

1. Domestic Tax Paper:

A critical analysis of the implementation of the ‘pay now, argue later’ principle by SARS as provided by section 164 of the Tax Administration Act 28 of 2011

By

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1. Domestic Tax:

“A critical analysis of the implementation of the ‘pay now, argue later’ principle by SARS as provided by section 164 of the Tax Administration Act 28 of 2011”.

2. International Tax:

“Limitation of interest deduction in South Africa: a suggested approach to the application of sections 31 and 23M of the Income Tax Act 58 of 1962 to debt and equity business financing methods”

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To my family and my late Uncles: Joseph and Phillip Tseisi, I dedicate this paper to you.

ABSTRACT

The 'Pay Now, Argue Later' principle applies in income tax or value-added tax collection procedure after the South African Revenue Services has concluded an assessment in terms of the Tax Administration Act 28 of 2011 and found that an amount of tax is due and payable by the taxpayer. In terms of the 'pay now, argue later' principle, the taxpayer has to pay the assessed amount before being accorded an opportunity to raise any objections.

The purpose of this paper is, to do an in-depth evaluation of the implications of the implementation of the 'pay now, argue later' principle by SARS. The implementation of the principle will be evaluated to determine if it is unjust, inequitable or unreasonable. In addition to the latter evaluation, the principle's shortfalls will be highlighted with the inclusion of a brief legal position in other countries. The paper acknowledges the existence of the principle, although the implementation thereof by SARS remains questionable and a source of controversy.

The paper ultimately concludes that the 'pay now, argue later' principle, though constitutionally validated to a certain extent need to be revised. A balance has to be struck between the taxpayer's rights, public interest and SARS' powers in implementing the principle. A recommendation is therefore made to place the implementation thereof in the Tax Ombud in view of UK's Taxes Management Act where Commissioners resolve such disputes between taxpayers and the Inland Revenue Authority.

I. BACKGROUND

(a) OVERVIEW

The South African Revenue Services ("SARS") has the mandate from the government of the Republic of South Africa ("SA") and the people of SA, to collect revenue within SA from individual and corporate taxpayers who receive income from sources in SA and worldwide.¹

SARS assess taxpayers' compliance regarding the provisions of the Income Tax Act 58 of 1962 ("ITA"), the Value Added Tax Act 89 of 1991 ("VAT Act") and the Transfer Duty Act 40 of 1949. Where SARS assess the taxpayer and finds the taxpayer liable to pay tax regarding s 91 of the TAA, the taxpayer is obliged to make a payment before lodging an objection or appeal against the individual assessment decision.²

As defined in s 1 of the Tax Administration Act 28 of 2011 ("TAA"), an 'assessment' means "*the determination of the amount of a tax liability or refund, by way of self-assessment; or evaluation by SARS.*"

The applicability of the 'pay now, argue later' principle can be suspended on request by the taxpayer to the Commissioner for SARS.³ In most cases, and due to lack of impartiality the taxpayer's request for the application of the principle to be suspended by the Commissioner for SARS regarding s 164(2) of the TAA is typically rejected and as the result, taxpayers incur enormous costs in trying to appeal the Commissioner for SARS's decision.⁴ This practice, as will be illustrated in this paper, has caused a lot of animosity between SARS and taxpayers since the Commissioner for SARS might be inclined to decide in SARS's favour in some or most requests by the taxpayers.⁵

The 'pay now, argue later' principle has not been defined in the TAA and other tax legislations.⁶ However, put simply, the principle means the taxpayer is supposed to make a

¹ Section 2 of the Tax Administration Act 28 of 2011, as amended from time to time.

² S 164(1) of the TAA.

³ S 164(2) of the TAA.

⁴ *Metcash Trading Limited v Commissioner for the South African Revenue Service and Another* (CCT3/00) [2000] ZACC 21; 2002 (4) SA 317; 2002 (5) BCLR 454 (24 November 2000); and *CSARS v Capstone 556 (Pty) Ltd* (20844/2014) [2016] ZASCA 2; [2016] 2 All SA 21 (SCA); 2016 (4) SA 341 (SCA) (9 February 2016).

⁵ *Mokoena Albert Sepataka v C: SARS* 2011 (2) SA 556 (GSJ).

⁶ Income Tax Act, and Value-Added Tax Act.

payment to SARS before the taxpayer lodges an objection with SARS and with the court of law against the Commissioner for SARS' refusal to suspend the application of the principle.⁷

The principle itself is not problematic. However, the implementation thereof is of concern. It places unlimited discretionary powers at SARS' disposal, and this goes against the two most important principles of natural justice, namely, '*nemo judex in sua causa*' and '*audi alteram partem*'.⁸ The current implementation of the principle also undermines the process in Part B of the TAA, which deals with Objections and Appeals.

The *nemo judex in sua causa* principle means, nobody shall be a judge in his or her case.⁹ At times one is faced with a foregone conclusion under such circumstances, more especially the individual in the position of the taxpayer.¹⁰ The *audi alteram partem* principle means, hear the other side.¹¹

In human nature, it is far from difficult to persuade a person to change his or her mind than to convince a person who has approached an issue with an open mind to reach a particular decision.¹² That is why the *audi alteram partem* principle is so intimately linked to the fundamental principle of natural justice, the *nemo judex in sua causa* principle.¹³

(b) INTRODUCTION

Constitutional Court Justice, Johann van der Westhuizen once said, "*Justice must not only be done, it must be seen to have been done. It must manifest to all those affected by the trial and in particular, those accused of having transgressed the provisions of the legislation that the relevant officer acts reasonably, impartial and with an open mind. The appearance of bias may vitiate the proceedings wholly or in part. Appearances and perceptions are related because the public need to have confidence in the impartiality, fairness and independence of the officer.*"

This paper endeavours to do an in-depth analysis of the 'pay now, argue later' principle's implications as provided by s 164 of the TAA. This paper will begin by explaining the 'pay

⁷ S 164(3) of the TAA.

⁸ On the application of the *Audi Alteram Partem* rule and the *nemo judex in sua causa*, see *Semenya and Others v Commission for Conciliation Mediation and Arbitration and Others* (JA26/2003) [2006] ZALAC 2; [2006] 6 BLLR 521 (LAC) (23 March 2006) para 21, 22, and 26.

⁹ Baxter LG, '*Fairness and Natural Justice in English and South African Law*', Cambridge University http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5253&context=faculty_scholarship accessed on 23 August 2016.

¹⁰ See LexisNexis Library on the meaning of '*Nemo judex*'.

¹¹ *Ibid* note 9.

¹² *Ibid* note 10.

¹³ *Ibid* note 10.

now, argue later' principle and the rationale behind its enactment. Furthermore, the view of the judiciary in respect of the principle as expressed by the courts will be evaluated. The role and influence of the principles of natural justice in interpreting the statutes will also be examined to determine if the 'pay now, argue later' principle, despite passing the Constitutional test, conforms to the broader principles of natural justice.

II. THE PAY NOW ARGUE LATER PRINCIPLE EXPLAINED

(a) *BACKGROUND*

Before the enactment of s 164 of the TAA, the taxpayer's obligation to pay as recorded on an assessment issued by SARS was dealt with regarding s 88 of the Act and s 36 of the VAT Act. These two provisions were subsequently repealed and replaced by s 164 of the TAA. Section 164 of the TAA mirrors the repealed provisions.

Section 88 provided that unless the Commissioner for SARS directs otherwise, the obligation to pay any amount of tax due regarding the ITA will not be suspended by any objection and appeal against the assessment. The same principle applied to interest charged in respect of the amount of tax subject to the assessment.

Section 36 provided that, upon an assessment of the taxpayer by the Commissioner for SARS, and despite the noting of an appeal and an objection in respect of the assessed tax, the taxpayer is obliged to pay the assessed tax. Following from this was s 40 of the VAT Act, which empowered the Commissioner, where this payment is overdue, to file a statement with the court of law which had the effect of a civil judgment for a liquid debt.¹⁴

(b) *SECTION 164 OF THE TAX ADMINISTRATION ACT*

Section 164 of the TAA reads as follows, “*unless a senior SARS official otherwise directs in terms of subsection (3) - (a) the obligation to pay tax; and (b) the right of SARS to receive revenue and recover tax, will not be suspended by an objection or pending the decision of a court of law pursuant to an appeal under section 133*”.

The TAA provides further in s 164(2) that, “*a taxpayer may request a senior SARS official to suspend the payment of tax or a portion thereof due under an assessment if the taxpayer intends to dispute or disputes the liability to pay that tax amount due under Chapter 9*”.

(i) *REQUEST FOR SUSPENSION*

On request by the taxpayer, the obligation to pay the assessed tax amount can only be suspended by a SARS official.¹⁵ The taxpayer who has paid a disputed tax amount and whose

¹⁴ See *Metcash* para 1.

