing the first revised assessment in response to the respondent's objection, thereby fully allowing that objection. The further revised assessments amounted to a setting aside of the first revised assessments and a reinstatement of the original assessment and, because three years had passed since those original assessments were raised, they had become final which precluded SARS from reinstating them by way of further revised assessments.²¹

SARS on the other hand argued that it was entitled to issue further revised assessments by virtue of the fact that the respondents had filed objections, thereby allowing SARS to alter the assessments under objection. Moreover, it was submitted that the three-year prescription period ran from the date of the first revised assessments and not from the date of the original assessments, that on this basis three years had not passed and that it was thus competent for SARS to issue further revised assessments.²²

Cloete JA, writing for a unanimous court, held that the mutually exclusive arguments raised by the parties in relation to the assessments and whether or not they had prescribed had to be resolved with reference to the purpose which underlined the legislative provisions relating to the period of limitations and the objection and appeal procedure.²³

Having confirmed that the purpose of the provisions in question was to achieve finality, the Court concluded that to uphold SARS' argument would be to subvert that purpose. The provisions that provided for the period of limitations and the objection and appeal procedure

²⁰ At the time the period of limitations section was located in section 79 of the Act, it is now section 99 of the Tax Administration Act but its provisions remain analogous.

²¹ *Brummeria* at [24].

²² *Brummeria* at [25].

²³ *Brummeria* at [26].

entailed a balancing exercise of the public interest in the collection of taxes, on the one hand, and the public interest that disputes should come to an end on the other.²⁴

In the judgment of the Court, an honest taxpayer would suffer undue prejudice should SARS be allowed to constantly change the basis on which it assessed the taxpayer until it was satisfied that it had raised the correct assessment. Cloete JA held that it was for this very reason that Parliament had given SARS a period of three years within which to collect taxes, thereby achieving a balance between the imperative to collect revenue and the taxpayer's interests in reaching finality with regard to the quantum of tax liability due. Even after the expiration of three years SARS was still able to re-open assessments if the taxpayer was guilty of fraud, misrepresentation or non-disclosure and dishonest taxpayers were thus afforded no protection.²⁵

Cloete JA thus determined that an acceptance of SARS' argument would result in a disruption of the reasoned balance contemplated by the Legislature and would result in iniquitous consequences for the honest taxpayer.²⁶

Importantly, the Court held that once SARS had changed the entire basis on which it sought to assess the taxpayer in response to the latter's objection, such assessment became final in the absence of fraud, misrepresentation or non-disclosure on the part of the taxpayer. In the words of the Court "that was the end of the matter".²⁷

The decision in *Brummeria* illustrates that an assessment is a concept that transcends the paper on which it is reflected. To determine what constitutes a particular assessment one needs to have regard to the determination made by SARS in relation to the specified income which forms the subject matter of that assessment.

Once SARS had satisfied itself of the merit in the respondent's objection and changed the basis of the assessment, that assessment became final in the absence of taxpayer dishonesty. In

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ *Brummeria* at [27].

arriving at this conclusion, the Court was not beholden to the superficial aspects of the process of issuing assessments, but looked instead to what may be described as SARS' decision-making process. Once a decision had been made SARS was bound by it in circumstances where the period of limitations within which it could have interfered had elapsed.

This principle was confirmed in even clearer terms in the judgment of the Supreme Court of Appeal in *First South African Holdings (Pty) Ltd v Commissioner for the South African Revenue Service* to which I now turn.

C 2 – FIRST SOUTH AFRICAN HOLDINGS (PTY) LTD v COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE (“FIRST SOUTH AFRICAN HOLDINGS”)²⁸

First South African Holdings (Pty) Ltd, the taxpayer, brought an application in the High Court to set aside a decision made by SARS to the effect that the latter was precluded from entertaining the taxpayer's request that a reduced income tax assessment be issued in relation to its 2002 year of assessment.²⁹

The setting aside application was brought after the taxpayer had submitted an income tax return in relation to its 2002 year of assessment which disclosed a taxable income of R15 892 978. In terms of this return the taxpayer sought to set off from its taxable income an amount of R34 978 418 being an assessed loss carried forward from the preceding tax year. Consequently, by its calculations, the taxpayer suffered a tax loss of R19 085 440 during the 2002 year of assessment.³⁰

The taxpayer had, however, inadvertently omitted to take into account the fact that certain foreign exchange gains included in its taxable income were not fully taxable and had thus overstated its taxable income. SARS, being similarly unaware of this error, did not take issue with the taxpayer's 2002 return and assessed the taxpayer to tax thereon on 17 July 2003. In

²⁸ 2011 JDR 0449 (SCA).

²⁹ *First South African Holdings* at [1].

³⁰ *First South African Holdings* at [2].

doing so SARS allowed the carrying over of the assessed loss claimed and no tax liability thus arose in respect of the taxpayer's 2002 tax year.³¹

On 12 April 2006, however, SARS issued an additional assessment pertaining to the taxpayer's 2002 year of assessment in terms of which it disallowed the assessed loss. SARS was entitled to issue the said additional assessment on account of the fact that the three-year limitation period had commenced running on 17 July 2003 and had thus not yet elapsed. In the event, the taxpayer's entire taxable income for 2002 (amounting to R15 892 978) became payable.³²

In issuing the additional assessment as aforesaid SARS did not reassess the taxpayer's income but merely the set-off of the assessed loss that had been carried over from the 2001 year of assessment.³³ The taxpayer appealed against SARS' decision to disallow the assessed loss but the matter was settled and the taxpayer thus withdrew its appeal relating to that assessment.

Then on 24 July 2007 the taxpayer addressed a letter to SARS. The taxpayer had by this time become aware of the error it had made in overstating its 2002 taxable income and therefore applied to SARS for a reduced assessment.³⁴

In substantiation of its motion to set aside SARS' decision not to entertain its application for a reduced assessment, the taxpayer argued as follows: (i) the 2006 additional assessment was based on information submitted by the taxpayer in relation to its 2002 year of assessment, (ii) it was common cause that the taxpayer had overstated its taxable income in relation to its 2002 year of assessment, (iii) its tax liability had thus been determined with reference to an incorrect amount of taxable income, (iv) SARS should have recognised that it had a discretion to reduce the assessment, and (v) SARS was therefore wrong to assume that it was not entitled to consider the taxpayer's application for a reduced assessment.³⁵

31 *First South African Holdings* at [4].

32 *First South African Holdings* at [5].

33 *Ibid.*

34 *First South African Holdings* at [7].

35 *First South African Holdings* at [8].

Having dismissed a point *in limine* brought by SARS regarding the application of the section dealing with reduced assessments to the 2002 tax year Harms DP, writing for a unanimous court, proceeded to consider whether a redetermination of the taxpayer's taxable income had become time barred by virtue of the three-year period of limitations.³⁶

The Court held that this question depended on whether the prescription period began to run on the date of original assessment (i.e. 17 July 2003) or whether it only started to run from the date of the additional assessment (i.e. 12 April 2006).³⁷

According to Harms DP the date of the error which resulted in the overstatement of the taxpayer's 2002 taxable income was irrelevant. The question as to when prescription began to run was dependent on whether the word "assessment" in the period of limitations provision was a reference to the notice of assessment, in which case the 2006 date on which the additional assessment was issued would be the relevant one.³⁸

However, Harms DP held that an "assessment" was not a notice of assessment. Instead, the learned judge concluded that an assessment was a 'determination' by SARS of one or more matters as was apparent from the definition of 'assessment' in section 1 of the Act, which at the relevant time, read as follows:³⁹

"assessment" means the determination by the Commissioner, by way of a notice of assessment (including a notice of assessment in electronic form) served in a manner contemplated in section 106(2) –

- (a) of an amount upon which any tax leviable under this Act is chargeable;*
- or*
- (b) of the amount of any such tax; or*
- (c) of any loss ranking for set-off; or*

³⁶ *First South African Holdings* at [15].

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ *Ibid.*

(d) of any assessed capital loss determined in terms of paragraph 9 of the Eighth Schedule...⁴⁰

Harms DP emphasised that the 2006 additional assessment was a re-assessment of a loss ranking for set-off under paragraph (c), and did not amount to a re-assessment of the taxpayer's taxable income under paragraph (a). The taxpayer's application for a reduced assessment was brought in relation to its taxable income (i.e. paragraph (a)) as it sought to persuade SARS to re-assess the quantum of its taxable income pursuant to the erroneous overstatement of its income.⁴¹

As the assessment in relation to the taxpayer's taxable income had been made in 2003 (i.e. 17 July 2003) that assessment had become final in 2006 and SARS could therefore not revisit it.⁴²

Harms DP similarly rejected the taxpayer's argument that it effectively sought a re-assessment of the amount of tax payable as contemplated in paragraph (b) of the definition of "assessment" as this amount had only been assessed in 2006 by way of the additional assessment in terms of which SARS had disallowed the assessed loss. The learned judge held that this submission was merely another formulation of the taxpayer's argument under paragraph (a) as any re-assessment of the tax payable under paragraph (b) would by necessary implication also involve a re-assessment of taxable income under paragraph (a).⁴³

In dismissing the appeal the Court noted that the result may seem unfair towards the taxpayer in the particular circumstances of the case, but held that any other conclusion regarding the meaning of "assessment" would mean that SARS would be able to reconsider the taxpayer's 2002 taxable income within three years from the date of the additional assessment being raised in 2006. This would have meant that SARS could reconsider the taxable income of R15 892 978 by way of a new assessment (read determination) thereby possibly raising the taxpayer's 2002 taxable income six years subsequent to its original assessment thereof.⁴⁴

⁴⁰ This definition has essentially been carried over into the definition of "assessment" contained in section 1 of the Tax Administration Act.

⁴¹ *First South African Holdings* at [16].

⁴² *Ibid.*

⁴³ *First South African Holdings* at [17].

⁴⁴ *First South African Holdings* at [18].

Citing the judgment in *Brummeria* Harms JA remarked: “That is unthinkable”.⁴⁵ The judgment in *First South African Holdings* therefore confirms the principle expounded in *Brummeria* to the effect that an assessment connotes a determination made by SARS in relation to specific subject matter, not a notice of assessment or any other document.

When considering the relevance and consequences of an assessment one therefore needs to identify the aspect in relation to which SARS has satisfied itself in arriving at a decision to assess, re-assess, reduce etc.

Where SARS has previously satisfied itself in relation to a specific decision (i.e. to tax certain profits) and issued an assessment accordingly, the period of limitations will begin to run from the first time SARS made such a determination, regardless of what other determinations were made contemporaneously or what re-assessments may follow thereafter.

C 3 – CONCLUSION

What *Brummeria* and *First South African Holdings* show us is that, returning to the example giving rise to the hypothetical assessment referred to in the introduction, the determination made by SARS to tax Company A in terms of section 9D with reference to the profits of the CFC, constituted an assessment of that income stream, which once made, precludes repeat assessments in relation to the same income.

It would amount to economical double taxation if SARS were subsequently to decide to tax another entity (i.e. the CFC which was later declared to be resident in South Africa) on the same income, and any assessment on this basis would thus be incompetent unless sanctioned by an extraordinary legislative provision of a nature absent from the Act and the Tax Administration Act.

⁴⁵ *Ibid.*

The iniquity that would be flow from this result cannot be overemphasised. The group of companies concerned would be forced to pay tax twice on the same profits, a situation that Treasury, as mentioned above, explicitly sought to avoid when it introduced section 9D into the Act by providing for tax credits in appropriate circumstances.

Moreover, it will be recalled that section 9D was intended to operate as an anti-avoidance measure, not a mechanism to facilitate domestic double taxation. It cannot therefore be said that this type of economic double taxation was intended by the Legislature.

It is therefore submitted that, as the wording of section 9D does not in fact contemplate economic double taxation and as the purpose of the section is patently not to achieve this purpose, the issue of double taxation in relation to the hypothetical assessment is distinguishable from the type of injurious result considered by the SCA in *Milnerton Estates Ltd v Commissioner for the South African Revenue Service* 2019 (2) SA 386 where the court held that any anomaly flowing from a legislative provision that has iniquitous (and possibly unintended) consequences is for the Legislature to correct.⁴⁶

There is, additionally, equitable authority militating against an interpretation of section 9D that results in the inequities discussed above, for which I turn now to *Louw*'s case.

D THE SECOND ARGUMENT: *COMMISSIONER FOR INLAND REVENUE v LOUW* (“*LOUW*”)⁴⁷

Mr Louw, the respondent, was a civil engineer who practised as the senior partner in a firm of consulting engineers known as Van Wyk and Louw. During 1966 the partners of the firm elected to move the business into a company in which they would hold shares (“the company”). Upon incorporation, the newly formed board of directors of the company passed a resolution authorising the company to enter into an agreement with the previous partners of Van Wyk and

⁴⁶ *Milnerton Estates* at para [21].

⁴⁷ 1983 (3) SA 551 (A).

Louw in terms of which the business of the erstwhile partnership was sold to the company (“the sale agreement”).⁴⁸

In terms of the sale agreement, the purchase price to be paid by the company was to equal the Rand amount by which the business’ assets exceeded its liabilities. Part of the purchase price was to be paid to the partners by allotting shares in the company to them, and part thereof was payable by crediting loan accounts in their names. The loan accounts were to bear no interest and were repayable as and when the company’s financial position permitted.⁴⁹

Directors’ salaries were to be determined on an *ad hoc* basis at year end and shareholders were paid dividends from time to time.⁵⁰

The income that Mr Louw earned subsequent to the incorporation of the company (i.e. his director’s salary and the dividends owing to him in his capacity as shareholder) was substantially less than what he earned in his capacity as partner of Van Wyk and Louw prior to its incorporation.⁵¹

Initially, the shareholder’s loan accounts remained in credit but during 1971 these accounts went into debit balances on account of significant loans that had been advanced by the company out of its retained earnings to the shareholders.⁵²

On 1 January 1978 SARS issued revised assessments against Mr Louw pursuant to section 103 of the Act in relation to the years of assessment from 1974 – 1976. In terms of these assessments, a proportionate share of the company’s income was included in Mr Louw’s income.⁵³

SARS invoked the provisions of section 103 of the Act in relation to both the transactions relating to the incorporation of the company as well as to the loans subsequently advanced to

48 *Louw supra* at 565.

49 *Ibid.*

50 *Louw* at 567E.

51 *Ibid.*

52 *Louw* at 567A.

53 *Louw* at 568G.

the shareholders and argued that all of the above amounted to a scheme of avoidance the nature of which was inconsistent with an arm's length transaction.⁵⁴

On behalf of Mr Louw it was argued that the transactions in question did not amount to a scheme as envisaged in section 103 and, furthermore, that SARS was in any event precluded from re-opening the relevant assessments inter alia on strength of the provisions of sections 3(2) and 79 of the Act, as they read at the relevant time.⁵⁵

Section 3(2) of the Act provided that any discretionary decision made by SARS could not be withdrawn or amended after a period of two years subsequent to the date on which the taxpayer was notified of the decision in question. Section 79 was the section that dealt with the period of limitations for the issuance of assessments which has since been repealed and the latest permutation of which is now contained in section 99 of the Tax Administration Act.

The Court held that the transactions in terms of which the company was incorporated and those relating to the fronting of loans to shareholders were distinct and could not be viewed as a single transaction or scheme for purposes of section 103, and proceeded to find that those transactions relating to the incorporation were not abnormal in the manner required to be susceptible to the provisions of section 103.⁵⁶

What remained, therefore, was to determine the legitimacy or otherwise of SARS' decision to invoke section 103 in relation to the loan transactions. In this regard Corbett JA held that the relevant loans were advanced on terms that were irreconcilable with an ordinary arm's length transaction and were thus 'abnormal' so as to bring the impugned transactions within the ambit of section 103.⁵⁷

⁵⁴ *Louw* at 570.