¹⁵ TAA s 164(2).

objection and appeal is subsequently upheld, is entitled to interest from the date of payment of the disputed amount.¹⁶

The taxpayer, therefore, does not need to first object against an assessment before requesting the SARS official for a suspension regarding s 164(2) of the TAA as the taxpayer may first require reasons under Rule 3 to allow the taxpayer to formulate an appropriate objection.¹⁷ A request for suspension is typically made also to indicate the taxpayer's intention to object.

(ii) *DISCRETIONARY POWERS*

In consideration of the merits of the taxpayer's argument and the strength in respect of the assessment, SARS has been vested with the discretionary powers to consider a request for suspension by the taxpayer. SARS' discretionary powers are noted in s 164(3). Section 164(3) allows a senior SARS official to suspend the application of the principle on request by the taxpayer. Section s 164(5) empowers a senior SARS official to deny a motion regarding s 164(2) or revoke a decision to suspend with immediate effect if satisfied that the taxpayer's objection is baseless.¹⁸

(c) *TAX ADMINISTRATION DISPUTES*

As noted in chapter one of this paper, SARS is entrusted with the mandate of administering and collecting taxes in SA. Section 2(1) of the ITA provides that the Commissioner for SARS

¹⁶ TAA s 164(8).

¹⁷ Rule 3(1)(a) of the Tax Court.

¹⁸ Section 164(3) provides that – “A senior SARS official may suspend payment of the disputed tax having regard to—

- (a) *the compliance history of the taxpayer;*
- (b) *the amount of tax involved;*
- (c) *the risk of dissipation of assets by the taxpayer concerned during the period of suspension;*
- (d) *whether the taxpayer can provide adequate security for the payment of the amount involved;*
- (e) *whether payment of the sum required would result in irreparable financial hardship to the taxpayer;*
- (f) *whether sequestration or liquidation proceedings are imminent;*
- (g) *whether fraud is participating in the origin of the dispute; or*
- (h) *whether the taxpayer has failed to furnish information requested under this Act for purposes of a decision under this section.”*

Further to the above, section 164(5) provide that, - “A senior SARS official may deny a request concerning subsection (2) or revoke a decision to suspend payment concerning that subsection with immediate effect if satisfied that—

- (a) *after the lodging of the objection or appeal, the objection or appeal is frivolous or vexatious;*
- (b) *the taxpayer is employing dilatory tactics in conducting the objection or appeal;*
- (c) *on further consideration of the factors referred to in subsection (3), the suspension should not have been given; or*
- (d) *there is a material change in any of the factors referred to in subsection (3), upon which the decision to suspend the amount involved was based.”.*

is responsible for executing the provisions of the tax legislations. Furthermore, ss 2(2) of the ITA provides that, jurisdictional prerequisites and procedures for purposes of the effective performance of any duty, power, or obligation or the exercise of any right regarding tax legislations are, to the extent regulated by the TAA.

The powers that the Commissioner has been entrusted with can be exercised or performed by him personally or by any SARS official or person engaged in carrying out those provisions under his control, direction or supervision.¹⁹

On substantive matters, the taxpayer may follow the formal process for the resolution of disputes or issues of tax liability through the informal alternative dispute resolution process under which SARS and the taxpayer may attempt to resolve the conflict.²⁰ On tax dispute matters involving a certain amount of money, the Tax Board, Tax Court, the High Court and the Supreme Court of Appeal respectively, can be approached for a resolution depending on the stage of the particular matter.²¹

Chapter 9 of the TAA form an integral part of the effective, fair and just implementation of the TAA provisions by SARS. Chapter 9 gives taxpayers a voice by enabling taxpayers to dispute SARS' decisions. However, s 164 was not enacted subject to this Chapter 9 as SARS is empowered to obtain a judgment after just an objection but before the taxpayer appeals.²²

(d) RATIONALE BEHIND THE PRINCIPLE

Since it is the government's responsibility to fund social and economic programmes together with the provision of public goods and services, it was found to be imperative for the taxpayer to pay the tax amount due, pending any objection or legal dispute.²³ To fulfil the above responsibilities, the Government needs revenue; hence the principle's aim to discourage taxpayers who might want to delay the government from collecting revenue that is due.²⁴ The shortfall is that there are no guidelines as to when the Commissioner for SARS might solicit s 164 'pay now, argue later' principle and when the taxpayer is allowed to use Chapter 9 of the TAA provisions.

¹⁹ S 164(2) of the TAA.

²⁰ Chapter 9 Part A of the TAA.

²¹ Chapter 9 Part C of the TAA.

²² See s 164 of the TAA

²³ See *Metcash* para 8.

²⁴ *Supra* note 23.

The rationale as described above was acknowledged by the court in *Metcash*. The facts submitted in evidence by SARS with the support of the Minister of Finance in *Metcash* court case are as follows:²⁵

- The actual operation of the State depends upon its ability to impose tax laws and collect tax revenue;
- Social needs in SA demand that inequalities in all areas of life, should be addressed and corrected;
- The current economic planning was well thought, and its effectiveness depends on the relationship between estimated tax revenue and the actual tax collected in a given year of assessment;
- It has proven to be a legitimate concern that, it is inevitable in a tax system based on self-assessment, fraud might be committed;
- In SA taxpayers do not like complying with their obligation of paying taxes;
- Failure to pay the tax amount can deprive the State of its revenue. The State will in return fail to attend to the social needs of the people;
- The extermination of the principle might result in unfounded requests to defer the payment by taxpayers. The principle, therefore, is imperative, as it is intended to discourage such conduct; and
- The moment the application of the principle is deferred, the State loses on tax revenue. The income has to be recovered somehow. The loss thereof could, in turn, have dire consequences, i.e. SA's ability to borrow funds, employment reduction and SA's position in international capital markets.

The rationale behind the "pay now argue later" principle is also to speed up the collection of revenue and to limit any delay on the part of taxpayers. However, this principle is too broad and has been tailored as a 'one size fits all' as long as there is tax due to SARS. The onus to prove that the tax amount assessed is not due rests with the taxpayer.²⁶

Section 91(1)(b) provided that *"If any person fails to pay tax or interest in terms of section 89(2) or 89quat, the Commissioner may file with the clerk or registrar of any competent court with a statement certified by him as correct and setting forth the amount of the tax or interest payable by that person. The Commissioner's statement shall thereupon have all the effects of, and any proceedings may be*

²⁵ Jonathan Silke, 'Appeals and reviews no restrictions,' <https://www.mylexisnexis.co.za/Index.aspx> subscription required.

²⁶ S 102 of the TAA.

taken thereon as if it were, a civil judgment lawfully given in that court in favour of the Commissioner for a liquid debt of the amount specified in the statement."

The contents of the current s 164 of the TAA do not differ with the previous sections, namely, s 88 of the ITA and s 40 of the VAT. Put simply, the current s 164 puts the provisions of ITA and VAT Act regarding the principle in one section. The new s 164 gives the Commissioner for SARS the power to grant or refuse to suspend the payment of tax that is due and payable by the taxpayer.

(e) CONSTITUTIONAL STATUS

The legal position of the 'pay now, argue later' principle was thoroughly examined in the *Metcash* court case. The Constitutional Court in *Metcash* held that the principle was consistent with the provisions of the Constitution of SA.²⁷ However, this was in the context of the VAT Act. Various High Courts have confirmed this position by referring to the judgment.²⁸

The crucial issue that had to be determined by the Constitutional Court in *Metcash* was whether the provisions in respect of the principle were unjustifiably limiting the taxpayer's right of access to the courts as protected by s 34 of the Constitution.²⁹

From a VAT perspective, the Constitutional Court found that the public interest in the collection of VAT payment was of paramount importance.³⁰ The Constitutional Court reasoned that ensuring prompt payment of the tax amount assessed to be due is clearly an important public purpose.³¹ The public interest at play referred to by the Constitutional Court was held to be apparent and consequently related to economic development of the country as a developmental state, funding of governmental initiatives for the benefit of the public as a whole such as regulating the levels of employment and providing social security for the exposed.³²

²⁷ See *Metcash* at para 26.

²⁸ See *Singh v C: SARS* 2003 (4) SA 520 (SCA); *Mokoena Albert Sepataka v CSARS* 2011 (2) SA 556 (GSJ); and *Capstone 556 (Pty) Ltd v CSARS* [2011] ZAWCHC 297.

²⁹ See *Metcash* para 1.

³⁰ See *Metcash* para 60.

³¹ See *Metcash* para 60.

³² See *Metcash* para 60.

The Constitutional Court in *Metcash* held that the principle would reduce the number of frivolous objections, thereby guarding against the prejudice the fiscus will suffer through delays in obtaining finality of VAT liability.³³

Furthermore, the Constitutional Court recognised that various open and democratic countries adopted the principle and its immediate execution.³⁴ Therefore this suggested that the principle was acceptable in an open and democratic society based on freedom, dignity and equality as required by s 36 of the Constitution.³⁵

It was further noted by the Constitutional Court that, the quick, reliable and predictable recovery of VAT was a matter of national importance.³⁶

With an attempt to see if there is an established approach by the courts, the next chapter examines the various court cases that have dealt with the application of the ‘pay now, argue later’ principle.

³³ See *Metcash* para 60.

³⁴ See *Metcash* para 61

³⁵ See *Metcash* para 61.

³⁶ See *Metcash* para 61.

III. JUDICIAL ATTITUDE

(a) *BACKGROUND*

There have been numerous court cases within which the courts were approached to preside on the applicability of the 'pay now, argue later' principle in particular circumstances.³⁷ The courts have always presided on the issues raised by the parties to the proceedings before them but never has any court of law considered the 'pay now, argue later' principle from a holistic point of view, hence the different decisions. The courts have never questioned the implementation of the principle and the fairness in respect thereof. Courts have only considered the end results of the principle.³⁸

There is only one court case that has reached the highest court in SA, and such court case only dealt with issues raised regarding the VAT Act.³⁹ Although the wording regarding the VAT Act was materially similar to the language used in the ITA, the two Acts differ to a large extent and the tax issues that emanate from either Act differ. The VAT Act is self-executing while the ITA is primarily executed by the Commissioner for SARS. Therefore, it cannot be said that such a court case sets a precedent for both the VAT Act and the ITA from a Constitutional challenge perspective, however, from a VAT perspective, this judicial decision does set a legal precedent in respect of ITA matters as it was adjudicating on VAT matters.

Concerning the court cases that followed the decision of the Constitutional Court judgment about the 'pay now, argue later' principle, there seems to be some on-going confusion and misunderstandings regarding the policy. There are further two High Court cases that appear to be in conflict with each other.

Therefore, the attitude of the courts towards the application of the principle will be analysed in detail in the discussions that follow.

(b) *METCASH TRADING LIMITED V/S C:SARS*

The question advanced in the *Metcash Trading Ltd v CSARS* 2001 (1) SA 1109 (CC) was whether the 'pay now, argue later' principle provisions, as they then stood, unjustifiably limited the right of access to courts protected by s 34 of the Constitution.⁴⁰ Notwithstanding

³⁷ See *Metcash, Singh, Capstone, and Mokoena* cases.

³⁸ See *Metcash* reasoning in this regard.

³⁹ See *Metcash* court case.

⁴⁰ See *Metcash* Para 1.

the noting of an appeal, a taxpayer was obliged to pay the assessed value-added tax, possible adjustments and refunds being left for later dispute and determination.⁴¹

The case came before the Constitutional Court from the High Court, which had held that the provisions were neither reasonable nor justifiable.⁴²

The provisions were then declared invalid by the High Court and certain ancillary orders were made, including an interdict preventing the Commissioner for SARS from enforcing the payment of the assessed tax pending the conclusion of *Metcash's* appeal.

The main contention by *Metcash* was that the provisions were illusory or inadequate as they compelled the taxpayer to pay up and can but only hope to get the money back from SARS.⁴³ This provisions were said to be analogous to the provisions dealt with in the case of *Chief Lesapo v North West Agricultural Bank and Another* 2000 (1) SA 409 (CC) as they permit self-help and therefore oust the jurisdiction of the courts to a certain extent.⁴⁴

The Constitutional Court, however, illustrated as part of its judgment that, the Commissioner for SARS is not a judicial officer and assessments and the concomitant decisions by the Commissioner for SARS are administrative, not judicial actions.⁴⁵ It then follows that a challenge to such actions before the Special Court or board is not an appeal in the sense of the word.⁴⁶ What does this mean for the current s 174 of the TAA that provides that the statement must be treated as a civil judgment lawfully given in the appropriate court of law in SARS' favour?⁴⁷

The Constitutional Court further held that, in its textual context and on its plain wording the ss is concerned with ensuring that two but related objectives were met.⁴⁸ Namely, first, that the obligation of the aggrieved vendors to pay their tax and associated tax is not delayed by their pursuing remedies regarding the VAT Act and, second, that where necessary refunds, plus interest, will be made later.⁴⁹

⁴¹ *Supra Metcash.*

⁴² See *Metcash* para 5.

⁴³ See *Metcash* para 9.

⁴⁴ *Chief Lesapo v North West Agricultural Bank and Another* 2000 (1) SA 409 (CC) para 19.

⁴⁵ See *Metcash* para 32.

⁴⁶ *Supra Metcash.*

⁴⁷ See s 174 of the TAA.

⁴⁸ See *Metcash* para 34.

⁴⁹ *Supra Metcash.*

The principle concerning the VAT Act was held to concern only the suspension of the obligation to pay the assessed VAT amount and after that tax chargeable under the Act.⁵⁰ It was held by the Constitutional Court that it does not afford the Commissioner for SARS any authority to circumvent the courts.⁵¹

One controversial aspect of the decision of the Constitutional Court is when it said that, the Commissioner for SARS must be able to justify his decision not to suspend the obligation to pay as being rational.⁵² The question is, to whom does the Commissioner for SARS justify his decision not to suspend the obligation? The Commissioner for SARS is a party to the case, and as such, there is a possibility that the Commissioner for SARS might fail to be objective in justifying his decision. It is my submission that the interpretation of the tax laws in *Metcash* by the Constitutional Court ignored the context within which the principle applied.

In *Metcash*, there was no mention of the impartiality of the Commissioner for SARS. Furthermore, I submit that the Constitutional Court failed to mention that, this is not just like any other administrative action, the tax legislation has always been interpreted differently, and this too, could apply to its implementation. To challenge the Commissioner for SARS' decisions might be costly to some taxpayer and not all taxpayers will be in a position to take the matter further. As much as the Constitutional Court had to listen to the arguments advanced by the respective parties to the case, the Constitutional Court should have considered the public interest in light of the taxpayers' interest who are in fact the public. Certainty is vital in the implementation of the various tax legislations.

However, in the *Metcash* court case, it is to be noted that the Constitutional Court's emphasis was based on the VAT Act and not the ITA. The Constitutional Court held that the scheme of VAT instituted by the VAT Act is rather complex and for efficacy, it is self-regulatory by registered vendors and regular periodic payments of VAT are mandatory.⁵³ By holding this position, the court's main point was that the VAT Act by its nature was susceptible to fraud by vendors. The VAT position can, however, be distinguished with the income tax rules which do not rely on self-regulation by taxpayers for efficacy.⁵⁴ Therefore the Constitutional Court's decision in *Metcash* can be persuasive to a certain extent on income tax matters in respect of

⁵⁰ See *Metcash* para 22.

⁵¹ *Supra Metcash*.

⁵² See *Metcash* para 42.

⁵³ See *Metcash* para 60.

⁵⁴ *Supra Metcash* para 60.

the principle. Therefore, each case in this regard should be evaluated based on its circumstances.

Considering that the majority of disputes between the taxpayer and the Commissioner for SARS are resolved by the courts of law, one could argue that conferring such powers upon the Commissioner for SARS knowing fully that the decision can favour either party makes the Commissioner for SARS a judge in his case. It can be further pointed that the decision is reversible by the Court of law, however, in the process, some taxpayers may suffer some financial distress.

The Constitutional Court illustrated that the very nature of VAT is that it is the vendor that calculates, collects and pays the tax on each transaction and because each such payment must be backed by the supplier's records and vouchers, the scope for factual disputes in good faith is very limited.⁵⁵ It is always a possibility that VAT vendors might commit fraud in respect of the VAT amounts that are owed to SARS.

Based on the discussion advanced, one can conclude that the Constitutional Court was forced to hold against the taxpayer due to the nature of the VAT Act. In the VAT system, vendors undertake periodic calculations and determine the balance of output as compared to input totals, the balance of which is paid to SARS.⁵⁶ As such, vendors are regarded as involuntary tax collectors. It so happens that, this makes it easier for vendors to defraud SARS.

(c) *SINGH V/S C: SARS - SCA*

The SCA in *Singh v Commissioner for the South African Revenue Services* 2003 (4) SA 520 (SCA) analysed the relevant provisions of the VAT Act, which were mostly similar to the provisions of the ITA.⁵⁷ In this case, the SCA confirmed that the Commissioner for SARS's right to file a statement was only suspended pending an objection but not pending an appeal.⁵⁸

The SCA further held that an amount may be due but not yet payable to SARS.⁵⁹ This may be the case with an assessed amount before the final determination of a dispute, to the extent that

⁵⁵ See *Metcash* para 70.

⁵⁶ B Croome & L Olivier, *Tax Administration: Tax Liability and Payment, Chapter 11*. 2nd ed. Juta. 2015 pg 373.

⁵⁷ See *Singh* para 16.

⁵⁸ See *Singh* para 4.

⁵⁹ See *Singh* para 11.

such assessment in question, is finally found to be correct, that amount was due and payable when the return was rendered.⁶⁰

The SCA emphasised that taking a judgment against a vendor and proceedings for sequestration or liquidation may, therefore, take place while an appeal is pending.⁶¹ The SCA further illustrated that SARS might only approach a court for judgment after the objection provisions regarding the VAT Act.⁶²

The SCA in this regard made a distinction between the objection phase and the appeal phase. As referred to above, the Commissioner for SARS cannot proceed with the judgment within the objection stage but may do so at the appeal stage.