⁵⁵ *Louw* at 570E.

⁵⁶ *Louw* at 572.

⁵⁷ *Louw* at 582.

Having come to this conclusion the Court turned to consider the question as to whether or not SARS was precluded from issuing the additional assessments by operations of sections 3(2) and 79 of the Act, referred to above.

The relevant portion of section 79 of the Act was to the effect that, if at any time SARS was satisfied that any amount which was subject to tax and should have been assessed to tax under the Act had not been assessed to tax, it could re-open an assessment already made in respect of such amount, notwithstanding the provisions of the Act relating to the finality of assessments. Such ability to re-open assessments was, however, subject inter alia to the proviso that SARS could not do so in circumstances where the amount in question was not assessed to tax in accordance with a practice generally prevailing at the date of original assessment.⁵⁸

The Court rejected the argument advanced on behalf of Mr Louw to the effect that all amounts in question that should have been assessed by SARS during the relevant years of assessment had been assessed either in the hands of the company or against Mr Louw personally, and that there was thus no “amount” that had forgone taxation as contemplated in section 79.⁵⁹

Corbett JA held that the reference to an “amount” in section 79 was to an amount in relation to a particular taxpayer:⁶⁰

“In other words, if a particular amount was subject to tax and should have been, but was not, assessed to tax in the hands of taxpayer A, s 79 applies, irrespective of the fact that prior to this the same amount may erroneously have been assessed in the hands of taxpayer B. Consequently, if in the present case the Commissioner came to the conclusion that by reason of the provisions of section 103 certain income should be taxed in the respondent’s hands, then, in my opinion, he was entitled under s 79 to re-open respondent’s assessments and issue revised assessments, notwithstanding the fact that the same income may previously have been taxed in the hands of the company.”

⁵⁸ Louw at 582.

⁵⁹ Louw at 583.

⁶⁰ Ibid.

The learned judge was, however, alive to the fact that this conclusion could result in economic double taxation in that, in the absence of interference, SARS might proceed to tax Mr Louw in terms of section 103 in relation to income that had already been taxed in the hands of the company. To that end, Corbett JA held as follows:⁶¹

“Naturally, the Commissioner may not have his cake and eat it. In such a situation equity demands that, in applying s 103 to respondent’s affairs, he should either make due allowance, where this is appropriate, for the tax already paid by the company (as he indeed did in this case) or that he should re-open and make a fitting adjustment to the company’s assessments.”

Reverting once more to the example pertaining to the hypothetical assessment discussed in the introduction, it is submitted that the demands of equity would be equally compelling in the situation where the erstwhile CFC, now newly resident South African taxpayer, were to be taxed on the same income as was previously assessed to tax in the hands of Company A by virtue of section 9D.

It is accordingly submitted that, even were the plea of economic double taxation *per se*, insufficient to persuade SARS not to raise the hypothetical assessment, the judgment in *Louw* constitutes solid authority precluding SARS from proceedings on that basis.

The decision in *Louw* would be equally effective in assisting the newly resident CFC from staving off the hypothetical assessment in a scenario such as that which obtained in *First South African Holdings*. It will be recalled that in the latter case it was held that SARS was precluded from re-opening the relevant assessment in order to issue a reduced assessment in favour of the taxpayer (in relation to an undisputed error which gave rise to an overstated tax liability), as the period of limitations had expired.

On the facts of the hypothetical example, it is clear that should the assessment raised against Company A in terms of section 9D have prescribed by the time that SARS seeks to raise the hypothetical assessment against the newly resident CFC, it will not be able to hide behind the

⁶¹ *Ibid.*

period of limitations and argue statutory inability to re-open and correct the section 9D assessment, thereby securing a result of economic double taxation. On strength of the judgment in *Louw*, it is submitted that SARS would have to make due allowance for the tax already paid pursuant to the prior section 9D assessment.

The next section of this paper deals with the third and final argument, outlined in the introduction, against the competency of the hypothetical assessment and involves an argument that taxpayers who were not drawn into South African residency during the subsistence of the first issue of SARS' interpretation note on residency by way of place of effective management could resist attempts by SARS to do so now by relying on a practice-generally-prevailing-argument.

E THE THIRD ARGUMENT: RESIDENCE BY WAY OF PLACE OF EFFECTIVE MANAGEMENT AND THE DEFENCE OF A PRACTICE GENERALLY PREVAILING

E 1 PERIODS OF LIMITATION, PRACTICES GENERALLY PREVAILING & RELIANCE ON INTERPRETATION NOTES

As mentioned above, the period of limitations for the issuance of assessments is now set out in section 99 of the Tax Administration Act. The prescription period differs in relation to the various types of assessment, whilst in certain instances no additional assessment is permitted regardless of the amount of time that has elapsed since the preceding assessment.

An assessment may not be made three years subsequent to the date of an original assessment by SARS or five years subsequent to the date of an original assessment in relation to any self-assessment (whether or not a return was required for the latter).⁶²

Additional assessments may not be raised at all in circumstances where the amount that should have been assessed to tax under the preceding assessment was not assessed in accordance with

⁶² Section 99 (1)(a) – (c) of the Tax Administration Act.

the practice generally prevailing at the date of such preceding assessment.⁶³ This principle is also applicable where the full amount of tax which should have been assessed was not assessed in accordance with the practice generally prevailing when the initial assessment was made.⁶⁴

The periods of limitation do not apply, and SARS may therefore re-open assessments that would otherwise have prescribed, if in the case of an assessment by SARS the full amount of tax liability chargeable was not assessed on account of fraud, misrepresentation or non-disclosure on the part of the taxpayer.⁶⁵ Similarly, in the case of self-assessments, assessments may be re-opened where the full amount of tax chargeable was not assessed due to fraud, intentional or negligent misrepresentation, intentional or negligent non-disclosure of material facts or the failure to submit a return on the part of the taxpayer.⁶⁶

In terms of the definition of “practice generally prevailing” contained in section 1 of the Tax Administration Act read with section 5 thereof, a practice generally prevailing is defined as “a practice set out in an official publication regarding the application or interpretation of a tax Act”.

Section 5 of the Tax Administration Act further provides that a practice generally prevailing only ceases to be such in circumstances where the provision of the tax Act to which it relates is repealed or amended, a court has overturned or modified an interpretation of a tax Act which is materially the subject of the official publication or where the official publication is withdrawn or modified by SARS.⁶⁷

An “official publication” is defined in section 1 of the Tax Administration Act and expressly includes SARS interpretation notes.

⁶³ Section 99 (1)(d)(i)(aa) of the Tax Administration Act.

⁶⁴ Section 99 (1)(d)(i)(bb) of the Tax Administration Act. See also the judgment in *CSARS v KWJ Investments Services (Pty) Ltd* 81 SATC 1 where the taxpayer was successful in resisting an assessment based on a practice generally prevailing argument.

⁶⁵ Section 99 (2)(a) of the Tax Administration Act.

⁶⁶ Section 99 (2)(b) of the Tax Administration Act.

⁶⁷ Section 5(2)(a) – (c) of the Tax Administration Act.

In the recent case of *Commissioner for the South African Revenue Service v Marshall N.O. and Others*⁶⁸ the Supreme Court of Appeal had occasion to consider the role SARS interpretation notes play in the interpretation and application of the statutory provisions to which they relate.

The dispute between the parties in *Marshall* related to whether or not the taxpayer, a welfare organisation and registered vendor, was eligible to zero-rate payments received for certain supplies made as contemplated in section 11(2)(n) of the Act.

The court found for the Commissioner on the basis that the zero-rating provision in question did not apply to actual services rendered and dealt only with deemed services where there was no link between the payments received and services rendered (i.e. as where the taxpayer received grants or subsidies).

After having analysed the relevant statutory provisions, the court turned to the interpretation notes issued by SARS and considered these with reference to the arguments made on behalf of the taxpayer. The contents of the said interpretation notes were destructive of the taxpayer's contentions and supported the court's interpretation of the applicable legislative provisions.

With regard to the use of interpretation notes as aids to establishing the meaning of fiscal legislation, Dambuza JA held as follows:⁶⁹

“These interpretation notes, though not binding on the courts or a taxpayer, constitute persuasive explanations in relation to the interpretation and application of the statutory provision in question. Interpretation Note 39 has been in circulation for years and has not been brought into contention until now.”

The taxpayer applied for leave to appeal to the Constitutional Court and, in refusing leave, that court handed down a brief judgment which was largely focussed on addressing “the extent to which a court may consider or defer to an administrative body's interpretation of legislation,

68 2017 (1) SA 114 (SCA).

69 *Marshall* at para [33].

such as the Interpretation Note, and whether the approach of the Supreme Court of Appeal was in accordance with this.”⁷⁰

Whilst the taxpayer contended that the SCA should not have considered the interpretation note at all, the Commissioner argued that it was permissible for a court to have regard to an administrative body’s interpretation of legislation where such interpretation amounts to proof that the provision in question has been interpreted consistently for a period of time by those responsible for its administration, and only where such proof was necessary to tip the balance in a marginal case of interpretation.

In its judgment, the Constitutional Court stated there was cause to reconsider the rule relating to marginal issues of interpretation (“*the rule*”) described above, and followed in the important case of *CSARS v Bosch*,⁷¹ as the rule traced its origins to the previous dispensation of legislative supremacy when the interpretative exercise was aimed at determining the draftsman’s intention.⁷²

Although the Constitutional Court noted that the judgment in *CSARS v Bosch* had acknowledged that the rule needed to be adapted to contextual statutory interpretation,⁷³ it stated that the fundamental contextual change from legislative to constitutional supremacy was missing from the adaptation of the rule as expounded in *Bosch*.⁷⁴

In this regard the Court commented as follows:

“Why should a unilateral practice of one part of the executive arm of government play a role in the determination of the reasonable meaning to be given to a statutory provision? It might conceivably be justified where the practice is evidence of an impartial application of a custom recognised by all concerned,

⁷⁰ *Marshall NO & Others v Commissioner, South African Revenue Service* 2019 (6) SA 246 (CC).

⁷¹ 2015 (2) SA 174 (SCA).

⁷² *Marshall NO & Others v Commissioner, South African Revenue Service* 2019 (6) SA 246 (CC) at para [7].

⁷³ Such adaptation entails a change in rationale for considering the manner in which an administrative body has interpreted legislation, what is gleaned therefore no longer redounds to “custom” but instead provides evidence in determining “the meaning that should reasonably be placed upon” the relevant language.

⁷⁴ *Marshall NO & Others v Commissioner, South African Revenue Service* 2019 (6) SA 246 (CC) at para [10].

but not where the practice is unilaterally established by one of the litigating parties. In those circumstances it is difficult to see what advantage evidence of the unilateral practice will have for the objective and independent interpretation by the courts of the meaning of legislation, in accordance with constitutionally compliant precepts. It is best avoided.”

Ultimately, leave to appeal to the Constitutional Court was refused on the basis that the taxpayer’s case carried poor prospects of success and on account of the fact that the Supreme Court of Appeal had first interpreted the relevant statutory provisions independently before having regard to the interpretation note, and the court’s objective interpretation as aforesaid supports that court’s ultimate conclusion.

Although the judgments in *Marshall* may well have far reaching consequences for the rule pertaining to cases of marginal statutory interpretation, it does not, it is submitted, have any bearing on the relevance of interpretation notes as they relate to practices generally prevailing.

This is because the latter does not necessarily entail questions of marginal statutory interpretation, and more importantly, by virtue of the fact that section 5 of the Tax Administration Act expressly states that a practice generally prevailing is one ‘set out in an official publication regarding the application or interpretation of a tax Act’.

Having established these fundamental principles regarding the time periods within which SARS may re-open assessments and as to what constitutes a practice generally prevailing, the next section deals with tax residency on the basis of place of effective management.

E 2 RESIDENCE BY WAY OF PLACE OF EFFECTIVE MANAGEMENT

In terms of the definition of “resident” contained in section 1 of the Act, a person, other than a natural person, is a tax resident of South Africa if it is incorporated, established or formed in the Republic or if it has its place of effective management in the Republic.

This definition of residence was inserted when South Africa's taxation system became residence-based, and the inclusion of the term "place of effective management" was clearly made to ensure that the maximum possible number of taxpayers could be assessed based on their worldwide receipts. The term "place of effective management" is also said to have been introduced to address the inconsistent use of the concepts "managed and controlled", "managed or controlled" and "effectively managed".⁷⁵

"Place of effective management" is not, however, defined in any tax Act. From inception SARS, in terms of the first issue of its practice note on the subject (which is discussed comprehensively below), adopted the position that the ordinary meaning of the words, taking into account international precedent and interpretation, should serve to ascribe a meaning thereto.

The use of this test for residence has resulted in some controversy on account of, inter alia, (i) the fact that there is no authoritative South African case law to clarify the meaning of the term or its application in the context of companies,⁷⁶ (ii) the fact that foreign case law indicates that "place of effective management" residency may cause tension with the provisions of section 9D of the Act, and (iii) the fact that SARS' interpretation notes on the subject appear to have displayed a shift in the meaning which SARS attributes to the term "place of effective management".⁷⁷

The friction between "place of effective management" as a test for residency and the CFC provisions of the Act (i.e. (ii) above) arises on account of the fact that classification as a controlled foreign company necessarily entails non-residence coupled with the fact that a South African resident (or South African residents) hold(s) more than fifty percent of the participation rights in such foreign company.

⁷⁵ SARS Interpretation Note No 6 (Issue 1) at para 1.

⁷⁶ Although the Court in *Oceanic* dealt with the issue to some extent, it was decided in the context of a trust and, in any event, the Court held that there were insufficient facts placed before it to make a determination. *Oceanic* is therefore merely persuasive in general terms.

⁷⁷ See in general: Tracy Gutuza 'Has Recent United Kingdom Case Law Affected the Interplay Between "Place of Effective Management" and "Controlled Foreign Companies"?' (2012) 24 SA Merc LJ 424-437 and Annet Wanyana Oguttu 'Resolving The Conflict Between Controlled Foreign Company Legislation and Tax Treaties: A South African Perspective' (2009) 42 Comparative and International Journal of Southern Africa 73.

Depending on how one formulates the test for place of effective management, it is possible that possession of more than 50 percent of participation rights in a foreign company could result in that company being declared resident in South Africa. The risk of this occurring is especially high in circumstances where the control of a company vests in only one or two individuals leading to singularity of shareholding and management.⁷⁸

In the English case of *Laerstate BV v Revenue and Customs Commissioners*⁷⁹ the Court had to determine whether the tax residence of the taxpayer, a Dutch company, was located in the United Kingdom, or in the Netherlands. The inquiry into residence was characterised by the fact that, during the period under consideration, the taxpayer had only two directors, one of whom was its sole shareholder and was only in office for a part of the relevant time.

It was common cause that the test for residency of a company in terms of the applicable United Kingdom tax Act was determined by identifying where the taxpayer's "central management and control abides".⁸⁰

The Court's inquiry focused, inter alia, on the conduct of one Mr Bock who held the entire shareholding in the taxpayer, had been a director of the taxpayer and was found to have retained central decision-making authority in relation thereto even after he was no longer a director. Counsel for the taxpayer argued that central management and control of the taxpayer should be determined with reference to the taxpayer company's constitutional documentation, the location where company resolutions are made or official documents signed.⁸¹

Whilst counsel for Her Majesty's Revenue and Customs ("HMRC") accepted that a company's management and control would be located within the boardroom in circumstances where the board was actually taking the relevant decisions, he argued that on the facts of the case those decisions were in fact being taken by Mr Bock, even after his resignation from the board.⁸² The Court accepted HMRC's argument and held that the taxpayer had been resident in the United Kingdom. The Court's judgment was based firmly on its analysis and determination of

⁷⁸ For a comprehensive analysis on this topic see Gutuza note 54 supra at page 430.