(d) *MOKOENA V/S C: SARS – SGHC*

In *Mokoena Albert Sepataka v CSARS* 2011 (2) SA 556 (GSJ), the taxpayer challenged the judgement obtained by the Commissioner for SARS on the basis that he had not been made aware of the judgment until he approached Nedbank for a bond and a credit check revealed this outstanding monetary judgment against the taxpayer.⁶³

This case concerned the then ss 91, 91A and 92 of the ITA.⁶⁴ These ss 91, 91A and 92 dealt with recovery of tax and the correctness of assessment respectively.⁶⁵ The Commissioner for SARS believed that there was what was termed ‘unexplained income’ based on an income tax audit conducted by SARS.⁶⁶

The court discussed the powers conferred on the Commissioner for SARS under the then, s 78 of the ITA read with ss 79, 81(1), 89 and 91 of the ITA which empowers the Commissioner for SARS to obtain a judgment based on an estimate.⁶⁷

The court emphasised that the provision is draconian and should, therefore, be exercised with care by appropriately experienced and suitably qualified personnel since it may otherwise be reduced to an arbitrary decision by the Commissioner for SARS with grave after effects to the

⁶⁰ *Supra Singh* para 11.

⁶¹ *See Singh* para 19.

⁶² Section 32 of the then VAT Act, *Singh* case at para 35.

⁶³ *Mokoena Albert Sepataka v CSARS* 2011 (2) SA 556 (GSJ) para 2.

⁶⁴ *Supra Mokoena* para 4.

⁶⁵ *Supra Mokoena* para 4.

⁶⁶ *See Mokoena* para 8 and 9.

⁶⁷ *Supra Mokoena* para 10.

taxpayer.⁶⁸ This assertion in *Mokoena* was made by the court because the Commissioner for SARS is entitled, even if there is an objection or an appeal, to seize and realise taxpayer's assets notwithstanding that the Commissioner for SARS' actions may jeopardize the taxpayer's cash flow and the proper running of the daily activities of the business.

It has to be noted that in this case, the Commissioner admitted to the fact that he was wrong in his estimations relating to the assessment in question.⁶⁹ The Commissioner's incorrect estimate was based on a duplication of certain amounts which suggest that suitably qualified or experienced persons were not engaged to perform the forensic analysis or accounting calculations.⁷⁰ In the end, the results were fundamentally flawed.⁷¹

The court admitted that it is self-evidently incompetent, having regard to the taxpayer's rights of objection and appeal, to obtain a judgment in the interim.⁷² The court further went to illustrate that such conduct is inconsistent with the framework of the ITA and its provisions.⁷³ The express right to collect tax despite an objection and appeal would be unnecessary if the judgment could be obtained in the interim.⁷⁴

This Court in *Mokoena* also pointed to the fact that, the issues involved reveal the dangers in the exercise of powers by the Commissioner to estimate taxes based on an effective lifestyle audit under s 78(1) and the implementation of an assessment under that. If care is not taken to ensure that before a statement is filed under s 91(1)(b) of the Act that responsible individuals at SARS office is content that there is no pending objection or appeal.⁷⁵ This case does not accord with the *Singh* judgement as discussed as the SCA in *Singh* case distinguished between the objection and the appeal phase.

A further inference was made that this case, suggests that individual checks and balances may be required to guard the rights of taxpayers in the implementation of s 91(1)(b).⁷⁶

⁶⁸ *Supra Mokoena* para 10.

⁶⁹ See *Mokoena* para 12 - 14

⁷⁰ See *Mokoena* para 13.

⁷¹ *Supra Mokoena* para 13.

⁷² *Supra Mokoena* para 16.

⁷³ *Supra Mokoena* para 17.

⁷⁴ See ENS, "taxpayer victory as "pay now, argue later" principle successfully challenged". 3 September 2015 <https://www.ensafrica.com/news/taxpayer-victory-as-pay-now-argue-later-principle-successfully-challenged?Id=1959&STitle=tax%20newsflash> last accessed 12 October 2016.

⁷⁵ *Supra Mokoena* para 19.

⁷⁶ *Supra Mokoena* para 20.

The court, therefore, held that s 91(1) as it then stood did not provide adequate safeguards to the way in which it is implemented and possibly to continue satisfying the requirements of constitutional proportionality.⁷⁷

Also, the court held that the statement by the Commissioner for SARS should clearly indicate that-⁷⁸

- (i) *“The assessment relied upon is an estimated assessment under the exercise of the powers conferred under section 78(1) of the Act;*
- (ii) *The suitability of the qualification and experience of the person to conduct the estimated assessment; and*
- (iii) *Finally, that the responsible person has satisfied himself or herself from the records maintained by SARS that no objection or appeal is pending or if lodged has been finally disposed of or so that there is no impediment to filing the statement.”*

The distress caused by the Commissioner's mistake to the taxpayer is significant. Had this been dealt with by an impartial, yet qualified and experienced individual, the court processes that taxpayers had to go through to get the decision of the Commissioner for SARS to be rescinded would have been avoided at a lesser cost. It is appalling to note that despite an opportunity on the objection phase for SARS to change its decision, SARS still did not see anything wrong with its assessment until the court was called upon to adjudicate on the matter.

This paper does not seek to address the validity of the principle, and the Constitutional Court has already validated the principle's existence, but rather the implementation of the principle by SARS personnel. Contrary to other cases, this case, in my opinion, denotes the very part that has not been directly challenged by taxpayers before the courts. The implementation and the suitability of SARS officials tasked with implementing the principle.

It is evident from the court's judgment above that it is possible for SARS to make a mistake. Therefore, an objection and an appeal should be lodged and executed before the final determination by the Commissioner for SARS.

The court concluded by suggesting to the Commissioner that, appropriate safeguards against similar errors occurring in future must be put in place.⁷⁹

⁷⁷ *Supra Mokoena* para 21.

⁷⁸ *Ibid* note 74.

⁷⁹ See *Mokoena* para 22.

(e) *CAPSTONE 556 (PTY) LTD V/S CSARS [2011] ZAWCHC 297 AND
KLUH INVESTMENTS (PTY) LTD V/S CSARS - WCHC*

The *Capstone 556 (Pty) Ltd v CSARS [2011] ZAWCHC 297* court case was heard together with *Kluh* court case on agreement by the two taxpayers.⁸⁰ The two taxpayers sought relief following an assessed tax liability under the ITA.⁸¹ Even after this court case, the ‘pay now, argue later’ principle remains controversial.

The parties, in this case, were seeking leave to appeal against the judgment which dismissed their application for interim relief prohibiting SARS from taking any further steps to enforce its assessment finding on their tax affairs.⁸²

The Judge in these two cases was, however, not persuaded that there is a reasonable prospect that another court will arrive at a different conclusion in respect of the construction of s 88 of the ITA to that reached by the Western Cape High Court ("WCHC").⁸³ The learned Judge also stressed that there is no version of s 88 of the ITA requiring SARS to consider the merits of the pending tax appeal in making its decision.

The implications of the WCHC decision in *Capstone* was that SARS is entitled to refuse a suspension request if it considered the appeal to be frivolous or vexatious.⁸⁴

Based upon the Supreme Court of Appeal court case of *Singh* discussed above, it was held that an assessed amount remains payable before the final determination of the dispute, even if it later transpires that it was not due at any time.

The WCHC in *Capstone* further held that, while s 88 of the ITA suspension is in place, the amount remains payable, but the taxpayer's obligation to make payment is unenforceable by the Commissioner for SARS.⁸⁵ Therefore collection by the Commissioner for SARS is at this moment excluded. However, it does not alter the status of the assessed tax as payable.⁸⁶ Furthermore, two categories of assessed tax are envisaged by the ITA, namely, payable, but suspended and payable and exigible.

⁸⁰ *Capstone 556 (Pty) Ltd v CSARS [2011] ZAWCHC 297* para 1.

⁸¹ *Supra Capstone* para 1.

⁸² *Supra Capstone* para 47.

⁸³ *Supra Capstone* para 9.

⁸⁴ *Supra Capstone* para 39.

⁸⁵ *Supra Capstone* para 42.

⁸⁶ *Supra Capstone* para 42.

In these two court cases, the applicants were unable to establish a reasonable prospect of success on review.⁸⁷

The applicants also accused the Commissioner of SARS of bias due to the proximity in timing of the decision to refuse the taxpayer's request for a suspension and the decision of the Commissioner in *Kluh* case. The High Court found that the applicants did not establish a sound basis for their insinuation. Further to that, there was also no basis for the accusation of procedural unfairness.

The above court case clearly illustrated that each instance would be determined on a case by case basis depending on the circumstances in question and either the taxpayer or SARS will succeed and fail to advance its arguments before the court of law.

One can argue that if a partial party decides on both the objection and the appeal phases, the taxpayer might be discouraged to take the matter further to court. At times taxpayers would just choose to take the matter further, not because they think they are right, but because taxpayers do not have confidence in the decision made by SARS officials and hope that the court might decide otherwise.

(f) NO ESTABLISHED GUIDANCE FROM THE JUDICIARY

It was a common occurrence that the decision between the parties in the proceedings, and rightly so, the decision by the Commissioner for SARS concerning the ITA provisions to refuse or withdraw a suspension of the taxpayers' payment obligations constituted administrative action. Therefore a review of an administrative action will unquestionably be subject to the provisions of the Promotion of Administrative Justice Act 3 of 2000.⁸⁸

From the court cases discussed above, it is clear that the judiciary's attitude in respect of the provisions dealing with the implementation of the 'pay now, argue later' principle is not yet settled. Subject to the circumstances of each case, courts can still reach a differing conclusion. *Metcash* case dealt with VAT, and in this respect, it does not set a precedent for income tax matters. The Constitutional Court referred to other countries which also use the VAT system

⁸⁷ See *Kluh* and *Capstone*.

⁸⁸ *Supra Capstone* para 15.

and illustrated that, they too, follow the 'pay now, argue later' principle. Croome and Olivier argue that this is not the case with income tax.⁸⁹

SARS in this respect cannot have taxpayers believing that there is no room for discussion or debate on the existence or scope of the principle.⁹⁰ It cannot then be concluded that the Constitutional Court has laid a static rule in *Metcash* as the judgment only related to VAT Act and not the ITA.

It is also evident from the above court decisions that every court is adopting a varying approach. However, it is only the SGHC in *Mokoena* that considered the shortfalls of the implementation of the provisions by SARS as it questioned the suitability of the SARS officials who are tasked with making the decisions having examined the factors as laid down in the TAA. RC Williams writes that, in the ITA, there is far more scope for genuine dispute about income tax liability than liability for VAT.⁹¹ More so, the courts are faced with different circumstances.

(i) *SUPREME COURT OF APPEAL*

The SCA in *Singh* case in reaching its judgment made a distinction between two phases, one being the objection phase and the other being the appeal stage. The SCA was of the view that, a taxpayer can object and in the process of opposing, SARS cannot go on and enforce the provisions in respect of the 'pay now, argue later' principle until all the processes have been completed.

The SCA approach, however, differed with that of the High Courts in *Capstone* and *Mokoena*.

In general, taxpayers object because they believe that the outcome of the assessment as conducted by SARS is not correct. However, the whole process of determining the outcome of the objection is carried out by SARS. At times, SARS, like any other administrative body, might be guilty of reaching an illogical conclusion concerning its assessment. So to entrust it with this power at this stage of the process might be unfair to the taxpayer, while an independent person (e.g. Tax Ombud and courts of law) can be of great assistance. However,

⁸⁹ *Ibid* see note 56 pg 375.

⁹⁰ RC Williams, "Unresolved aspects of the "pay now argue later" rule". 07 February 2012 <http://www.thesait.org.za/news/83050/Unresolved-aspects-of-the-pay-now-argue-later-rule.htm> accessed on 29 November 2016.

⁹¹ *Ibid* RC Williams note 90.

this was the highlight of what one believes are the shortfalls that underlie the 'pay now, argue later' principle.

On income tax matters, taxpayers are doing to SARS what SARS is doing to vendors in VAT matters. SARS believe that it is easier for vendors to defraud them as the due VAT amount is determined by the suppliers.⁹² Taxpayers equally believe that SARS can be wrong in some of its assessments on income tax matters as the assessed amount is determined by SARS.⁹³

(ii) *HIGH COURT CASES: MOKOENA & CAPSTONE*

The High Court divisions have jurisdiction over defined areas and judgments from the High Courts are binding on Magistrates' Courts in their respective jurisdictions.⁹⁴ Therefore the decisions of the WCHC in *Capstone* and the SGHC in *Mokoena* are binding on Magistrates' Courts within their areas of jurisdiction respectively.

The confusion and misunderstanding regarding the controversy of the principle in the context of the ITA as portrayed by the WCHC and the SGHC respectively shows there is no predetermined interpretation of the provisions in respect of the principle. RC Williams also wrote that the two High Courts came to a diametrically opposite conclusion on the most significant aspects of the rule.⁹⁵

Following my analysis, *Mokoena's* case dealt with an uninformed decision made by a new tax official while the *Capstone* case had to do with issues in respect of a vexatious appeal by the taxpayers. The court in *Capstone* said that there was no prospect of success by the taxpayers. The court in *Mokoena* emphasised that the principle is severe and as such, the Commissioner for SARS must exercise its powers in implementing the policy with caution. The *Capstone* case did not touch much on the principle as it felt that the taxpayer did not have a case against SARS.

The SGHC in *Mokoena* held that, if a taxpayer objects against an assessment, the Commissioner for SARS cannot after that take 'judgment' against the taxpayer regarding s 91(1)(b). But must await the determination of the objection and any appeal to the Tax Court or the superior courts.

⁹² See *Metcash* case para 20.

⁹³ See *Mokoena* case para 13.

⁹⁴ The South African Judiciary. <http://www.judiciary.org.za/high-courts.html> last accessed 29 November 2016.

⁹⁵ *Ibid* RC Williams note 90.

In Capstone, the WCHC held that SARS decision does not have the rights determining the character of a judiciary delivered judgment, and it is a mere recovery provision. In this case, the taxpayer had no legal basis for interdicting SARS from taking a judgment against him.

The different decisions in this respect illustrate that none of the court cases set any precedent concerning the way in which courts will interpret the s 164 provisions.

IV. A JUSTIFIED DISCRETIONARY POWER OR SARS IS A JUDGE IN ITS CAUSE!

(a) BACKGROUND

As a general norm, it was welcomed that the provisions dealing with the 'pay now, argue later' principle are repealed and replaced by s 164 of the TAA. In the various court cases, as discussed above, SARS had a reasonable concern that taxpayers may seek to lodge trivial objections to postpone the fixed payment of tax due. It is also believed that the Commissioner for SARS requires the power to insist on the timeous payment of that tax where, in the Commissioner for SARS' opinion, had taxpayer lodged a shallow objection, failing which the payment due would be in an invidious position.⁹⁶ But it is paramount that balance is struck between the need for SARS to have an appropriate legislation to enforce paying tax and the rights of taxpayers, thereby ensuring the proper collection of tax and the rights of the taxpayers.⁹⁷

Revenue authorities face diverse challenges within their tax systems. Countries have different ways of enacting and implementing their tax policies. Therefore, a standard approach to tax administration may be neither practical nor desirable in a particular instance. However, this should not deter an appropriate tax authority from upholding the principles of fairness.

This chapter seeks to evaluate and raise issues in respect of the discretionary powers of SARS regarding s 164 of the TAA to collect the assessed tax amount before the taxpayer raises any objection in respect thereof. In light of the principles of natural justice, whether or not SARS is a judge in its course. *Metcash* judgment and the rights of the taxpayer will be considered.

The chapter will further discuss some of the rights which taxpayers are entitled, followed by the brief discussion of Part B of the TAA which covers objection and appeal phases. The principles of natural justice and the factors concerning s 164(3) will be discussed. The chapter will conclude by highlighting some of the issues arising from the provisions.

⁹⁶ See article by B Croome titled, "*Dear SARS: Objections and Appeals*". 1 May 2008 <http://www.accountancysa.org.za/dear-sars-objections-and-appeals/> accessed on 29 November 2016.

⁹⁷ *Ibid* see footnote 96.

(b) *THE RIGHTS OF THE TAXPAYERS*

The uncertainty in respect of the principle as it stands is that the requirements in s 164 are onerous. They do not cater for the taxpayer during the duration of the objection and appeal phase.

The taxpayer who is aggrieved under the ITA is allowed to object to the Commissioner for SARS, where after the taxpayer can appeal the Commissioner's decision not to allow the objection.⁹⁸ At this stage, the application of the principle may infringe upon the right of access to court as guaranteed under s 34 of the Constitution and could not be justified under the limitation clause as envisaged in s 36 of the ITA.⁹⁹

To avoid any counter argument to the point raised, it has to be noted that, in *Metcash*, the Constitutional Court referred to the provisions of fiscal statutes in other countries and indicated that most countries, which have VAT systems in place, make use of the 'pay now, argue later' principle.¹⁰⁰

In a study approved by the OECD Council on 27 April 1990, a survey of twenty countries in 1990 evaluated whether there is a suspension of tax payment when an assessment is under appeal.¹⁰¹ The study concluded that two-thirds of countries surveyed allowed for postponing tax due, pending the hearing of an appeal.¹⁰² To the contrary, the *Singh* case discussed above illustrate that during the appeal phase, the Commissioner for SARS can take steps to recover the tax due.¹⁰³

The study also found that most countries did not have explicit taxpayer's rights.¹⁰⁴ However, the study recognized that the following fundamental rights were present in many tax systems: the right to be informed, assisted and heard; the right of appeal; the right to certainty; and the right to privacy; and the right to confidentiality and secrecy.¹⁰⁵

⁹⁸ Section 104(3) of the TAA.