⁷⁹ [2009] UKFTT 209 (TC).

⁸⁰ Laerstate at para 27.

⁸¹ Laerstate at para 25.

⁸² Laerstate at para 26.

shareholder activity that amounted to or resulted in the effective control and management of the company.

The judgment in *Laerstate* cannot be criticised for its reasoning, which is clearly logical, but if a similar test for residence were to be applied in South Africa the possibility exists that the distinction between “place of effective management” and the threshold requirement of 51 percent participation rights for purposes of the controlled foreign company rules would merge, thereby drawing controlled foreign companies into South African tax residency.⁸³

I turn now to consider the position in South Africa with reference to case law and SARS interpretation notes relating to place of effective management as a test for residency. Part E then concludes with an analysis of the judgment of the Australian High Court in *Bywater Investments Ltd v Commissioner of Taxation*.

E 2.1 – SARS Income Tax Interpretation Note 6 – Issue 1

Interpretation Note 6 (“IN 6”) Issue 1 was published on 26 March 2002 and dealt with residence by way of place of effective management in relation to persons other than natural persons.

The first issue of IN 6 emphasised that effective management was not tantamount to shareholder control or control by the board of directors but rather a question of management determined with regard to the entity’s purpose and business.⁸⁴

The general approach to determining effective management amounted to an inquiry as to where the company was managed on a regular or day-to-day basis, regardless of where “overriding” control was exercised or where the board of directors met (i.e. not shareholder-function).⁸⁵

Under the heading “practical application” of the first issue of IN 6 the following was stated:⁸⁶

83 Gutuza note 54 supra at page 436.

84 IN 6 Issue 1 at para 3.1.

85 IN 6 Issue 1 at para 3.2.

86 At para 3.3.

“If these management functions are not executed at a single location due to the fact that directors or senior managers manage via distance communication (e.g. telephone, internet, video conferencing, etc.) the view is held that place of effective management would best be reflected where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented, in other words, the place where the business operations/activities are actually carried out or conducted.”

(emphasis provided.)

It is submitted that the interpretation of the test for place of effective management residency contained in the first issue of IN 6 was therefore clearly based on “day-to-day operational management” as opposed to considerations of high level, overarching strategic or policy decisions.

With regards to the taxation of controlled foreign companies, the first issue of IN 6 merely stated that should a company be resident in South Africa on account of its place of effective management it will not be regarded as a controlled foreign company but as a resident susceptible to South African income tax in its own right. Although not specifically stated, one wonders whether the “day-to-day” approach to residence which characterises the first issue of IN 6 was not specifically adopted in order to achieve congruence between residence and section 9D of the Act.

The approach adopted by SARS in IN6 Issue 1 was, however, abandoned in favour of an entirely novel interpretation of the concept of “place of effective management” subsequent to the decision of the Western Cape High Court in *Oceanic*, which is the topic discussed under the next section.

E 2.2 – *Oceanic Trust Company Ltd N.O. v Commissioner for the South African Revenue Service*⁸⁷ (“*Oceanic*”)

Oceanic was registered and incorporated in terms of the laws of Mauritius and had its principal place of business in Port Louis. Oceanic was the sole trustee of SISM, a trust similarly established and registered in Mauritius.⁸⁸

In terms of SISM’s deed of settlement Oceanic was designated as its original trustee and Mauritian law governed all aspects of the trust, it was also prescribed by the deed that trustees must have their principal place of business in Mauritius and conduct their affairs from premises in Mauritius. SISM was also registered as a trust in South Africa in terms of the South African Trust Property Control Act, 57 of 1988.⁸⁹

SISM was established to conduct business as a captive reinsurer of a South African registered company, mCubed Life Limited. Income derived by SISM by way of policy premiums in this regard was invested, inter alia, in South Africa in a variety of investments. To this end SISM made use of the services of an asset manager in South Africa to manage its investments.⁹⁰

At all relevant times SISM rendered income tax returns to the Mauritian revenue authorities and was of the opinion that it had no tax obligations in South Africa.⁹¹ In 2008 SARS issued a notice to SISM indicating its intention to conduct an audit and requesting relevant information. Oceanic responded to the audit notice in its capacity as SISM’s sole trustee and provided the information sought by SARS without conceding any liability to tax in South Africa.⁹²

Subsequently, SARS raised income tax assessments against SISM in the amount of R1.5 billion including additional tax and interest. It did so on the basis that SISM was resident in the Republic because it had its place of effective management in South Africa or, alternatively, on

⁸⁷ (2012) 74 SATC 127.

⁸⁸ Oceanic at paras [1] – [3].

⁸⁹ Oceanic at para [3].

⁹⁰ Oceanic at para [4].

⁹¹ Oceanic at para [5].

⁹² Oceanic at para [6].

the basis that SISM derived income from a South African source that carried on business through a permanent establishment in South Africa.⁹³

SISM filed an objection to this assessment but SARS, in the interim, appointed SISM's bankers (the Standard Bank of South Africa) as an agent and required the latter to remit the full amount of SISM's assessed tax liability to SARS. Pursuant to this agency appointment, Standard Bank paid an amount in excess of R20 million over to SARS.⁹⁴

Oceanic, in its capacity as the sole trustee of SISM, filed an urgent application in the Western Cape Division of the High Court in terms of which it sought, inter alia, declaratory orders to the effect that SISM was not tax resident in South Africa and that SARS was thus liable to repay the amount of R20 million that it had received pursuant to the agency appointment.⁹⁵

Louw J essentially dismissed the application on the basis that declaratory relief could only be granted in relation to questions of law and that the issue before the Court would require, at least partially, a determination of facts. In reaching this conclusion the Court based its reasoning on the English case of *Commissioner for her Majesty's Revenue and Customs v Smallwood and Another*⁹⁶ which had been submitted by Oceanic in support of its application for a declarator.⁹⁷

The learned judge analysed the decision in *Smallwood* and held that the following principles relating to the determination of "place of effective management" ("POEM"), as originally contained in the OECD's Model Tax Convention, could be extracted therefrom.⁹⁸

POEM is the place where key *management* and *commercial decisions* that are necessary for the conduct of the entity's business are in substance made;

93 Oceanic at para [7].

94 Oceanic at para [9].

95 Oceanic at para [11].

96 [2010] EWCA Civ 778.

97 Oceanic at para [56].

98 Oceanic at para [54].

- i. POEM will *ordinarily* be the place where the most senior group of persons (e.g. a board of directors) makes its decision, where *the actions to be taken* by the entity as a whole are determined;
- ii. No definite rules can be given and all relevant facts and circumstances must be examined to determine the POEM of an entity;
- iii. There may be more than one place of management, but only one POEM at any one time;
- iv. The decision in *Smallwood* was not only based on the general test for POEM but also on the specific section of the UK legislation which provided that the trustees be treated as a single and continuing body of persons who shall be treated as resident in the UK unless the general administration of the trust is ordinarily carried on outside the United Kingdom and the trustees or the majority of them for the time being are not resident or not ordinarily resident in the United Kingdom; and
- v. The Court in *Smallwood* undertook a painstaking analysis of the facts and the way the scheme was set up and implemented in order to arrive at a conclusion regarding where the POEM of the trust in that case was located.

Having regard to the test for place of effective management set out in *Smallwood*, Louw J held that Oceanic had failed to make out a case for declaratory relief on two bases.

Firstly, as indicated above, the learned judge held that a determination of residency would of necessity involve factual findings regarding where SISM's key management and commercial decisions necessary for the conduct of SISM's business were in substance made during the relevant period. The inquiry regarding SISM's residency was therefore not simply a question of law and the matter would have to be decided at first instance by the Tax Court.⁹⁹

⁹⁹ Oceanic at para [57].

Louw J could have left the matter there but instead proceeded to set out the second basis on which he dismissed Oceanic's application. The learned judge held that even if the facts before the Court had been sufficiently clear to allow the Court to make a decision, they did not in their present form put up grounds to establish that the place where the key management and commercial decisions that were necessary for the conduct of SISM's business were in substance made outside of South Africa. SISM's place of effective management had thus not been demonstrated to be outside the Republic.¹⁰⁰

The Court held that on the facts before it "at least some of the key management decisions and at the very least, key commercial decisions necessary for the conduct of SISM's business were in substance made in South Africa".¹⁰¹ Thus, on an application of the *Smallwood*-test the facts did not establish that SISM's place of effective management was located in Mauritius and the application was dismissed.

In reaching his decision the learned judge did not have any regard to SARS' IN 6 Issue 1 and determined the case on the basis of the decision in *Smallwood*.

It is submitted that the test for place of effective management expounded in *Smallwood* differs materially from that contained in the first issue of SARS' interpretation note on the topic. Whereas SARS' interpretation of the concept focused on the day-to-day activities of the entity, the test in *Smallwood* (and consequently the test in *Oceanic*) centres the inquiry on high-level strategic management. The two approaches are thus antithetical.

As was pointed out by *Gutuza*,¹⁰² the inquiry in *Oceanic* (as in *Smallwood*) related to a trust and not a company. It is, however, submitted that the general *ratio* of these judgments with regard to the manner in which place of effective management is determined is no less persuasive on this score and need only be considered in context when one is concerned with determining the place of effective management of a company.

100 Oceanic at para [58].

101 Ibid.

102 Note 54 supra at page 434.

E 2.3 – SARS Income Tax Interpretation Note 6 – Issue 2

On 3 November 2015, subsequent and presumably in response to the *Oceanic* judgment, SARS released the second issue of Interpretation Note 6 which is still in force.

IN 6 Issue 2 specifically cites the judgments in *Oceanic* and *Smallwood* and, it is submitted, constitutes a departure from the interpretation contained in the first issue. The second issue of the interpretation note states that place of effective management means the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.¹⁰³

The second issue of the interpretation note also cites the case of *Wensleydale's Settlement Trustees v Inland Revenue Commissioners*¹⁰⁴ which had been decided in 1996 (i.e. prior to the first issue of IN 6). The salient portion of the judgment in *Wensleydale* quoted in IN 6 Issue 2 concludes with the remark that “The place of effective management is where the shots are called, to adopt a vivid transatlantic colloquialism”.¹⁰⁵

With reference to *Smallwood* IN6 Issue 2 specifically mentions that where there is a distinction between the scheme of management (i.e. the key management and commercial decisions that are taken) and the day-to-day management exercised by trustees the former will be determinative of the entity's place of effective management.¹⁰⁶

Developing this interpretation IN6 Issue 2 proceeds, under the heading “operational management versus broader top-level management”, to state that operational decisions generally have little relevance in the inquiry to determine place of effective management and must be distinguished from the key management and commercial decisions.¹⁰⁷

103 IN 6 Issue 2 at para 4.1.

104 [1996] STC (SCD) 241.

105 IN 6 Issue 2 at para 4.1 on page 5 – being the exact wording used in the OECD MTC.

106 Ibid.

107 IN 6 Issue 2 at para 4.2.6 on page 11.

Operational management is interpreted as being the oversight of the day-to-day business operations and activities of the company whereas key management and commercial decisions relate to broader strategic and policy decisions, which tend to be taken by members of senior management: “what constitutes a key management or commercial decision as opposed to an operational management decision is critical since it is the former that is relevant in the context of establishing the place of effective management.”¹⁰⁸

Of great importance is the statement at the end of IN6 Issue 2 to the effect that it is not anticipated that the application of the second issue of the interpretation note, as opposed to the first, will result in “many, if any” determinations that companies that were previously held to have their place of effective management abroad, now have their place of effective management in South Africa.¹⁰⁹ IN 6 Issue 2 only applies to years of assessment commencing subsequent to its issue (i.e. as it was issued during November 2015 it will be applicable from the 2017 year of assessment).

Before turning to discuss the effect of the change of approach evidenced between the first and second issues of IN6, I pause to consider the Australian decision of *Bywater* which lends some international perspective to the debate on the interpretation of place of effective management.

E 2.4 – *BYWATER INVESTMENTS LTD v COMMISSIONER OF TAXATION; HUA WANG BANK BERHAD v COMMISSIONER OF TAXATION (“BYWATER”)*¹¹⁰

In its recent¹¹¹ judgment in *Bywater* the High Court of Australia, being the apex court of that country and not the equivalent of its titular counterpart in South Africa, was called upon to decide whether or not the appellant companies were resident in Australia by virtue of their “central management and control” having being exercised there during the relevant years of assessment.

¹⁰⁸ IN 6 Issue 2 at para 4.2.6 on page 12.

¹⁰⁹ IN 6 Issue 2 at para 5 on page 14.

¹¹⁰ High Court of Australia: [2016] HCA 45.

¹¹¹ Judgment handed down on 16 November 2016.

Section 6(1) of the Australian Income Tax Assessment Act 1936 (Cth) provides, inter alia, that a foreign company will be a tax resident of Australia if its “central management and control” is found to be exercised in Australia in a manner that is analogous to the “place of effective management” criterion contained in the definition of “resident” contained in section 1 of the South African Income Tax Act.

The appeal concerns four appellant companies against which the Full Court of the Federal Court of Australia had made orders declaring them to be tax resident in Australia on account of the fact that their central management and control had been found to have been exercised there via a third-party accountant by the name of Mr Gould. These orders were made in circumstances where the appellants’ boards of directors were all located abroad and purported to perform the usual functions expected of a board.¹¹²

For convenience sake I refer to the first three appellants (i.e. Bywater, Chemical Trustee and Derrin) collectively as ‘Bywater’, and to the fourth appellant, Hua Wang Bank Berhad, as ‘HWB’.

Counsel for all the appellants accepted that, should the Court find that the relevant companies had their central control and management exercised from Australia, the same would hold true for their respective places of effective management as contemplated in the relevant double tax agreements in issue, and that the appellants would thus not be protected from Australian taxes by virtue of those agreements.¹¹³

In the High Court, the following argument was advanced on behalf of Bywater:

- i. the courts below had erred in focusing on the question of decision-making (which was found to have been a function of Mr Gould) as opposed to considering where the “formal organs of control” of the entities lay. It was argued that references in the authorities to concepts such as the “real business” of a company or to the “superior or directing authority” thereof (which had previously been laid down as

¹¹² *Bywater* at para 3, 12, 16, 20, 26 and 28.

¹¹³ *Bywater* at para 6.

indicators of the locus of “central management and control” and thus residency), connoted a company’s “constitutional organs” or its “lawful organs with authority to bind” it: all of the above ultimately being a reference (or so it was said) to the companies’ respective boards;¹¹⁴

- ii. save for two exceptions, an individual could not be deemed to form part of the “constitutional organs”, “real business” or “superior directing authority” of a company unless that person is a legally appointed director of that company. On this basis, it was contended that an individual who takes decisions on behalf of a company could not be regarded as exercising the “central management and control” of that company unless he or she was a director thereof;¹¹⁵
- iii. the mere fact that a board of directors may habitually elect to act in accordance with the advice of a party who is not part of the company’s “lawful organs of corporate control”, does not mean that the said third party exercises that company’s “central management and control”. This was said to be the case even where the board “invariably” follows the third-party’s advice “without any thought” being given to the merits thereof or to the question as to whether such advice was bona fide or otherwise in the company’s best interests;¹¹⁶
- iv. the only exceptions to this was argued to be situations where (i) a third party holds a legally enforceable right to compel directors to act in accordance with his or her directions, or, (ii) where a third party usurps the functions of the board by making and implementing central management and control decisions without going through the formality of referring such decisions to the directors for implementation as if these were decisions of the board;¹¹⁷
- v. In the event, it was contended that as Mr Gould was not part of the lawfully appointed constitutional organs of the appellants, and by virtue of the fact that no

114 *Bywater* at para 30.