⁹⁹ The Constitutional Court in *Metcash* as held by Kriegler J did acknowledge that this principle limits the taxpayer's right of access to court, but the limitation is justifiable. Para 9 and 27 of the *Metcash* judgment.

¹⁰⁰ *Ibid* B Croome see note 96.

¹⁰¹ OECD Committee on Fiscal Affairs Forum on Tax Administration, "*Taxpayers' Rights and Obligations*" – *Practice Note*. 27 April 1990 [https://www.oecd.org/tax/administration/Taxpayers' Rights and Obligations-Practice Note.pdf](https://www.oecd.org/tax/administration/Taxpayers%20Rights%20and%20Obligations-Practice%20Note.pdf) accessed 23 October 2016.

¹⁰² *Ibid*, note 101.

¹⁰³ See *Singh* case para 4

¹⁰⁴ *Ibid* note 101.

¹⁰⁵ *Ibid* note 101.

The current provisions on the principle are onerous and do not give the taxpayer hope when dealing with the Commissioner for SARS. SARS wield more discretionary powers that can place the taxpayer in a bad financial position when successfully exercised.

(c) *OBJECTION AND APPEAL – PART B OF THE TAA*

The powers given to SARS regarding s 164 of the TAA are not expressly made subject to the objection and appeal provisions which are believed to form an integral part of the administration of tax in SA.¹⁰⁶ The nature of SARS' powers in enforcing the principle prohibits the taxpayers from using the simpler and more practical objection and appeal process in Part B of the TAA, and as such, the taxpayer will just have to take the matter straight to court for review under PAJA. However, the PAJA route is costly and not every taxpayer will manage to utilise it.

Taxpayers may not object or appeal SARS' decision concerning the TAA provisions but may do so concerning the PAJA provisions by taking the matter on review to the High Court. As correctly put by Croome & Olivier, the taxpayer would be required to make the case to the High Court on the ground that SARS has failed to comply with its obligations under PAJA as a public body.¹⁰⁷

The vexation encountered by taxpayers in their attempt to apply for the suspension of the payment is that the eFiling system of SARS does not yet cater for the submission of the requests by taxpayers online, writes Croome & Olivier.¹⁰⁸ When filed, such requests by taxpayers are neither acknowledged nor attended to by SARS.¹⁰⁹

In most cases, the first time taxpayers become aware of the fact that a tax amount is due to SARS is when a SARS' collection department alert them demanding payment of that tax amount despite having lodged an objection with SARS.¹¹⁰ Taxpayers are mainly not accorded enough opportunity to handle this. In respect of the assessed amount, taxpayers always have to be granted the chance to object and to request for reasons from SARS, however, dealing with SARS' collection department; the whole system becomes flawed as the usual procedures are ignored. The *audi alteram partem* principle is not be observed.

¹⁰⁶ Chapter 9, Dispute Resolution. TAA.

¹⁰⁷ *Ibid* see note 56 pg 381.

¹⁰⁸ *Ibid* see note 56 pg 381.

¹⁰⁹ *Ibid* see note 56 pg 381.

¹¹⁰ *Ibid* see note 56 pg 381 and 382.

Apart from the above challenge, the taxpayer's prospects of success are limited to a large extent. Van Schalkwyk argues that the lack of success by taxpayers who have challenged the principle might lead taxpayers into believing that they are fighting a losing battle and should this always be the case, this might increase the already low tax morality on taxpayers and the high incidence of tax evasion in SA.¹¹¹

There is significant pressure on SARS to meet its collection target, so as such, SARS, as a judge in a case to which it is a party, will always have its best interests. Some of the challenges faced by taxpayers in respect of the principle could be avoided if it was being implemented by an independent party and not by SARS as a judge in its case.

There is also no time frames that the Commissioner can adhere to regarding this s 164(3) provisions.¹¹²

Section 164 of the TAA should, therefore, be made subject to Part B which deals with objections and appeals to avoid rendering Part B provisions nugatory on disputes involving the principle.

(d) PRINCIPLES OF NATURAL JUSTICE AND SECTION 164(3) FACTORS

There is a presumption that illustrates that a statute is not unjust, inequitable or unreasonable. This presumption goes to the bottom of what citizens believe a legal order should, at any rate, seek to achieve while it avoids as far as is humanly possible, personal hardships.¹¹³ *"Justice emphasises the need for operative institutions, norms and procedures that express, accommodate and put into operation a society's sense of fair play. Equity underlines the need for a personalization and particularization of institutional, normative and procedural justice. Lastly, reasonableness emphasises the need for rational, considered and justifiable decision-making."*¹¹⁴

Two areas in which the presumption has traditionally held sway can be distinguished:¹¹⁵ *"onerous provisions have been construed restrictively, these include provisions encroaching on vested rights and imposing burdens as well as penal provisions; and where the legislature authorizing a public official or body to take action that may adversely affect the rights of an individual, or where the*

¹¹¹ L van Schalkwyk, "Constitutionality and the Income Tax Act – revisited" Meditari Accountancy Research Vol. 12 No. 2 2004: 185–201.

¹¹² The South African Institute of Tax Practitioners, "Call for comment – Draft Taxation Laws Amendment Bill 2009; Draft Taxation Laws Second Amendment Bill 2009". 18 June 2009 accessed at SABINET Law Journals subscription required.

¹¹³ Du Plessis 1998 Stell LR 239 – 242 accessed at LexisNexis.

¹¹⁴ Baxter *Administrative Law* ch 13 accessed at LexisNexis.

¹¹⁵ *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530.

individual has a legislative expectation, the said legislation has been construed to include the person's right to be heard."

(i) ONEROUS PROVISION – AFFECTING EXISTING RIGHTS

Historically it was said to be a "*well-established rule in the construction of legislation that where a statute is capable of different interpretations, that one should be preferred which does not take away existing rights unless it is plain that such was the intention of the Legislature.*"¹¹⁶

It is understood that the restrictive understanding of onerous statutory provisions, including those interfering with existing rights, is in agreement with the value system of the Constitution.¹¹⁷ A court is, as a matter of fact, enjoined to invoke the Constitution and subsidiary constitutional legislation, where applicable, as prime sources for the assessment of such encroaching legislation.¹¹⁸

In addition to the above, reliance on the common law to deal with statutory encroachments on rights not protected under the Constitution is still allowable.¹¹⁹ The SA bill of rights does not deny the existence of any other rights or freedoms that are recognised or conferred by common law, customary law or legislation, to the extent that they are consistent with the bill of right.

(ii) ONEROUS PROVISIONS – IMPOSING BURDENS

The propensity has always been to understand legislation that imposes obligations on subjects restrictively.¹²⁰ Just like the statutory provisions interfering with the existing rights, a restrictive understanding of onerous regulations is in harmony with the value system of the Constitution.¹²¹ However, there is no explicit provision in the Constitution from which the necessity for such restrictive approach can be deduced.

In *Partington v A – G* (1869) 21 LT, the court said that the taxation laws have most often been dealt with as manifestations of statute law imposing burdens, resulting in the recognition of a presumption *contra fiscum* for the construction of tax provisions.¹²² In the taxing legislation,

¹¹⁶ Hahlo and Kahn *SA Legal System and its Background* p 208.

¹¹⁷ *Ibid* note 113.

¹¹⁸ *Ibid* note 113.

¹¹⁹ *Manyeka v Marine & Trade Insurance Co Ltd* 1979 2 ALL SA 491 (SE), para 848 F – G.

¹²⁰ *Supra Manyeka* para 848 F – G.

¹²¹ *Ibid see* note 114.

¹²² *Partington v A – G* (1869) 21 LT para 370 to 375.

one has to look at what is apparently said.¹²³ There is no equity in tax.¹²⁴ There is no presumption as to tax. Nothing is to be read in, and nothing is to be implied.¹²⁵

However, the courts have in due course, parted with the idea that there is something unique about tax laws and tax legislation and have since been treating tax legislations like all other burdensome enactments.¹²⁶ The presumption *contra fiscum* had been held to be decisive in favour of the person sought to be taxed only in cases of doubt that is in the absence of clear and unambiguous language.