115 *Ibid.*

116 *Bywater* at para 31.

117 *Ibid.*

evidence had been led to demonstrate that Mr Gould fell into the category of one of the exceptions mentioned above, the court below ought to have found that it was the directors of the companies alone who exercised central management and control. As all the relevant boards were located abroad, the appellants could thus not have been drawn into Australian tax residency.

Argument on behalf of HWB followed a similar pattern and can be summarised as follows:¹¹⁸

- i. The court below had erred in failing to recognise that the “real business” or “superior or directing authority” of a company must be “organic” thereto, something that Mr Gould, as a third-party, was not;
- ii. The authorities should correctly be interpreted as demonstrating that a company is resident at the place where its organs meet to make decisions, even if that decision-making process amounts to no more than the rubber-stamping of decisions made elsewhere;
- iii. This would be the case unless the board has ceased to function and merely implements decisions made elsewhere without any board involvement.

The Commissioner, on the other hand, relied on the decision of the House of Lords in *De Beers Consolidated Mines Ltd v Howe* [1907] UKHL 626, in arguing that a taxpayer company’s central management and control is located where:¹¹⁹

“...the company’s ‘real business’ is carried on, the real business of a company is carried on at the place from where its operations are controlled and directed, and the place whence its operations are controlled and directed is invariably ‘a pure question of fact to be determined, not according to the construction of this

118 *Bywater* at para 35 – 36.

119 *Bywater* at para 37.

or that regulation or bye-law, but upon a scrutiny of the course of business and trading”.

The Commissioner conceded that scenarios could arise in which a board of directors retained its function while approving and implementing the advice of third parties, but contended that in such circumstances the board would have to ‘exercise independent judgment as to whether to implement the steps advised’. In the present case, however, the court below had found that the role played by the Bywater boards was fake, and that the board of HWB only performed back-office functions.¹²⁰

In dismissing the appeals before it, the majority¹²¹ of the High Court held that the central issue for determination was the question as to whether, in view of the findings of the court below in relation to the substantive decision-making role played by Mr Gould and the correlating absence of decision-making functionality on the part of the various boards of directors, the location of the boards in foreign jurisdiction was ‘sufficient to locate the residence of the appellants abroad’.¹²²

In this regard the Court recognised that it was, ordinarily, the board of directors of a company that “makes the higher-level decisions which set policy and determine the direction of operations and transactions of a company” and that, for this reason, it will ordinarily be found that a company is resident in the jurisdiction where its board meets. Rejecting the arguments advanced by the appellants, the Court held that it does not follow from what is stated above that the “ordinary” result would obtain where a board:¹²³

“abrogates its decision-making power in favour of an outsider and operates as a puppet or cypher, effectively doing no more than noting and implementing decisions made by the outsider as if they were in truth decisions of the board.”

120 *Bywater* at para 37.

121 Four of the five justices on the panel concurred in the majority judgment while Gordon J penned a concurring minority judgment.

122 *Bywater* at para 41.

123 *Ibid.*

The Court confirmed that the correct position with regard to residency by way of place of “central management and control” was that “a company had its central management and control where the central management and control actually abides, that being a question of fact and degree to be determined according to the facts and circumstances of each case”.¹²⁴

The judgment proceeds with a comprehensive review of the relevant Australian case law and, in each instance, the Court indicates that even where the facts of a previous decision appeared to be better aligned with the appellants’ argument that the location of the board was the critical consideration in determining the residency of the company concerned, the only precedential value therein was that it served to demonstrate that each case was decided on its own peculiar facts and circumstances, and that this “of itself says nothing about what the result should be in other circumstances...”¹²⁵

With regard to the case law pertaining to the test for residence, the Court acknowledged that the Australian jurisprudence had developed from several United Kingdom decisions.¹²⁶ The Court accordingly also considered recent decisions from that jurisdiction¹²⁷ such as the cases of *Wood v Holden* [2006] 1 WLR 1393 and *Revenue and Customs Commissioners v Smallwood* [2010] BTC 637.

In *Wood v Holden* the English Court of Appeal had drawn a distinction between residency cases where “central management and control is exercised through a company’s constitutional organs on the basis of external advice or influence, but in fulfilment of the constitutional organ’s functions” on the one hand, and cases where “the functions of the company’s constitutional organs are usurped by an outsider who dictates the decisions to be implemented, independently of or without regard to those constitutional organs.”

124 *Bywater* at para 40.

125 *Bywater* at, for example, paras 53 – 54.

126 *Bywater* at para 40.

127 *Bywater* at paras 70 – 77.

The High Court noted that the reasoning employed in the recent United Kingdom decisions under consideration also “rested heavily” on the specific facts of the relevant case in order to determine the question of tax residency.¹²⁸

The Court also had regard to judgments from the Supreme Courts of Canada and the United States of America, the reasoning and conclusions of which were in keeping with the approach in terms of which each case had to be determined contextually with reference to its own facts, the ultimate question being where the central management and control actually takes place. The Court quoted the following extract from the judgment of the Supreme Court of the United States of America in *Hertz Corp v Friend* 599 US 77:¹²⁹

“[the statutory criterion of ‘principal place of business’ is] best read as referring to the place where [the] corporation’s officers direct, control, and coordinate the corporation’s activities. It is the place that Courts of Appeals have called the corporation’s ‘nerve centre’. And in practice it should normally be the place where the corporation maintains its headquarters – provided that the headquarters is the actual centre of direction, control, and coordination, i.e., the ‘nerve centre’, and is not simply an office where the corporation holds its board meetings (for example attended by directors and officers who have travelled there for the occasion),”

In the event, the Court dismissed the appeals on the basis that the question of residence was to be determined with reference to the location of the high-level decision-making organs of the companies, and that as this function had been performed by Mr Gould in Australia, the companies were liable to tax as residents of Australia.¹³⁰

Bywater is compelling authority, supported by leading decisions from the eminent commonwealth jurisdictions, to the effect that the correct approach to be adopted in determining tax residency is one that considers where the executive, policy-determining management of a company is exercised with reference to the facts of the relevant case, and not

128 *Bywater* at para 71.

129 *Bywater* at para 84.

130 *Bywater* at para 88 read with para 41.

where “the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented”.¹³¹

The test applied in *Bywater* is by no means novel, and can trace the roots of its reasoning directly back to the 1876 judgment of the United Kingdom Court of Exchequer in *Cesena Sulphur Company v Nicholson*.¹³²

E 3 CONCLUSIONS

Of what import is all of this to the hypothetical assessment and hypothetical newly-resident CFC described in the example provided in the introduction? It serves to demonstrate that the approach adopted by SARS in IN 6 Issue 1 was diametrically opposed to the established test for residency by way of place of effective management that had been applied in the leading common law jurisdictions since the latter half of the 19th century.

It is submitted that for the duration of the validity of IN 6 Issue 1 (i.e. from 26 March 2002 until 1 March 2016) there is a compelling argument to be made to the effect that the practice generally prevailing at SARS was to determine place of effective management by determining where high-level policy decisions made by top management were *implemented*, as opposed to where they were made.

It is inconceivable that SARS could have formulated its approach in this regard in ignorance of the established position that prevailed in the jurisdictions of the United Kingdom, Canada, the United States and Australia. It is submitted that SARS’ position on the issue as contained in IN 6 Issue 1 is all the more indicative of a considered, domestic policy-based interpretation of the concept of place of effective management on account of the degree to which it differed from the position adopted in foreign jurisdictions to which recourse is customarily had for guidance.

¹³¹ Which was the approach expounded in SARS Interpretation Note 6 Issue 1.

¹³² (1876) 1 Ex D 428 at 446-447 per Kelly CB, 453-454 per Huddleston B..

It is therefore further submitted that, should SARS attempt to raise the hypothetical assessment in relation to years of assessment falling within the period of validity of IN 6 Issue 1 against a CFC which was not considered to be a South African resident at the relevant time, SARS would be precluded from doing so now by applying the approach to determining residency expounded in IN 6 Issue 2 on the basis that such hypothetical assessment would be in the nature of that prohibited by section 99(d)(i)(aa) of the Tax Administration Act (i.e. an amount that had not been assessed to tax contemporaneously in accordance with a practice generally prevailing).

It must also be noted that although *Oceanic* does not amount to conclusive authority for the position that South African courts will adopt should they be called upon to define the approach to be followed in applying the test for residency by way of place of effective management in South Africa in future, it is unlikely that any subsequent court would come to a different conclusion, especially when regard is had to the decision in *Bywater* and the slew of international authorities on which it is premised.

F FINAL REMARKS

In conclusion, it is submitted that the course of action contemplated by SARS in the example culminating in the issuance of the hypothetical assessment is overtly incorrect and unjust, would offend the principle prohibiting economic double taxation and is clearly contrary to the stated purpose behind the enactment of section 9D of the Act.

It is understandable that revenue authorities in any jurisdiction that taxes income with reference to residence should concern themselves with avoidance schemes whereby profits are shifted to foreign entities, but to allow the application of the CFC rules (already fraught with the tension of possible treaty-override) and the test for residence to be applied cumulatively and in succession to the effect suggested in the hypothetical example would, with respect, be a step too far.

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**SECTION 7C OF THE INCOME TAX ACT – SWORD, SHIELD OR
RETROSPECTIVE MENACE?**

By

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A dissertation presented for the approval of Senate in fulfilment of part of the requirements for the degree Master of Laws in Tax Law in approved courses and a minor dissertation. The other part of the requirements for this qualification was the completion of a programme of courses.

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Word count: 13 606

I hereby declare that I have read and understood the regulations governing the submission of Master of Laws in Tax Law dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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A INTRODUCTION

The insertion of section 7C into the Income Tax Act, 58 of 1962 (“the Act”) in 2017, and the amendments that have subsequently been made thereto, have resulted in a significant disruption to the manner in which tax structures had traditionally been employed in South Africa.

Section 7C encapsulates a policy decision taken by Treasury to clamp down on the manner in which trusts had been employed to widespread success to dilute the taxable income of the tax base.

Prior to the insertion of section 7C, donations tax was generally not payable on favourable (i.e. non-market related) loan accounts held in trust structures. The only tax exposure that the gratuitous settlor faced previously was liability in relation to the interest income earned by the trust in circumstances where a stipulation or legislative provision (such as section 7(5) of the Act) prevented the beneficiaries from accessing the income.

In such circumstances, the settlor was saddled with the income tax liability in relation to the income earned by the trust and the initial settlement amount was regarded as being an ongoing donation for income tax purposes, as least since the decision of the Appellate Division in *Commissioner for Inland Revenue v Berold* 1962 (3) SA 748 (A).

Section 7C was first inserted into the Act during March 2017 and was amended twice thereafter, in both instances with effect from 19 July 2017. The section subjects loans, advances or credit transactions, which are interest free or levy interest below market rates, to tax by deeming the interest forgone to be a donation and raising donations tax accordingly.¹³³

This paper discusses the alleged retrospective effect of section 7C in original and subsequent iterations to determine firstly, whether such retrospective effect is in fact present, secondly, to

¹³³ This being a departure from the position which prevailed previously, as to which see in general *Commissioner for the South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others* 2007 (6) SA 601 (SCA).

determine the nature of such retrospective effect if found to be present and, thirdly, to examine whether the section may be attacked on the basis of its retrospectivity.

In order to achieve this purpose, the paper starts by analysing section 7C in both its original and amended forms. The recent decision of *Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue Service and Another*¹³⁴ which was concerned with an attack on retrospective fiscal legislation is then considered in detail and the conclusions drawn therefrom are employed in a discussion on the prospects of success that a similar attack on section 7C might carry. The paper concludes with some general remarks and a discussion on an exception to which, it will be argued, section 7C does not apply.

The next section commences with an overview of the language in which section 7C was originally enacted.

B AN ANALYSIS OF THE FIRST ITERATION OF SECTION 7C

According to the Explanatory Memorandum published by Treasury in relation to the Taxation Laws Amendment Bill of 2016 (“the 2016 Explanatory Memorandum”), Section 7C was introduced in order to “prevent estate duty and donations tax avoidance through the use of interest free or low interest loans”.¹³⁵

The 2016 Explanatory Memorandum sets out the three main tax avoidance planning techniques used by taxpayers to facilitate the transfer of assets into a trust namely, a donation, a loan-sale transaction and a loan transaction.

The donation technique is where a taxpayer donates assets to a trust. The transaction gives rise to a donations tax liability that is payable by the donor and is levied at 20 percent of the fair market value of the assets donated.¹³⁶ The donations tax may also be recouped from the donee,

¹³⁴ 2017 (6) SA 435 (GP).

¹³⁵ Explanatory Memorandum on the Taxation Laws Amendment Bill 17B of 2016 at para 1.6.

¹³⁶ Section 54 of the Act.

jointly and severally, in circumstances where the donor fails to make timeous payment thereon.¹³⁷

The second mechanism by which assets may be transferred into trust is a sale transaction on loan account. Should the interest charged on the loan-sale transaction be market related the person advancing the funds would be taxed on the interest component of the loan repayments received from the trust.

Thirdly, a loan may be advanced to a trust, either to fund the acquisition of trust assets or simply in order for the trust to retain the funds for capital growth. Should the interest charged on the loan transaction be market related, the person advancing the funds would be taxed on the interest component of the loan repayments received from the trust.

Prior to the insertion of section 7C, however, it was easy for taxpayers to avoid both donations tax liability and tax liability on interest received, as described above, by simply concluding either loan-sale or pure loan transactions and charging either no interest at all or by charging interest below the market-related rate. Consequently, no donation arises as nothing is donated into trust and, as no interest is charged or as interest is charged below the market rate, the person advancing the funds also escapes liability to income tax in this regard either partially or entirely, as the case may be.

In addition to the aforesaid, the tax base was being eroded in a further respect as taxpayers were prone to reduce or waive the capital amount of the loan advanced by them to the trust¹³⁸ resulting in a further diminution in the estate of the taxpayer which would eventually result in even less estate duty being payable to the *fiscus*.

The 2016 Explanatory Memorandum therefore cites the avoidance of estate duty and donations tax on the transfer of wealth through the use of interest free loans or loans with interest below

¹³⁷ Section 59 of the Act.

¹³⁸ Hence section 7C(2).

market rates as the reason for the insertion of section 7C, its stated purpose being to limit taxpayers' ability to transfer wealth to a trust without being subjected to tax in this regard.

The first version of Section 7C was deemed to have come into operation on 19 July 2017,¹³⁹ and applied in respect of any amount owed by a trust in respect of a loan, advance or credit provided to that trust before, on or after that date.¹⁴⁰

Section 7C's response to the avoidance strategies discussed in the introduction was twofold. First, it served to refuse deductions, losses, allowances and capital losses sought to be claimed in relation to loans, advances or credit transactions contemplated in section 7C (1)¹⁴¹ and, second, it levied donations tax on any interest forgone on an interest-free loan, advance or credit to a trust or, alternatively, the amount of interest charged below the official interest rate. The amounts deemed to be donations as aforesaid were instead treated as a donation made on the last day of the relevant year of assessment and assessed to tax accordingly.¹⁴²

In order for section 7C's anti-avoidance provisions to apply the target loan transaction between the taxpayer and the trust must (i) have been advanced to the trust by a certain type of natural person or company and (ii) possess certain characteristics.

In terms of the first iteration of section 7C (1) the loan, advance or credit must have been advanced to a trust either by a natural person, or by a company at the instance of a person where that person was a connected person, as defined, in relation to the trust (a concept discussed in detail below).

Alternatively, and in order to spread the net wider, the section was also triggered where the loan, advance or credit had been advanced by any person that was a connected person in relation to the natural person or company mentioned above. In other words, it was sufficient

¹³⁹ Section 7C was enacted in terms of section 12(1) of the Taxation Laws Amendment Act, 15 of 2016.

¹⁴⁰ Section 12(1) of the Taxation Laws Amendment Act, 15 of 2016.

¹⁴¹ This in terms of section 7C(2).

¹⁴² Section 7C(3).

for the person advancing the loan, advance or credit to be a connected person in respect of a person or company that was a connected person vis-à-vis the trust.

The first iteration of Section 7C (1) also provided that the advance in question could be either directly or indirectly made to the trust which, to the extent that such wording was still necessary having regard to the connected persons matrix described above, suggested that the interposition of an intermediary would not have served to exclude the operation of the section.

Having set out the class of persons to which the section applies, sub-section (3) prescribed the type of transaction that had to be present in order to trigger liability under section 7C. Two types of transactions were identified, namely, loan, advance or credit transactions which attract no interest and, loan, advance or credit transactions which attract interest at a rate lower than the official rate of interest as defined in paragraph 1 of the Seventh Schedule to the Act.¹⁴³

It is clear from a reading of the first iteration of section 7C that the meaning of “connected person” is crucial to the application of the section as it was only a loan advanced by a person or company that is a connected person vis-à-vis the trust (or by a person who is a connected person to the said person or trust) in question that would be susceptible to tax liability in terms of the section.

Section 1 of the Act defines connected person in the following terms:

'connected person' means-

- (a) in relation to a natural person-
 - (i) any relative; and
 - (ii) any trust (other than a portfolio of a collective investment scheme) of which such natural person or such relative is a beneficiary;
- (b) in relation to a trust (other than a portfolio of a collective investment scheme)-
 - (i) any beneficiary of such trust; and
 - (ii) any connected person in relation to such beneficiary;

¹⁴³ Which reads as follows: 'official rate of interest' means-

- (a) in the case of a debt which is denominated in the currency of the Republic, a rate of interest equal to the South African repurchase rate plus 100 basis points; or
- (b) in the case of a debt which is denominated in any other currency, a rate of interest that is the equivalent of the South African repurchase rate applicable in that currency plus 100 basis points:

Provided that where a new repurchase rate or equivalent rate is determined, the new rate of interest applies for the purposes of this definition from the first day of the month following the date on which that new repurchase rate or equivalent rate came into operation

- (bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme), any other person who is a connected person in relation to such trust;
- (c) in relation to a member of any partnership or foreign partnership-
 - (i) any other member; and
 - (ii) any connected person in relation to any member of such partnership or foreign partnership;
- (d) in relation to a company-
 - (i) any other company that would be part of the same group of companies as that company if the expression 'at least 70 per cent of the equity shares in' in paragraphs (a) and (b) of the definition of 'group of companies' in this section were replaced by the expression 'more than 50 per cent of the equity shares or voting rights in';
 - (ii) and (iii)deleted
 - (iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of-
 - (aa) the equity shares in the company; or
 - (bb) the voting rights in the company;
 - (v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company;
 - (vA) any other company if such other company is managed or controlled by-
 - (aa) any person who or which is a connected person in relation to such company; or
 - (bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and
 - (vi) where such company is a close corporation-
 - (aa) any member;
 - (bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme) which is a connected person in relation to such member; and
 - (cc) any other close corporation or company which is a connected person in relation to-
 - (i) any member contemplated in item (aa); or
 - (ii) the relative or trust contemplated in item (bb); and
- (e) in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person:
 Provided that for the purposes of this definition, a company includes a portfolio of a collective investment scheme in securities

For purposes of the company referred to in section 7C(1)(b), therefore, the person at whose instance the loan, advance or credit was advanced by the company must individually, or jointly with any person who is a person connected to them, have held no less than 20 percent of either the equity shares or the voting rights in the company advancing the loan, advance or credit.¹⁴⁴

It should be noted that in the case of *NST Ferrochrome (Pty) Ltd v Commissioner for Inland Revenue* (“NST”)¹⁴⁵ the Supreme Court of Appeal had occasion to consider the meaning of the

¹⁴⁴ Paragraph (d)(iv) of the definition of connected person.

¹⁴⁵ 2000 (3) SA 1040 (SCA).

words “any person” in sub-paragraph (d)(iv) of the definition of connected person. At the time that *NST* was decided the word ‘person’ was defined¹⁴⁶ in section 1 of the Act to “[include] the estate of a deceased person and any trust”.

In this regard the Court held,¹⁴⁷ presumably with reference to the word “include(s)”, that the meaning of ‘person’ was not limited to a deceased estate or a trust but had a wider meaning. In order to determine what that wider meaning might encompass the Court had regard¹⁴⁸ to the definition of ‘person’ contained in section 2 of the Interpretation Act 33 of 1957, which provides:

Definitions

The following words and expressions shall, **unless the context otherwise requires or unless in the case of any law it is otherwise provided therein**, have the meanings hereby assigned to them respectively, namely-

...

‘person’ includes-

- (a) any divisional council, municipal council, village management board, or like authority;
- (b) **any company incorporated or registered as such under any law**;
- (c) **any body of persons corporate or unincorporate**

(emphasis added)

With reference to sub-paragraphs (b) and (c) of the definition of ‘person’ contained in the Interpretation Act 33 of 1957 the Court concluded that the words “any person” in subparagraph (d)(iv) of the definition of connected person in the Income Tax Act are to be construed as including a company unless the context indicates to the contrary.¹⁴⁹ The definition of connected person therefore comprehends of both natural persons and juristic persons.

¹⁴⁶ The definition of ‘person’ presently contained in section 1 of the Act reads as follows:

‘person’ includes-

- (a) an insolvent estate;
 - (b) the estate of a deceased person;
 - (c) any trust; and
 - (d) any portfolio of a collective investment scheme,
- but does not include a foreign partnership.

¹⁴⁷ *Ibid* at para [8].

¹⁴⁸ *Ibid*.

¹⁴⁹ *Ibid*.

The definition of what or whom constitutes a connected person was thus cast in wide terms,¹⁵⁰ which rendered the interposition of another person or entity in order to avoid the application of section 7C very difficult.

With regard to the language used in the first iteration of section 7C(1) in particular it is submitted that while the words “that person” contained in sub-section 1(b) are used to refer to the natural person contemplated in section 7C(1)(a), whereas the words “any person” used at the end of the last phrase of section 7C(1) extend to the full definition of ‘person’ including companies, insolvent estates, deceased estates, trusts and portfolios of collective investment schemes but excludes partnerships.¹⁵¹

C THE EFFECT OF THE FIRST ITERATION OF SECTION 7C

In an article titled “Loans To Trusts: Certain Aspects Of Section 7C”¹⁵² *Emslie* examines the application of the first iteration of section 7C with reference to a hypothetical scenario often encountered in practice, namely, the position of a family trust and the arrangements made in relation thereto pursuant to the conclusion of divorce proceedings between two of the beneficiaries/trustees.

Emslie postulates the following set of facts; *H* and *W* were previously married in community of property and were both trustees and beneficiaries of the *H&W* Family trust. Subsequent to their divorce in 2010 *H* took the following steps in terms of the divorce settlement; he resigned as a trustee and beneficiary, ceded all his past and future loan claims to *W* and advanced R3 million to the trust on loan account. In addition to the advance of R3 million, which was made pursuant to the divorce settlement, *H* had also previously advanced loans totalling R2 million to the trust during the subsistence of his marriage to *W*.¹⁵³

¹⁵⁰ See further in this regard SARS Interpretation Note 67 (Issue 2).

¹⁵¹ Note 12 *supra*.

¹⁵² *Emslie* T “Loans To Trusts: Certain Aspects Of Section 7C” *The Taxpayer* (2017) Vol 66 No 3 at page 42.

¹⁵³ *Ibid* at page 43.

Subsequent to the divorce, and in 2014, *W* also advanced a loan to the trust in the amount of R4 million. None of the loan accounts were repaid to *W* until the trust took out short term finance and repaid R 5 million to her during February 2017.

Emslie argues that the proper application of the first iteration of section 7C to the above scenario should result in the following fiscal consequences:¹⁵⁴

- i. The loans advanced during the subsistence of the marriage should be deemed to have been advanced by both *H* and *W* in equal portions on account of the fact that they had a joint estate at the time that the loans were made;
- ii. As both *H* and *W* were connected persons vis-à-vis the trust when these loans were advanced section 7C could potentially apply to the loans of R1 million provided to the trust by each party (being the loans totalling R2 million that had been advanced by *H* during the subsistence of the marriage now split equally between the parties on account of the joint estate);
- iii. *H* cannot, however, have any tax liability under section 7C as he was no longer a connected person when the section came into force, this by virtue of the fact that he was no longer a beneficiary of the trust or a relative of *W* on 1 March 2017;
- iv. *H* would in any event not have been exposed to liability under section 7C if regard is had to the wording of section 12(1) of the Tax Laws Amendment Act, 15 of 2016 in terms of which section 7C was enacted. The relevant portion of the said section reads as follows (with emphasis provided):

“Subsection (1) comes into operation on 1 March 2017 and applies in respect of any amount owed by a trust in respect of a loan, advance or credit provided to that trust before, on or after that date.”

¹⁵⁴ *Ibid.*

- v. *Emslie* reasons that it is implicit in the wording of the above section that the amount which must be owed by a trust in order for section 7C to apply, must be owed to the natural person contemplated in section 7C(1)(a) (i.e. the natural person who provided the loan to the trust in the first place);
- vi. It would be absurd if section 7C were to be read to impose donations tax liability on a party in the position of *H* who is no longer a connected person in relation to either the trust or the loan and who is thus unable to charge interest, waive or require repayment of the loan;
- vii. A proper reading of section 7C would require that the amount owed by the trust be owed by the natural person who actually provided the loan, advance or credit to the trust;
- viii. *H* could for the same reason not be assessed to tax under section 7C in relation to the amount of R3 million advanced by him to the trust pursuant to the divorce settlement;
- ix. Following this line of argument *W* can similarly not be taxed under section 7C with reference to the R1 million loan advanced to the trust by *H* during the subsistence of their marriage despite the fact that the relevant loan claim has been ceded to her due to the fact that she was not the person who advanced the loan to the trust in the first place.

Whilst this interpretation of the application of section 7C could have been supported under the wording of the first iteration thereof, it is submitted that the reasoning employed in *Emslie*'s example is no longer applicable by virtue of further amendments that were made to section 7C pursuant to avoidance schemes implemented by taxpayers in response to the first iteration thereof.

D AVOIDING THE FIRST ITERATION OF SECTION 7C

In the form of its first iteration, Section 7C applied only to any loan, advance or credit directly or indirectly provided to a trust. Shortly after the section came into effect Treasury identified structures put in place by taxpayers in order to avoid the deemed annual donation contemplated in section 7C (3). This gave rise to legislative amendments to section 7C which were first tabled in the Taxation Laws Amendment Bill of 2017.¹⁵⁵

The first avoidance strategy identified in the Explanatory Memorandum published by Treasury in relation to the Taxation Laws Amendment Bill of 2017 (“the 2017 Explanatory Memorandum”), relates to the fact that Section 7C pertains to loans provided to trusts, and only trusts.¹⁵⁶

In this regard taxpayers interposed companies to which interest free or low interest loans were then advanced in circumstances where the trust in question owned the shares of the borrowing company. As the first iteration of section 7C only provided for loans made to trusts, this type of structuring resulted in the anti-avoidance mechanism contained in section 7C itself being avoided.

The second avoidance strategy identified in the 2017 Explanatory Memorandum concerned the situation where a natural person, as contemplated in section 7C(1)(a), advances a loan, advance or credit to the trust in question but later concludes an agreement in terms of which such person cedes or otherwise transfers his or her loan account to another person. As the first iteration of section 7C was only triggered in relation to a natural person who “provides” the loan to the trust, the cedent of the loan account would fall outside the scope of the section and thereby escape liability as the link between the person who advanced the loan and the loan itself was said to have been broken.

¹⁵⁵ Explanatory Memorandum on the Draft Taxation Laws Amendment Bill of 2017 at para 1.3.

¹⁵⁶ *Ibid* at page 9.

E SECTION 7C IN ITS CURRENT FORM

Section 7C has been amended on two further occasions. Firstly, On 19 July 2017 the Draft Taxation Laws Amendment Bill, 2017 was published. In response to the avoidance strategies discussed above, the following amendments to section 7C were, amongst others, included to “refine” the provision:

- i. The replacement of section 7C (1) by the following:

- (1) This section applies in respect of any loan, advance or credit that—
 - (a) a natural person; or
 - (b) at the instance of that person, a company in relation to which that person is a connected person in terms of paragraph (d)(iv) of the definition of connected person, directly or indirectly provides to—
 - (i) a trust in relation to which—
 - (aa) that person or company, or
 - (bb) any person that is a connected person in relation to the person or company referred to in item (aa), is a connected person; or
 - (ii) a company that is a connected person in relation to the trust referred to in subparagraph (i).**

(emphasis added)

and;

- ii. the insertion of the following as section 7C(1A):

- (1A) If a natural person acquires a claim to an amount owing by a trust or a company in respect of a loan, advance or credit referred to in subsection (1), that person must for purposes of this section be treated as having provided a loan, advance or credit to that trust or company—
 - (a) on the date on which that person acquired that claim; or
 - (b) if that person was not a connected person on that date in relation to—
 - (i) that trust; or
 - (ii) the person who provided that loan, advance or credit to that trust or company, on the date on which that person became a connected person in relation to that trust or person, that is equal to the amount of the claim so acquired.

The Bill was enacted as the Taxation Laws Amendment Act, 17 of 2017 and came into force on 18 December 2017. Importantly, however, the amendments to section 7C are deemed to have come into operation on 19 July 2017 (i.e. the date of publication of the Bill).

The abovementioned refinement of section 7C effectively serves to address the two avoidance schemes discussed under the previous section. The amendment of sub-section (1) deals with the interposition of a company as recipient of the loan in question by bringing a loan advanced to a company that is a connected person to the trust within the ambit of the taxing provision of section 7C.

The scheme whereby the connection between the person who advanced the loan was “broken” by a cession is dealt with by the new sub-section (1A), which provides that where a person acquires a claim to an amount owing by a trust or company, that person must be ‘treated’ as having provided the loan in question on the date on which he or she acquired the claim, alternatively, if the person was not a connected person when the claim was acquired then he/she is treated as having advanced the loan in question from the date on which he/she becomes a connected person.

Secondly, subsection (1)(b)(ii) – being the provision that deals with the interposition of a company as discussed above – was substituted by section 9(1) of the Taxation Laws Amendment Act, 23 of 2018, again with a deemed effective date of 19 July 2017, and presently reads as follows:

- (ii) a company if at least 20 per cent of –
 - (aa) the equity shares in that company are held, directly or indirectly; or
 - (bb) the voting rights in that company can be exercised,by a trust referred to in sub-paragraph (i) whether alone or together with any person who is a beneficiary of that trust or the spouse of a beneficiary of that trust or any person related to that beneficiary or that spouse within the second degree of consanguinity.