(iii) *THE RIGHT TO BE HEARD*

If the legislative authorises a public official or body to take action that may adversely affect the rights of the, or where an individual has a legislative expectation, such legislation is, in agreement with a fundamental conception of 'fair play' presumed to include the person's right to be heard.¹²⁷

However, this presumption has ceased to be the prime source of the *audi alteram partem* rule requirement, at least in respect of administrative proceedings. PAJA has been adopted in SA to give effect to the constitutional entrenchment of a right to administrative justice.¹²⁸ The enacted legislations that were previously inconsistent with the PAJA, especially in so far as such legislation relates to the '*audi alteram partem*' rule, have been repealed by implications and by force of s 33 of the Constitution.¹²⁹

In the matter of *Bailey v Commissioner for Inland Revenue* 1933 AD 204, the court indicated that a Special Court under the Income Tax Acts is not an appeal court in the ordinary sense, but a court of revision with the power to investigate the matter and to hear the evidence thereon.¹³⁰ If the Special Court arrives at the conclusion that the appellant is liable for the tax, which the Commissioner for SARS has levied, the Special Court is not precluded from upholding the same merely because its conclusion is based on the basis other than that

¹²³ *Supra Partington.*

¹²⁴ *Supra Partington.*

¹²⁵ *Commissioner for Inland Revenue v George Forest Timber Co Ltd* 1924 AD 516 Para 531 – 532.

¹²⁶ *Ibid George Forest Timber & Delfos* AD cases.

¹²⁷ *R v Ngwevela* 1954 1 ALL SA 286 (A) para 131 H.

¹²⁸ Section 3 and 4 of the PAJA Act.

¹²⁹ Section 33 of the Constitution, 1996.

¹³⁰ *Bailey v Commissioner for Inland Revenue* 1933 AD 204.

advanced by the Commissioner for SARS in support of his levy, provided the maxim *audi alteram partem* rule is observed.¹³¹

(iv) *SARS: A JUDGE IN ITS CAUSE!*

SARS cannot be a judge in a case to which it is a party. This statement accords to the principle of natural justice, namely the '*nemo judex sua causa*'. This principle means, "*no-one should be a judge in his cause*". SARS has a vested interest in the case and cannot be an impartial arbiter. This principle has been strictly applied to any appearance of possible bias, even if there is none. At the heart of fair trials, there is a principle that was acknowledged by the Constitutional Court in *S v Dzukuta and Others*¹³² which provides that, justice must not only be done but must be seen to have been done.

Section 164(3) of the TAA list the factors that must be considered by a Senior SARS official before suspending payment of the disputed tax or a portion thereof. The concern about this provision is that SARS as a party to the dispute is provided with the discretionary powers to consider whether the taxpayer has an 'arguable case' against it.

The Constitutional Court had an opportunity to adjudicate on the competence of a public body that did not adhere to the *nemo judex* principle in the case of *Park-Ross and Another v The Director, Office for Serious Economic Offences* 1995 (2) BCLR 198 (C). The *Park-Ross* case dealt with s 6 of the Investigation of the Serious Economic Offences Act 117 of 1991.¹³³ Section 6 allowed the director to enter and search premises and to seize any property including books and documents and remove them without authorization from an impartial party.¹³⁴ The director was also given the discretion to authorise persons to carry out such search and seizure.¹³⁵

In delivering its judgment, the court referred to *Hunter* case on the *nemo judex* principle and said, "*The Combines Investigation Act, required the Director to obtain a certificate from a member of the restrictive trade practices commission before a search or seizure which was an emphasis on accountability before the fact.*"¹³⁶

¹³¹ *Supra Baily* court case.

¹³² *S v Dzukuta and Others* 2000 (11) BCLR 1252 (CC) para 28.

¹³³ *Park-Ross and Another v The Director, Office for Serious Economic Offences* 1995 (2) BCLR 198 (C) para 1 one accessed at LexisNexis.

¹³⁴ *Supra Park-Ross* Page 203.

¹³⁵ *Supra Park-Ross* Page 203.

¹³⁶ *Supra Park-Ross* Page 209.

In *Park-Ross* court case the Judge said that "*in his view, investing the members of the commission with significant investigatory functions has the result of vitiating the ability of a member to act in a judicial capacity when authorising a search and seizure. The Judge further emphasised that this was not an attack on the honesty or good faith of the commission or its members. It was rather a conclusion that the administrative nature of the commission's investigatory duties ill accords with the neutrality and detachment requisite to assess whether the evidence reveals that the point has been reached where the interest of the individual must constitutionally give way to those of the State. He further said that the maxim nemo iudex catches a member of the RTPC passing on the appropriateness of the proposed search under the combines' investigation Act in sua causa [my underlining, for emphasis]."¹³⁷ Such member of the commission simply cannot be a fair-minded arbiter necessary to grant a valid authorization at all times, the Court held.*

On this basis, it is submitted that an impartial party, be it the Tax Ombud or an individual with an appropriate experience or expertise in interpreting legislation, may be mandated with the implementation of the 'pay now, argue later' principle. Having an impartial party might be crucial to achieve equity and justice between the parties and subsequently, give hope & confidence to the taxpayer.

In light of the Constitutional Court's judgment in *Park-Ross*, it is, therefore, my view that similar limitations should apply to the Commissioner for SARS on the powers vested in him regarding s 164 provisions. It has to be noted that it is the Commissioner for SARS who must first determine if the taxpayer has an arguable case against the revenue authority.¹³⁸

(e) *INADEQUACIES TO THE PRINCIPLE*

As indicated above, it is clear that there is and will always be a dispute between SARS and the taxpayer for as long as the legislation remains onerous and arbitrary. As always, a distinction must be drawn between the situation in which the taxpayer initiates disputes just to delay the process and the situation within which the taxpayer genuinely thinks the assessment by SARS might be incorrect.

The importance of the court cases highlighted in this paper is potentially far-reaching.

¹³⁷ *Supra Park-Ross* Page 222 of [1995] 2 All SA 202 (C).

¹³⁸ *Ibid*, see note 116.

A balance between the rights of the taxpayers and SARS' discretionary powers to enforce the application of the principle must, therefore, be achieved. On VAT matters and because of the *stare decisis* principle, the decision in *Metcash* court case is binding on all courts unless it can be proven that the Constitutional Court erred. However, on ITA matters, it cannot then be concluded that the decision is equally binding and persuasive as the two Acts differ.

It was noted by Keulder that, the ongoing confusion and misunderstanding in respect of the principle persist.¹³⁹ Keulder further notes “*that the Commissioner for SARS is a judge in the dispute within which SARS is a party.*” SARS, as a party to the litigation, can decide whether the taxpayer will alienate assets, and can then proceed accordingly with the proceedings.¹⁴⁰ Taxpayers will not have any confidence if the very same party that the taxpayer is saying is wrong is tasked with deciding whether or not the tax payment should be suspended.

Keulder also indicated that it is unclear whether the fraud referred to in the amended section relates only to alleged fraud or to an original fraud conviction.¹⁴¹ More so, “*If an alleged fraud is taken into account, this would be unfair to the taxpayer as he is supposed to be given an opportunity to be heard and defend himself against the allegations.*”¹⁴² The use of the phrase ‘*prima facie*’ suggested that there should not be an actual fraud conviction.¹⁴³ This warrants the taxpayer's defence before the execution of the principle.

One issue not catered for by the current provisions of the TAA is the subject in respect of costs that might be incurred by the taxpayer during the objection and appeal phases and the subsequent court battles with SARS. The payments rendered by the taxpayer to the tax practitioners, lawyers and advocates tasked with gathering evidence and arguing the court case before the court can cause an irreparable financial harm to the taxpayer.

In the court cases discussed in this paper, namely, *Mokoena* and *Capstone* cases, the two High Courts came to entirely two different conclusions in respect of the principle and their attitude on interpreting the principle differed. In *Mokoena*, the High Court held that, while SARS is competent to demand payment of tax pending a decision in the objection or appeal phase based

¹³⁹ C Keulder, “*Pay now, argue later’ rule - before and after the Tax Administration Act.*” PER vol.16 n.4 Potchefstroom Apr. 2013.

¹⁴⁰ *Ibid* note 139.

¹⁴¹ *Ibid* note 139.

¹⁴² *Ibid* note 139.

¹⁴³ *Ibid* note 139.

on the principle, it may not obtain a judgment in the meantime.¹⁴⁴ Mokoena judgment was criticised in *Capstone* as the filing of a statement does not amount to a ruling.¹⁴⁵ However, Binns-Ward J conceded that, *although the filing of a statement is not a judgment, it has the effect of a court decision as SARS will then be able to obtain a writ of execution.*"¹⁴⁶

Binns-Ward J in *Capstone* said that *"although a statement filed by the Commissioner for SARS regarding s 91(1)(b) has all the effects (i.e. consequences) of a judgment, it is nevertheless not in itself a judgment in the ordinary sense. The Commissioner's statement does not determine any dispute or contest between the taxpayer and the Commissioner for SARS"*.¹⁴⁷ It has the effect of a court decision, however, in enabling the Commissioner for SARS to obtain a writ of execution to attach and sell in execution the taxpayer's assets to exact payment of an amount that is payable.¹⁴⁸

It is accepted that legislation is interpreted based on the grammatical and ordinary meaning of the words of the law. The interpretation was echoed by the Supreme Court of Appeal in *Commissioner, SARS v Executor, Frith's Estate*.¹⁴⁹ The Supreme Court of Appeal illustrated held that *"the first rule in the construction of a statutory provision is to ascertain the intention of the legislature. In this respect one seeks to achieve this by giving the words under consideration their ordinary grammatical meaning, unless to do so would lead to an absurdity so glaring that the legislature could not have contemplated it."* The literal approach to interpretation was described in the judgment of *Commissioner for Inland Revenue v Simpson*:¹⁵⁰ *"in a taxing Act, one has to look merely at what is clearly said. There is no equity about 'tax'. There is no presumption as to tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used."*

The approach was, however, qualified to some extent in the case of *R Koster & Son (Pty) Ltd & another v CIR* where it was held that:¹⁵¹ *"in construing a provision of an Act of Parliament the plain meaning of its language must be adopted unless it leads to some absurdity,*

¹⁴⁴ *Supra* see *Mokoena* para 14

¹⁴⁵ *Supra Capstone* para 37.