The second and final amendment, as set out above, thus simply provides more detail than the first version thereof by expressly stipulating when the interposition of a company will not assist the taxpayer in avoiding the ambit of section 7C.

The effect of these refinements to section 7C is that the provision in its present form is deemed to have come into operation on 19 July 2017 and applies to any amount owed by a trust or

company in respect of a loan, advance or credit provided to that trust or company before, on or after 19 July 2017.

It is submitted that even in terms of the first iteration thereof, section 7C altered the legal effect of past taxpayer conduct. This is by virtue of the fact that any arrangement made prior to the promulgation of section 7C (whether the first or subsequent iterations thereof) would not have been subjected to donations tax and taxpayers would therefore, on the advice of their consultants, legitimately and legally have arranged their tax affairs in such a manner as to pay as little tax as possible.

It is trite that taxpayers are entitled to avoid paying tax by structuring their affairs to attract the least possible tax, this principle was most recently confirmed by the Supreme Court of Appeal in *Sasol Oil (Pty) Ltd v CSARS* [2019] 1 All SA 106 (SCA) which is merely the latest pronouncement on a principle the root of which may be traced to the decision of the House of Lords in *IRC v Duke of Westminster* [1936] AC 1 (HL).¹⁵⁷

Taxpayers who took advice and structured their affairs according to the prevailing laws are likely to react with outrage when informed that a subsequent law has altered the consequences of their past decisions and imposes a new donations tax of 20% thereon from the date that section 7C came into force.

The fact that section 7C does not seek to impose donations tax from the historical date on which the loan, advance or credit in question was actually advanced, but only from the date that the section came into force, is likely to be cold comfort to taxpayers.

The effect that section 7C has on past conduct evokes, perhaps understandably, strong feelings of inequity amongst taxpayer who cite, *inter alia*, certainty, being a fundamental tenant of the rule of law, as an argument against the legitimacy of legislative provisions of this nature. These argument will be discussed in more detail in the next section, which considers the nature of the

¹⁵⁷ An adopted into South African law by cases such as *Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (3) SA 942 (A) and *Commissioner for Inland Revenue v Conhage (Pty) Ltd* 1999 (4) SA 1149 (SCA).

retrospective effect of section 7C with a view to determining whether or not the section may be successfully attacked on this basis.

F THE VALIDITY OF RETROSPECTIVE FISCAL LEGISLATION

South African common law distinguishes between ‘true’ retrospectivity, being the situation where an Act provides that a new law shall be deemed to have been in operation from a past date, and ‘weak’ retrospectivity in terms of which a new statute or new legislative amendment interferes with or is applicable to existing rights.¹⁵⁸

Although neither type of retrospectivity is precluded outright, true retrospectivity will only be allowed in circumstances where the legislature clearly intended the statute or amendment in question to take away or impair a vested right previously acquired under contemporaneously prevailing laws.¹⁵⁹ There is a rule of interpretation to the effect that, unless such legislative intention is clearly evident from the wording of the provision in question, the legislation shall be presumed *not* to have true retrospective effect.¹⁶⁰

The validity of retrospective fiscal legislation was considered by the High Court in the recent case of *Pienaar Brothers (Pty) Ltd v Commissioner, South African Revenue Service* (“*Pienaar Brothers*”)¹⁶¹ which is discussed in detail under the next sub-section.

F 1 PIENAAR BROTHERS (PTY) LTD v COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE & ANOTHER

The facts in *Pienaar Brothers* were as follows. Serurubele Trading 15 (Pty) Ltd (“the taxpayer”), entered into an amalgamation transaction as contemplated in section 44 of the Act in terms of which it acquired all the assets of Pienaar Brothers (Pty) Ltd on 16 March 2007,

¹⁵⁸ *Unitrans Passenger (Pty) Ltd t/a Greyhound Coach Lines v Chairman, National Transport Commission and Others* 1999 (4) SA 1 (SCA).

¹⁵⁹ This rule of interpretation may require amendment to bring it in line with the modern contextual approach to statutory interpretation as expounded in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA).

¹⁶⁰ See for example *Peterson v Cuthbert and Co Ltd* 1945 AD 420 and *Baartman v Dempers* 1952 (2) SA 577 (A).

¹⁶¹ 2017 (6) SA 435 (GP).

with the acquisition having effect from 1 March 2007 in terms of the agreement concluded between the parties.

The business to be formed by the amalgamation required the buy-in of a BEE equity partner and the taxpayer procured advice from its attorneys regarding the implementation of such a transaction.¹⁶²

The resulting transaction envisaged *inter alia* the following:¹⁶³

- i. The existence of *Pienaar Brothers* (being the amalgamated company) would need to be terminated in order to benefit from the provisions of section 44 of the Act. For this reason, *Pienaar Brothers* distributed its shares to its shareholders, *pro rata* to their shareholding, and was then liquidated;
- ii. The taxpayer then became the owner of the business and its directors resolved to make a distribution of R29 500 000 to shareholders, again *pro rata* to their shareholding, out of the taxpayer's share premium account ("the distribution"), the distribution was effected on 3 May 2007;
- iii. In order to introduce the BEE partner, the taxpayer's existing shareholders sold 25.1% of the taxpayer's issued share capital to Naha Properties (Pty) Ltd ("Naha");
- iv. The transfer of shares to Naha was confirmed by the taxpayer's directors on 7 May 2007;
- v. When the taxpayer resolved to make the distribution, and at the time that the distribution was effected and finalised, it did not amount to a 'dividend' for purposes of the imposition of Secondary Tax on Companies ("STC") under the

¹⁶² *Pienaar Brothers* at para [7].

¹⁶³ *Ibid.*

Act. This was, *inter alia*, on account of an exemption contained in the definition of ‘dividend’ in section 1 of the Act;

- vi. It was common cause that, but for the aforesaid exemption, the distribution would have attracted liability for STC which would have obliged the taxpayer to file an STC return by 30 June 2007 (a month after the distribution);

Notwithstanding the above, the distribution was assessed to STC on strength of a retrospective amendment to section 44 of the Act that entailed the insertion of section 44(9A) which made distributions in amalgamation transactions under section 44 of the Act susceptible to STC by removing it from the ambit of any exemption.¹⁶⁴

The Explanatory Memorandum pertaining to the abovementioned legislative amendment (“the amendment”) stated, *inter alia*, the following:¹⁶⁵

As a theoretical matter, section 44 amalgamations should act as a deferral mechanism. All assets and tax attributes would roll over from the target company to the acquiring company with the acquiring company subsequently bearing these tax benefits and burdens. This same theory holds for the Secondary Tax on Companies (STC). The distribution of acquiring company shares in an amalgamation is accordingly free of STC. The distribution of acquiring company shares in an amalgamation is accordingly free from STC. However, the profits of the target company do not roll over to the acquiring company. The net result is often a complete STC exemption when the acquiring company makes a distribution of former target company assets.

It has come to Government’s attention that certain private stakeholders are attempting avoidance transactions that are specifically aimed at exploiting this gap. In these transactions, a pre-existing target company with substantial assets and profits is amalgamated into a newly formed company without any assets or profits. The newly formed company then distributes the former target company

¹⁶⁴ *Id* at para [10].

¹⁶⁵ *Id* at para [11].

assets, but this distribution is free from STC due to the lack of profits within the newly formed acquiring company.

From the above anomaly, the proposed amendment inserts section 44(9A) which deems resultant company equity share capital (and share premium) arising from the amalgamation to be profits not of a capital nature available for distribution to shareholders to the extent of any profits distributed by the amalgamated company in terms of sub-section (9). The result is that the amalgamated company's profits are effectively rolled over to the resultant company, so that STC remains payable when the resultant company makes a subsequent distribution.

Prior to the promulgation of the amendment, the following actions were taken to alert the public to the impending amendment:¹⁶⁶

- i. In his budget speech delivered on 20 February 2007, the Minister of Finance referred, in general terms, to an intention to pass retrospective legislation to deal with certain anti-avoidance schemes pertaining to STC;
- ii. SARS issued a press release on 21 February 2007 stating that the STC exemption for amalgamation transactions had been withdrawn;
- iii. On 27 February 2007, the Draft Taxation Laws Amendment Bill, 2007 was released for public comment, as foreshadowed in the abovementioned press release, the Bill proposed the amendment of section 44 by deleting sub-sections (9) and (10) thereof, which amendments would be deemed to have come into operation on 21 February 2007 and would apply in respect of any disposal of an equity share, or any deemed declaration of a dividend, by an amalgamated company (i.e. *Pienaar Brothers*) on or after that date;

¹⁶⁶ *Ibid.*

- iv. The Taxation Laws Amendment Bill, 2007 was published on 7 June 2007 together with an Explanatory Memorandum. The Bill no longer envisaged the deletion of the sub-sections (9) and (10) of section 44 but rather proposed the insertion of section 44(9A), which amendment would be retrospective to 21 February 2007.

Pienaar Brothers alleged that the release of the Bill on 7 June 2007 was the first time that it had received warning of the fact that an amendment to the Act would affect its STC liability. The Bill was promulgated as Act 8 of 2007 (“the Amending Act”) without any further changes being made thereto.¹⁶⁷

Pienaar Brothers argued that, at no stage prior to the coming into force of the amendment, did it receive any indication or warning via any communication from SARS or the Minister of Finance to draw its attention to the fact that it would be exposed to STC liability whether with retrospective effect or otherwise.¹⁶⁸

The taxpayer therefore approached the High Court (Gauteng Division, Pretoria) on motion seeking an order declaring section 34(2) of the Amending Act to be inconsistent with the Constitution and thus invalid. Alternatively, an order was sought in the following terms:

- i. Declaring that the provisions of section 44(9A) of the Act did not apply to the distribution on 3 May 2007 in the amount of R29 500 000;
- ii. Declaring that the assessment to STC on 13 December 2011 was invalid;
- iii. To the extent necessary, setting aside the STC assessment; and
- iv. Referring the order to the Constitutional Court for confirmation.

¹⁶⁷ *Pienaar Brothers* at para [11].

¹⁶⁸ *Ibid.*

It was common cause that the transaction in question had been completed prior to the commencement of the Amending Act and that no liability to STC had arisen contemporaneously.

In support of the relief sought, the following arguments were made on behalf of *Pienaar Brothers*:¹⁶⁹

- i. The main complaint related to the constitutionality of the retrospective amendment and was to the effect that such retrospective legislation, “which *ex post facto* deems the law at a particular time to be what it was not”, infringed on the principle of legality and the rule of law, both of which are central to our constitutional order. The prejudice which the taxpayer stands to suffer under such legislation is augmented where, as in the present case, it results in adverse consequences to completed transactions in relation to which individuals have acquired vested rights prior to the coming into force of the retrospective amendments (“the constitutional argument”); and
- ii. Even if the retrospective amendment was not unconstitutional *per se*, *Pienaar Brothers* argued that the amendment did not apply to the distribution either by virtue of the fact that that transaction had already been completed when the amendment came into force, or because it was not possible to apply section 44(9A) (being the amendment which was inserted) fairly and practically in the context of the Act as a whole (“the interpretation argument”).

Mr Justice Fabricius held that, since the interpretation argument, if successful, would be dispositive of the constitutional argument, the judgment would start by dealing with the former.

The court noted that, at common law, a distinction existed between retrospectivity of legislation in the ‘weak’ and ‘strong’ senses. A provision with only prospective effects on the future of pre-existing transactions was said to be weakly retrospective while a provision would be

¹⁶⁹ *Pienaar Brothers* at para [14].

‘strong’ if it is deemed to have been in force from a date prior to that on which it factually came into force.¹⁷⁰

Pienaar Brothers contended that the amendment in question constituted retrospectivity in the strong sense as the Amending Act provided that the new section 44(9A) was deemed to have been in force since 21 February 2007 despite the fact that the Amending Act was promulgated on 8 August 2007.

According to *Pienaar Brothers* the Amending Act had to be interpreted in terms of the usual principles in order to determine whether the insertion of section 44(9A) had actual retroactive effect so as to expose the distribution to STC liability.

With regard to the interpretation of legislation having possible strong retrospective effect, reliance was placed on several cases as authority *inter alia* for the following propositions:

- i. No statute is to be construed as having retrospective operation (in the sense of taking away or impairing a vested right acquired under existing laws) unless the legislature clearly intended the statute to have that effect (*National Director of Public Prosecutions v Carolus* 2000 (1) SA 1127 (SCA));
- ii. Not only is there a presumption against retrospective activity, but even where a statutory provision is expressly stated to be retrospective in its operation it is an accepted rule that, in the absence of a contrary intention appearing from the statute, it is not treated as affecting completed transactions (*Bellairs v Hodnett and Another* 1978 (1) SA 1109 (A));
- iii. It was stated in *Carolus* that the basis of this presumption was founded on elementary considerations of fairness which dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly;

¹⁷⁰ *Pienaar Brothers* at para [16].

- iv. Generally, there is a strong presumption that a legislature does not intend to impose a new liability in respect of something that has already happened, because generally it would not be reasonable for a legislature to do that (from the decision of the House of Lords in *Sunshine Porcelain Potteries (Pty) Ltd v Nash* [1961] AC 927 which was cited with approval in *Du Toit v Minister of Safety and Security* 2009 (1) SA 176 (SCA));

In *Carolus* the court referred to the position in English Law and to the decision of the House of Lords in *L'Office Cherifien Des Phosphates and Another v Yamachita-Shinnihon Steamship Company Ltd: The Boucraa* [1994] 1 All ER 20 (“The Boucraa”). In the Boucraa, Lord Musthills referred with approval to the following *ratio* of Staughton LJ in *Secretary of State for Social Security and Another v Tunncliffe* [1991] 2 All ER 712 (CA):

In my judgment the true principle is that Parliament is presumed not to have intended to alter the law applicable to past events and transactions in a manner which is unfair to those concerned in them, unless a contrary intention appears. It is not simply a question of classifying an enactment as retrospective or not retrospective. Rather it may be a matter of degree – the greater the unfairness, the more it is to be expected that Parliament will make clear if that is intended.

On this basis, Lord Musthills made the following statement in the Boucraa:

Precisely how the single question of fairness will be answered in respect of a particular statute will depend on the interaction of several factors, each of them capable of varying from case to case. Thus, the degree to which the statute has retrospective effect is not a constant. Nor is the value of the rights which the statute effects, or the extent to which the value is diminished or extinguished by the retrospective effect of the statute. Again, the unfairness of adversely affecting the rights, and hence the degree of unlikelihood that this is what Parliament intended, will vary from case to case. So also will the clarity of the language used by Parliament, in the light shed on it by consideration of the circumstances in which the legislation was enacted. All these factors must be weighed together to provide a direct answer to the question whether the

consequences of reading the statute with the suggested degree of retrospectivity are so unfair that the words used by Parliament cannot have been intended to mean what they might appear to say.

It was submitted on behalf of *Pienaar Brothers*, having regard to the abovementioned principles and the contextual approach to statutory interpretation brought about by the judgment in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA), that while the Amending Act expressly made section 44(9A) retrospective to 21 February 2007, it does not expressly state that it should apply to completed transactions.¹⁷¹

As it was common cause that the transaction in question which led to the distribution was completed prior to the promulgation of the Amending Act, *Pienaar Brothers* argued that the presumptions referred to in the authorities above conduced to justify an interpretation of the Amending Act to the effect that it does not apply to a completed transaction such as the distribution.¹⁷²

As an addition to the above argument, it was furthermore submitted that courts should pay particular close attention to the practical impact that purported retrospectivity will have on the relevant legislative framework in its entirety. This argument was to the effect that the legislature was ‘most unlikely’ to have intended the retrospective consequences where the provisions in question omit to provide for the machinery necessary for a taxpayer to comply with the retrospective effect thereof. In other words, where a retrospective provision, for example, requires that a return should have been submitted and payment thereon made in the past, that provision should stipulate how such actions should be performed if presently triggered by the retrospective application of the legislation in question.¹⁷³

Should the Amending Act have retrospective effect as contended for by SARS, *Pienaar Brothers* argued that the taxpayer would immediately upon the coming into force thereof be in

¹⁷¹ *Pienaar Brothers* at para [19].

¹⁷² *Ibid.*

¹⁷³ *Ibid.*

default of a statutory obligation to pay STC by 30 June 2007 (i.e. one month after the distribution) and therefore be guilty of the criminal offence of failure to submit a return.

It was submitted that the legislature could not have intended these ‘unfair and anomalous’ results, and that these considerations bolstered the argument that section 44(9A) was not intended to apply to completed transactions retrospectively.

By contrast, SARS argued that the Amending Act was promulgated after sufficient public notice had been given (in the forms already described above), and in fact constituted a less drastic amendment than the deletion of the exemption contained in section 49(9), which less drastic course of action was facilitated by representations made in response to the Draft Bill.¹⁷⁴

The relevant section of the Amending Act read as follows:

*1(c) shall be deemed to have come into operation on 21 February 2007 and applies to **any** reduction or redemption of the share capital or the share premium of a resultant company including the acquisition by that company of its shares in terms of section 85 of the Companies Act 1973 on or after that date.*

(emphasis provided.)

With regard to the above provision of the Amending Act, the learned judge stated, “In my view this section is clear, and it applies to ‘any reduction’ ... On applicant’s argument it must be read to mean that it does not apply to a completed transaction”. This judicial statement tucked into the summary of arguments made on behalf of SARS signalled the first death knell for the taxpayer’s case.¹⁷⁵

Predictably, it was submitted on behalf of SARS that the relevant sections of the Amending Act were clear, unambiguous and indicated expressly that the Act applied to completed transaction.¹⁷⁶

¹⁷⁴ *Pienaar Brothers* at para [27].

¹⁷⁵ *Pienaar Brothers* at para [28].

¹⁷⁶ *Pienaar Brothers* at para [29].

As for *Pienaar Brothers*' argument regarding the lack of 'machinery' to comply with the relevant obligations to file returns and pay tax retrospectively, SARS submitted that the 'obvious answer' was to interpret the amendment to mean that a taxpayer's duty in this regard only arose on 8 August 2007 when the amendment came into force.

Ultimately, SARS's submissions relied heavily on the refrain that the Amending Act had been promulgated in order to close a loophole that taxpayers, such as the one in question, had exploited in order to avoid liability to STC. The imperative to close the loophole was informed by the following considerations:¹⁷⁷

- i. It was unfair to taxpayers and the public at large that certain taxpayers could exploit the loophole and avoid paying STC;
- ii. The effective collection of revenue is essential to the provision of services to ordinary South Africans. It was said in *Metcash Trading Ltd v Commissioner, South African Revenue Service and Another* 2001 (1) SA 1109 (CC) that the *fiscus* plays a vital role in the public interest of collecting taxes for the economic wellbeing of the nation as a whole;
- iii. The amendment did not place amalgamating companies such as the taxpayer in any worse position than other companies or treat them unfairly. It simply served to ensure that they, like all other companies, pay STC on the distribution of income to their shareholders.

Mr Justice Fabricius agreed with the arguments advanced on behalf of SARS and therefore decided the interpretation argument in its favour on the basis that the amendment was clear, its purpose was rational, and it applied to all transactions including those that were complete prior to the commencement of the Amending Act. As *Pienaar Brothers* had lost the interpretation argument, the learned judge proceeded to consider the constitutional argument.¹⁷⁸

¹⁷⁷ *Pienaar Brothers* at para [36].

¹⁷⁸ *Pienaar Brothers* at para [38].

Pienaar Brothers' argument with regard to the application of the Constitution was that the Amending Act was invalid on the basis that it was, to the extent that it applied retrospectively, inconsistent with the rule of law, being a foundational constitutional value.¹⁷⁹

The constitutional argument was fortified by the allegations that:¹⁸⁰

- i. The taxpayer had been made subject to a retroactive tax assessment resulting in a substantial STC liability for which it had not been prepared;
- ii. Any other taxpayer, all things being equal, would have suffered the same prejudice, which was inherent in the liability to pay a tax which was not payable contemporaneously with the completed transaction; and
- iii. *Pienaar Brothers*' shareholders and its BEE partners also suffered prejudice as the former's net asset value had been determined without taking the significant STC liability into account.

Pienaar Brothers accepted that the rule of law does not preclude retrospective legislation altogether, but conceded only a narrow exception, namely 'when there was adequate warning of the intention to implement the change retrospectively.' As, on its version, adequate notice had not been provided of the terms of the Amending Act, *Pienaar Brothers* contended that the retrospective enactment in question offended the rule of law and was therefore invalid.¹⁸¹

More particularly, *Pienaar Brothers*' argument was to the effect that retrospective tax legislation is presumptively unconstitutional, and in the absence of proper warning to taxpayers, a retroactive amendment can never pass constitutional muster.¹⁸²

With regard to the rule of law and what qualities it demands, it was submitted that the prime feature of a system subject to the rule of law is certainty. Only with certainty may citizens be

¹⁷⁹ *Id* at para [39].

¹⁸⁰ *Id* at para [40].

¹⁸¹ *Id* at para [69].

¹⁸² *Id* at para [72].

aware of their rights and predict the legal consequences of their actions; the rule of law is thus said to postulate, *inter alia*, that laws should not be applied retrospectively to the disadvantage of individuals as such retrospectivity deprives the individual of a fair chance at ‘knowing and predicting his rights and of knowing how to regulate his conduct unless he be remarkably prescient...’¹⁸³

The rule of law is expressly incorporated into our constitutional disposition by virtue of section 1 (c) of the Constitution which states that ‘supremacy of the Constitution and the rule of law’ is a founding value of Constitutionalism in this country. The first consequence of constitutional supremacy is the fact that any law or conduct which does not comply with the Constitution is invalid.¹⁸⁴

Relying on *Dawood and Another v Minister of Home Affairs* 2000 (2) SA 936 (CC), where it was held that an important principle of the rule of law is that rules be stated in a clear and accessible manner, it was argued on behalf of *Pienaar Brothers* that, for present purposes, this principle implied that persons subject to the law must be able to find it, understand it and thereby regulate their affairs accordingly.

Similarly, as is evident *inter alia* from *CSARS v NWK Ltd* 2011 (2) SA 67 (SCA), taxpayers are entitled to organise their affairs in order to pay as little tax as possible, avoidance (as opposed to evasion) being lawful.¹⁸⁵

Reliance was also placed on the minority judgment of Justice Mokgoro in *Veldman v Director of Public Prosecutions: Witwatersrand Local Division* 2007 (3) SA 210 (CC), where the learned judge concurred with American authority in holding as following:¹⁸⁶

Generally, legislation is not to be interpreted to extinguish existing rights and obligations. This is so unless the statute provides otherwise or its language clearly shows such a meaning. That legislation will affect only future matters and not take away existing rights is basic to notions of fairness and justice which

¹⁸³ *Id* at para [41].

¹⁸⁴ *Ibid.*

¹⁸⁵ *Id* at para [42].

¹⁸⁶ *Veldman* at para [26].

are integral to the rule of law, a foundational principle of our Constitution. Also central to the rule of law is the principle of legality which requires that law must be certain, clear and stable. Legislative enactments are intended to “give fair warning of their effect and permit individuals to rely on their meaning until expressly changed.”

Section 35(3)(I) of the Constitution expressly prohibits retroactive legislation in the context of criminal law by providing that the right to a fair trial includes the right not to be convicted for an act or omission that was not an offence at the time that it was committed or omitted.

Taking note of the fact that our Courts have yet to consider definitely whether retrospective legislative amendments may pass constitutional muster outside of criminal law, *Pienaar Brothers* argued that, in the light of the constitutional imperative described above, courts *must* vindicate the rule of law by setting aside legislation which contravenes that principle. Any legislation that is inconsistent with the Constitution must be declared invalid.

Counsel acting for *Pienaar Brothers* then referred to authorities from the United States and the United Kingdom for guidance.¹⁸⁷

As far as the United States is concerned, it was held by the Supreme Court in *United States v Carlton* 512 US 26 (1994), that retrospective amendments to fiscal legislation was constitutionally permissible provided that such amendments met a ‘due process test’, which is linked to the rationality of the legislative purpose of the amendment.

In the United Kingdom, courts had not been called upon to adjudicate a challenge to retrospective legislation based on the rule of law, although the latter is certainly an accepted principle of English Law. With reference to the English authorities cited by *Pienaar Brothers*, Mr Justice Fabricius quoted substantially from the decision of the House of Lords in *National*

¹⁸⁷ *Pienaar Brothers* at para [44].

Westminster Bank Plc v Spectrum Plus Ltd and Others [2005] 4 All ER 209 where Lord Nicholls of Birkenhead made, *inter alia*, the following observations:¹⁸⁸

- i. From time to time court decisions on points of law represent a change in what until then the law in question was generally thought to be. This happens most obviously when a court departs from, or an appellate court overrules, a previous decision on the same point of law. The point of law may concern the interpretation of a statute or it may relate to a principle of a ‘judge-made’ law, that is, the common law...A change of this nature does not always involve departing from or overruling a previous court decision. Sometimes the court may give a statute, until then free from judicial interpretation, a different meaning from that commonly held;
- ii. A court ruling which changes the law from what it was previously thought to be operates retrospectively as well as prospectively. The ruling will have a retrospective effect so far as the parties to a particular dispute are concerned;
- iii. People generally conduct their affairs on the basis of what they understand the law to be. This ‘retrospective’ effect of a change in the law of this nature can have disruptive and seemingly unfair consequences. ‘Prospective overruling’, sometimes described as ‘non-retroactive overruling’, is a judicial tool fashioned to mitigate these adverse consequences. It is a shorthand description for court rulings on points of law which, to greater or lesser extent, are designed not to have the normal retrospective effect of judicial decisions.

Mr Justice Fabricius commented that the process described by Lord Nicholls is ‘almost the same in the South African legal system’ and referred in particular to section 172(1)(b) of the Constitution which gives courts the power, when making orders of constitutional invalidity, to limit the retrospective effect thereof.¹⁸⁹

¹⁸⁸ *Pienaar Brothers* at para [44] quoting from *National Westminster Bank* at para [4].

¹⁸⁹ *Ibid.*

On this basis, and referring to the foreign authorities, Mr Justice Fabricius concluded that:¹⁹⁰

It is clear from this incisive summary that not only do certain statutes affect rights or vested rights retrospectively, but that decisions of courts do so in many cases. I am not aware of any authority, and none has been provided to me, that those results would mean that any such statute or decision is unconstitutional per se, irrespective of the reason for the adoption of the statute or the facts of a particular case before a court of law, and irrespective of its wording.

Finally, on the subject of English authorities relating to retrospective fiscal legislation, Mr Justice Fabricius referred to the judgment in *The Queen on the application of R Huitson v HMRC* [2010] EWHC 97, where Mr Justice Kenneth Parker referred to the following general propositions in relation to tax laws:¹⁹¹

- i. In securing the payment of taxes, a national authority must strike a fair balance between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights, including the right that a person enjoys to the peaceful enjoyment of his possessions;
- ii. In framing and implementing policies in the area of taxation, the state will enjoy a wide margin of appreciation and the court will respect the legislature's assessment in such matters unless it is devoid of reasonable foundation. The domestic analogue of the margin of appreciation is the discretionary area of judgment and is especially wide in the field of social and economic policy;
- iii. The more the subject matter of legislation concerns matters of broad social policy, the less ready will be a court to intervene;

¹⁹⁰ *Pienaar Brothers* at para [45].

¹⁹¹ *Id* at para [46] quoting from para 75 of the judgment in *The Queen on the application of R Huitson v HMRC*.

- iv. Nonetheless the court will carefully examine all the relevant circumstances including the history of the challenged provisions, to determine whether a fair balance has been struck;
- v. These principles apply to tax legislation that is retrospective;
- vi. Article 1 of the First Protocol to the European Convention for the Protection of Human Rights and Fundamental Freedoms does not ‘as such’ prohibit retrospective legislation. The question to be answered is whether in the applicant’s specific circumstances, the retrospective application of the law imposed an unreasonable burden on them and thereby failed to strike a fair balance between the various interests involved;
- vii. The imposition of a tax is not devoid of reasonable foundation by reason only that it may have some retrospective effect.

Mr Justice Fabricius noted that the ‘fair balance test’ was not the test that applies in our legal system but otherwise stated that he regarded these propositions as being ‘particularly instructive’ in the present context.¹⁹²

The learned judge next considered the application of these principles to the South African legal system. He stated that the ‘touchstone’ for determining the validity of retrospective legislation would always be the question as to whether or not the rule of law had been contravened.¹⁹³

In *Robertson v City of Cape Town* 2004 (5) SA 412 (C), Mr Justice Bozalek stated that ‘retrospective legislation contravenes the rule of law where it unreasonably or unfairly impairs the ability of those bound by the law to regulate their conduct in accordance therewith’. Mr Justice Fabricius found himself unable to agree with this statement if what was suggested was that ‘unfair impairment’ is the appropriate test in our constitutional dispensation.¹⁹⁴

¹⁹² *Pienaar Brothers* at para [46].

¹⁹³ *Id* at para [48].

¹⁹⁴ *Pienaar Brothers* at para [48].

In this regard the learned judge opined that there are ‘degrees of unfairness’, that not all laws are fair and that:

The real question would be whether a law is ‘unjust’, ie whether it passes constitutional muster, ie was the law, accepting that its language is clear, passed for a rational reason?

The next element of *Pienaar Brothers*’ constitutional argument was that the taxpayer had not received fair warning of the amendment contained in the Amending Act and that, such warnings as were received, differed materially from the amendment that was in fact enacted.¹⁹⁵

It was submitted that the court should adopt a rigorous approach towards infringements of the rule of law. As court have ‘extended themselves to the maximum’ by applying the presumptions against retrospective legislation, so too should they demand a very high level of correlation between the changes to the law of which taxpayers were notified and the actual legislative amendments that follow before being satisfied that taxpayers must suffer the consequences of the change retrospectively.¹⁹⁶

The learned judge rejected *Pienaar Brothers*’ arguments in this regard and stated that he was unaware of any authority that required ‘fairly precise warning’ must be given before parliament may proceed to enact retrospective legislative provisions, whether generally or in the context of fiscal legislation. On this basis Mr Justice Fabricius concluded that “if the tax statute is rationally connected to a legitimate purpose, no precise warning is required, if one at all”.¹⁹⁷

By contrast, it was contended on behalf of SARS that the Constitution does not generally preclude the enactment of retrospective legislation save for in the criminal context as provided in section 35(3)(I). On SARS’ version, the question was therefore to what extent the entrenchment of the rule of law inhibited or prohibited retrospective legislation.¹⁹⁸

¹⁹⁵ *Pienaar Brothers* at para [53].

¹⁹⁶ *Id* at para [62].

¹⁹⁷ *Id* at para [64].

¹⁹⁸ *Id* at para [68].

Having regard to *Pienaar Brothers*' contention that the Amending Act was invalid on the basis that insufficient notice of its contents had been provided, SARS argued that this approach was untenable for the following reasons:¹⁹⁹

- i. It is inconsistent with the approach in the foreign jurisdictions to which our courts have frequently looked for guidance in such matters, such as Canada, the United States, the United Kingdom and the European Union;
- ii. It is inconsistent with the approach the Constitutional Court has laid down in relation to the constitutional scrutiny of legislation; and
- iii. *Pienaar Brothers*' challenge fails on its own formulation of the test as sufficient notice was in fact provided to taxpayers before the amendment was enacted.

SARS argued further that the use of retrospective legislation was 'a necessary tool of modern government throughout the world's leading democratic societies' and that examples of such enactments existed in our own jurisdiction, namely:²⁰⁰

- i. Previously, the Income Tax Act proceeded from the premise that a trust was a person in law and therefore subject to tax. When the decision in *Friedman v Commissioner for Inland Revenue* 1991 (2) SA 340 (W) was handed down and confirmed on appeal, holding as it did that a trust was not a person in law and therefore not subject to taxation, the consequences for the *fiscus* would have been calamitous and Parliament moved swiftly to pass legislation in terms of which the definition of 'person' in the Income Tax Act was extended to expressly include a trust. The amendment came into force on 1 July 1991 with retrospective effect from March 1986 and therefore had retrospective effect spanning in excess of five years;

¹⁹⁹ *Id* at para [69].

²⁰⁰ *Id* at para [70].

- ii. Where judicial pronouncements had cast doubt on the validity of a withholding tax levied in the erstwhile Ciskei, the Ciskei government responded by enacting legislation to provide specifically for the imposition of such taxes during 1993 with retrospective effect from March 1985;
- iii. An even more drastic example was when doubt was cast on the validity of the Exchange Control Regulations promulgated under the Currency and Exchanges Act, 9 of 1933, which doubt led to Parliament amending the said legislation on two occasions during 1987 and 1988 with retrospective effect from 1961. These enactments thus had retrospective effect across 27 to 27 years respectively;
- iv. Courts have always developed the common law with retrospective effect despite the fact that the development in question may amount to a novel amendment to the common law or to the introduction of a brand-new rule.

As far as our constitutional dispensation is concerned, SARS stressed that in terms of the doctrine of objective constitutional validity, an unconstitutional law is rendered invalid with full retrospective effect from the outset. This naturally being subject to the discretion granted by the provisions of section 172(1)(b) of the Constitution which allows judges to limit the retrospective effect of declarations of invalidity in the interests of justice.²⁰¹

SARS argued that all of the above authorities and considerations demonstrate that the ability to amend laws retrospectively is a common and necessary rule of modern government and modern jurisprudence.²⁰²

It was contended that the aforesaid proposition was inconsistent with *Pienaar Brothers'* argument that 'there lurks in section 1(c) of the Constitution either a total prohibition of the retrospective legislation or one so constrained' as *Pienaar Brothers* motivated for.²⁰³

²⁰¹ *Pienaar Brothers* at para [71].

²⁰² *Ibid.*

²⁰³ *Ibid.*

Mr Fabricius next proceeded to analyse authorities submitted by SARS from the jurisdictions of Canada, the United States, the European Union, England and Germany. With the exception of Germany,²⁰⁴ which was the only civil law jurisdiction considered (where the doctrine of *stare decisis* is not observed), all the other jurisdictions recognised the validity of retrospective legislative amendments.²⁰⁵

SARS argued that the position under German Law was clearly distinguishable on the basis that ours is a common law system and is more aligned to the jurisdictions of England, Canada and the United States.²⁰⁶

Mr Justice Fabricius preferred, in particular, the English authorities and stated that they were persuasive in the absence of any apposite judgment of a South African court. The learned judge opined that a less strict approach than that adopted under German Law should be adopted in South Africa, at least in the context of tax statutes, where a rational reason appears in the interest of the *fiscus* and where a broad warning was given that a particular deficiency or ‘loophole’ would be addressed by the authorities.²⁰⁷

SARS’ argument proceeded, having established that retrospective laws are common and permissible in jurisdictions based on the rule of law, to consider the question as to what the standard is by which the constitutional validity of retrospective legislation should be judged in South Africa.²⁰⁸

Two standards for review exist in the context of determinations of constitutional validity of legislation in this country:²⁰⁹

²⁰⁴ *Id* at para [79] quoting from a paper presented by the President of the German Administrative Court. The German Federal Constitutional Court declared any law having retroactive to be ‘in principle unconstitutional and impermissible’. This decision was reached on the basis of the requirements of the rule of law and the necessity to protect legitimate expectations.

²⁰⁵ *Id* from para [72] – para [80].

²⁰⁶ *Id* at para [80].

²⁰⁷ *Pienaar Brothers* at para [80].

²⁰⁸ *Id* at para [81].

²⁰⁹ *Ibid.*

- i. First, the basic threshold enquiry of the ‘rationality’ test, which is the standard that is applied to all legislation under the rule of law pursuant to section 1(c) of the Constitution; and
- ii. Second, the tests of ‘reasonableness’ and ‘proportionality’ which are more exacting and apply when legislation limits a fundamental right in the Bill of Rights, in terms of section 36 (1) of the Constitution, such limitations will only be valid where they are found to be ‘reasonable and justifiable in an open and democratic society’.

As regards the question as to which of these standards applied to determine the validity of retrospective legislation, SARS argued the answer clearly depended on whether or not the legislation in question limits a fundamental right contained in the Bill of Rights. Where a fundamental right was in issue the standard would be that of ‘reasonableness’ and ‘proportionality’, if not the rationality standard would apply.²¹⁰

Mr Justice Fabricius agreed with this exposition of the law and noted that the rationality standard applicable in South Africa was the same as that which applied in the United States and is more exacting than the standards which apply in Canada, the United Kingdom and the European Union.²¹¹

In conclusion, SARS submitted that once it was accepted that the rationality standard was applicable in determining the validity of the Amending Act, *Pienaar Brothers*’ case must inevitably fail as it was eminently rational for Government to move to close the loophole that the taxpayer was exploiting and that, in the absence of a breach of a fundamental right, the taxpayer’s perceived injustice was simply irrelevant.²¹²

As was confirmed by the Constitutional Court in *Law Society of South Africa and Others v Minister of Transport and Another* 2011 (1) SA 400 (CC), the requirement of rationality is not directed at testing whether legislation is fair or reasonable or appropriate, nor is it aimed at

²¹⁰ *Pienaar Brothers* at para [83].

²¹¹ *Ibid.*

²¹² *Id* at paras [84] – [86].

deciding whether there are other or even better means that could have been used. Its use is restricted to the threshold question whether the measure the lawgiver had chosen is properly related to the public good it seeks to realise.²¹³

The sole remaining vestige of hope for *Pienaar Brothers*' argument was its complaint regarding the inadequacy of the notice it had been given by Government regarding the content of the amendments to be enacted. The learned judge had effectively already rejected this argument and proceeded to dispose of it outright by stating the following:

I am not aware of any provision in any of the jurisdictions that I have referred to, or indeed in ours, to the effect that the warnings given must related to the exact same amendment that is ultimately made. To adopt such an approach would undermine the parliamentary process and the public participation process completely. It would also mean that Parliament would be bound by an announcement made by the executive...I am therefore not of the opinion that a precise warning must be given in each and every case, nor that a warning, of whatever ambit, needs to be given in all cases. In my view, a proper approach would be to judge the legality of retrospective amendments on a case-by-case basis, having regard to the various considerations that I have referred to. The Constitution itself certainly does not prohibit retrospective legislation in civil law.

Pienaar Brothers' case was accordingly dismissed.

F 2 RETROSPECTIVITY IN THE CONTEXT OF SECTION 7C

It is evident from the above that the taxpayer's visceral reaction of perceived injustice when confronted with retrospective legislation, although understandable, does not necessarily find support in the constitutional jurisprudence on this country.

²¹³ At para [35].

On a textual level, it is clear that both iterations of section 7C are retrospective:

- i. The retrospective effect of the first iteration of section 7C is demonstrated by the wording of section 12 (2) of the Amending Act which provides that section 7C shall come into operation on 1 March 2017 and apply in respect of any amount owed by a trust in respect of a loan, advance or credit provided to that trust before, on or after that date; and
- ii. The retrospective effect of the second iteration of section 7C is even more marked when regard is had to the fact that the Amending Act in question, which came into force on 18 December 2018, provides that the amendments to section 7C are deemed to have come into force on 18 July 2017 (being the date on which the Draft Bill was published).

To varying degrees section 7C, in all its iterations, therefore has retrospective effect in the weak sense. None of its iterations constitute retrospective legislation in the strong sense, otherwise referred to as retroactivity, as they do not seek to assess taxpayers to tax retrospectively for the full historical period during which the relevant enactment is deemed to apply. Instead, section 7C imposes only prospective liability.

All the iterations of section 7C are, however, retrospective in the sense that they change the legal consequences of completed past conduct in circumstances where such conduct would have attracted no liability to tax pursuant to contemporaneous laws.

The current iteration of section 7C, and in particular subsection (1A), arguably has stronger retrospective effect than the first iteration in the sense that it imposes taxes on individuals who were not involved in granting the loans in question at all, let alone in the favourable terms which trigger the donations tax applicable.

The question then arises as to whether section 7C can be attacked on the basis of its retrospectivity, and by virtue of the perceived injustice experienced by taxpayers who are made subject to its provisions.

Having regard to the judgment in *Pienaar Brothers*, it would appear that any attack based on the rule of law in relation to the retrospectivity of section 7C would not stand good prospects of success, at least not in circumstances where it is confined to a non-fundamental right and therefore subject only to threshold rationality analysis.

It is respectfully submitted that much of the authority, both local and international, relied on in *Pienaar Brothers* related to the general retrospective effect of judgments handed down by courts in common law jurisdictions and that such authority is not entirely helpful in the context of legislative retrospectivity.

The vast majority of judgments that have “retrospective” effect are mere pronouncements on what the correct legal position always was, despite the contrary understanding thereof that one or more of the litigants may have toiled under.²¹⁴

It is only in rare cases where judgments have been relied on for some time and are subsequently overturned by appellate courts where the effect of a judgment truly takes on retrospective effect in a manner that is similar to that of legislative retrospectivity.²¹⁵

It is, however, submitted that even under the aforesaid infrequent circumstances the retrospective effect of the judgment in question will not be analogous to legislative retrospectivity. This is because a judgment of this nature will not apply to completed transactions to general retroactive effect and the consequences thereof may well be excluded by agreement between the parties (depending on the nature of the law being pronounced upon).

More importantly, and on a conceptual level, courts in common law jurisdictions must necessarily hand down judgements that have retrospective consequences in order to maintain

²¹⁴ See for example *National Westminster Bank Plc v Spectrum Plus Ltd and Others* [2005] 4 All ER 209 *supra* at para 100. It is implicit in Lord Nicholls’ use of the wording “what the law was generally thought to be” that the effect of the type of judgment in question was not to change the law retrospectively, but rather to state what the correct legal position had in fact always been.

²¹⁵ See for example *National Westminster Bank Plc v Spectrum Plus Ltd and Others* [2005] 4 All ER 209 *supra* at para 100.

the integrity of the legal system as a whole. There is no such imperative when it comes to the drafting of legislation.

As in *Pienaar Brothers*, section 7C was devised to close a so-called loophole in the law which allowed taxpayers to derive a tax benefit from structuring their affairs in a certain manner so as to avoid certain taxes and legitimately minimise their tax liability.

As *Emslie* points out,²¹⁶ the reasoning in *Pienaar Brothers* suggests that taxpayers “exploiting” such a “loophole” cannot be heard to complain when their scheme is exposed, and they are made to pay taxes hitherto successfully avoided.

Emslie argues for a different categorisation of what this taxpayer behaviour amounts to. He suggests that applying the general scope of the Act as it stands at any given point in time cannot be seen as exploiting a loophole as such categorisation would fly in the face of the accepted principle that taxpayers are entitled to structure their affairs in a tax efficient manner.

To the extent that the reasoning in *Pienaar Brothers* in fact encapsulates the sentiment that taxpayers who structure their affairs in such a manner cannot rely on perceived inequitable consequences when Parliament reacts with retrospective legislation it must, with respect, be rejected.

Legislative enactments with retrospective effect may have been brought about by pressing policy considerations but this is not the same as the position obtaining in the context of judicial pronouncements having retrospective effect and should therefore not be justified on the same basis.

When Parliament enacts retrospective provisions, it does so knowingly and with express intention, and not by virtue of the exigency that accompanies judicial pronouncements having retrospective effect.

²¹⁶ Emslie T from the editorial titled “Retroactive legislation and completed transactions” *The Taxpayer* (2017) Vol 66 No 4&5 at page 61.

Retrospective legislative enactments should therefore be consistent with the Constitution and the rule of law because, unlike the position in the United Kingdom, the South African Parliament is no longer supreme, and its actions must always pass constitutional muster.

Having said that, it is difficult to see how the legitimate policy considerations which underpin the *fiscus*' endeavours to realise taxes will fail to pass threshold rationality analysis: for the means of taxation will generally justify the ends of national economic wellbeing.²¹⁷

The taxpayers who will be hit by the provisions of the current iteration of section 7C will be deriving a benefit, for example, from the loan claims ceded to them and the 'rationality' of Treasury seeking to tax that benefit is, it is submitted, likely to be accepted by courts.

G CONCLUSION

There is, however, an exception to the reach of section 7C which refers back to *Emslie's* analysis on the consequences of the first iteration of the section which is discussion under part C above.

In the context of donations tax, it has been the position since the decision in *Welch's Estate v Commissioner for the South African Revenue Service* 2005 (4) SA 173 (SCA) that property settled on a trust pursuant to a divorce order, and so as to facilitate the fulfilment of the settlor's obligations in terms of that order, will not amount to a donation attracting donations tax in terms of the Act (provided that the order in question provides that the obligations will revert to the settlor should the trust fail to fulfil them).

This is because a donation requires pure liberality and disinterested benevolence, not self-interest or the expectation of a *quid pro quo*. The settlor in the above scenario, however, does not possess such disinterested benevolence as he or she makes the settlement with the express expectation of being relieved of the obligations imposed by the divorce order.²¹⁸

²¹⁷ See *Metcash Trading Ltd v Commissioner, South African Revenue Service and Another* 2001 (1) SA 1109 (CC)

²¹⁸ See *Welch's Estate* at para [19].

It is therefore submitted that section 7C does not apply to settlements made on trusts pursuant to the maintenance obligations imposed by a divorce order and will therefore have no effect on the cession of loan accounts in this context.

The aforesaid conclusion is supported by a contextual interpretation of the language used in section 7C as well as the stated purpose with which it was enacted (as reflected in the relevant Explanatory Memoranda). The mischief that the anti-avoidance provisions contained in section 7C are aimed at addressing is entirely distinct from the scenario in which loan accounts are ceded under the terms of a divorce order.

More generally, despite the initial sense of injustice which often accompanies the realisation that fiscal consequences are imposed with retrospective effect in terms of section 7C, it is submitted that the imperative to tax the transfer of generational wealth, as a policy consideration informing the enactment of the provision, seems to be entirely rational.

It is respectfully concluded that Mr Justice Fabricius was correct in his observation that our threshold rationality standard is more exacting than that which is employed in the United Kingdom where the test is focussed on equities and the striking of a fair balance.

As the rationality standard is disinterested and does not concern itself with such human ruminations as reasonability or appropriateness, it seems that the public good that section 7C seeks to realise will, under the circumstances, probably be found to be properly related to the ambit of its provisions.

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