¹⁴⁶ *Supra Capstone* para 37.

¹⁴⁷ *Supra* see *Capstone* para 38.

¹⁴⁸ See s 174 of the TAA which provides that: *"a certified statement filed under section 172 must be treated as a civil judgment lawfully given in the relevant court in SARS' favour for a liquid debt for the amount specified in the statement."*

¹⁴⁹ *Commissioner for SARS v Executor of the Estate of the Late Waldo Earl Frith* delivered 29 Nov 2000. Para 2

¹⁵⁰ Pieter van der Zwan 'ANALYSIS: INTERPRETATION OF TAX LAW,' 1 February 2015. Accessed at <http://www.accountancysa.org.za/analysis-interpretation-of-tax-law/> last accessed 21 November 2016.

¹⁵¹ *Ibid* see note 150.

inconsistency, hardship or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the Legislature could not have intended."¹⁵²

It is submitted with respect that the judgment of the court in *Capstone* was partly incorrect with its interpretation when it said that the statement does not have the effect of a ruling because this is not what the TAA provide in s 174. The TAA in s 174 provides that the statement and I quote, "... shall be treated as a civil judgment lawfully given in the relevant court in favour of SARS..." in terms of the approach referred to above, the court is not allowed to read different words into the legislation or remove certain words from it to "fix" the legislative act in order to conform to the intention of the legislature that is not reflected by the phrase used in the legislation. If the court endorses the onerousness of this 'pay now, argue later' principle, we will have a situation within which taxpayers lose hope on the very system.

For the Commissioner for SARS or SARS official to grant or refuse to suspend the request for the application of the principle, they must first consider the merits of the taxpayer's argument to determine if it is frivolous or if the argument is used as a delay tactic.¹⁵³ SARS is therefore a judge in a case to which it is a party with a vested interest.

It is eloquent to note that, if the taxpayer's obligation to pay tax pending an objection or an appeal is not suspended, SARS is not prohibited from actively taking steps to enforce the collection of the tax as catered for concerning s 174 of the TAA.

Olivier argues that¹⁵⁴ *"it was never the intention of the taxpayer in Metcash that under the scheme of the Act, the jurisdiction of the courts had been excluded. The Argument was that the principle excludes the jurisdiction of the courts at the time it is invoked. The special income tax court has the power to overturn the decision of the Commissioner for SARS to disallow an objection in a full hearing akin to a trial, and there exists an unqualified right of appeal from a hearing by this court to either a full bench or the High Court or, if the presiding judge so directs, to the supreme court of appeal."*

¹⁵² *R Koster & Son (Pty) Ltd & another v CIR* 47 SATC 23 1985 (2) SA 834 (A).

¹⁵³ S 164(3) of the TAA.

¹⁵⁴ Lynette Olivier, 'Tax collection and the Bill of Rights', TSAR 2001:1.

Olivier further argued that the fact that the 'pay now, argue later' principle may result in the taxpayer not being in a financial position to make use of these other avenues, was not looked at by the Constitutional Court.¹⁵⁵

It is agreed that the taxpayer can have the decision of SARS reviewed concerning PAJA, however, as raised earlier that the review proceedings are extremely limited in nature.¹⁵⁶ As such the Supreme Court of Appeal laid down the grounds for review in the matter between *Johannesburg Stock Exchange and Witwatersrand Nigel Ltd.*

Because the taxpayer cannot inquire as to the validity of the assessment on which the statement is based, one has to ask what the purpose of the review procedure would be in respect of tax matters about the 'pay now, argue later' principle? How will the taxpayer prove that the decision-maker failed to apply his mind to the matter if the validity cannot be questioned prior?

The process of implementing the principle by SARS is in itself grossly unreasonable. Olivier further argues that¹⁵⁷ *"a point not dealt with by the Metcash court case is that, although the commissioner has to inform a taxpayer of an assessment issued concerning the VAT Act, nothing prohibited him from using the summary collection procedures before a vendor is notified. It may thus happen that the summary collection procedures are used against a taxpayer who is not even aware that the Commissioner does not agree with its VAT returns."*¹⁵⁸

Another question one has to ask is whether the powers vested in the Commissioner for SARS are broad and require some limitations. The Constitutional Court in *Dawood v Minister of Home Affairs* struck down individual ss of the Aliens Control Act 96 of 1991 amongst other things on the ground of wide discretionary powers vested with the official.¹⁵⁹

In paragraph 46, O'Regan J reasoned as follows:¹⁶⁰ *"whenever a discretionary power is given to an official, the ground within which such powers have to be exercised have to be provided*

¹⁵⁵ *Ibid* see note 154.

¹⁵⁶ *Ibid* see note 154 and *Johannesburg Stock Exchange and Another v Witwatersrand Nigel Ltd. and Another* (18/1988) [1988] ZASCA 18 para 49 and 50.

¹⁵⁷ *Ibid*, see note 154.

¹⁵⁸ This point was also discussed in *Mokoena's* court case in this paper within which the taxpayer only became aware of the judgment against him when he went to apply for a bond at the bank.

¹⁵⁹ *Dawood and Another v Minister of Home Affairs and Others* 2000 (8) BCLR 837 (CC).

¹⁶⁰ *Supra Dawood* Para 46.

by the respective legislation by reason of the fact that, there is a difference between requiring a court or tribunal in exercising a discretion to interpret laws consistently with the Constitution and conferring a broad discretionary power upon an official, who may be entirely untrained in law and constitutional interpretation and expecting that official, in the absence of proper judicial guidance, to exercise the discretion in a manner consistent with the provisions of the Bill of Rights[my underlining, for emphasis]."

Olivier writes that, *"the mere fact that the exercise of discretion is subject to judicial review does not "relieve the Legislature of its constitutional obligation to promote, protect and fulfil the rights entrenched in the Bill of Rights".*¹⁶¹ The Commissioner for SARS and SARS officials are not exempted from the above references.

The TAA does not provide anywhere in the Act for the taxpayer to be informed of SARS' intention to file a certificate. Since a judgment obtained under s 36 of the VAT Act can be rescinded, it is a proper judicial decision. Therefore the taxpayer's right to be heard is undermined in this respect.¹⁶²

As said in *Mokoena*, SARS must have adequate personnel to execute the principle. Olivier also argues that, even though one can be sympathetic of the Commissioner for SARS who is tasked with enforcing sophisticated tax legislation systems in SA with insufficient and inadequately trained personnel against unscrupulous taxpayers, one cannot help but wonder that indeed the right of access to court has been debilitated by the Constitutional Court in *Metcash*.

(f) *OTHER CONSIDERATIONS*

(i) *FRIVOLOUS AND VEXATIOUS REQUESTS*

Beric Croome writes that *"I accept that the Commissioner has a reasonable concern that taxpayers may seek to lodge a shallows objection to postponing the fixed payment of tax amount."*¹⁶³

In Arnold BJ's opinion prepared for the SA Commissioner, Croome & Olivier writes that the Canadian taxpayers are restricted from paying taxes if the tax amount due and payable is

¹⁶¹ *Ibid* see note 154

¹⁶² *Ibid* note 116.

¹⁶³ *Ibid* see note 86 and also see *Motsepe v Commissioner of Inland Revenue* 59 SATC 245 [1997].

subject to a dispute.¹⁶⁴ On some large corporations, the Canadian revenue authority takes an immediate collection action for the one-half of the tax assessed until the 90 day period of filing an objection has passed.¹⁶⁵ Arnold in this instance concluded that s 88 of the ITA is both reasonable and justifiable in a democratic society, writes Croome & Olivier.¹⁶⁶ Arnold's opinion is compelling.

It has to be noted that SARS is faced with the challenge of determining which disputes are frivolous and which ones are genuine. Are SARS officials qualified enough to determine which of the taxpayer's arguments are frivolous and vexatious? Lack of adequately trained SARS officials to implement the provisions of s 164 is a cause for concern and uncertainty amongst taxpayers and the SA tax system.

The one question that arises in respect of the Constitutionality of the principle is, had it not been the VAT Act, was a different court going to hold a differing view? Croome argues that a different court would likely agree with the Metcash case on the basis that the tax act is a law of general application and as such, it applies to all taxpayers.¹⁶⁷

(ii) RECOVERY PROCESS

The fact that there is nothing within s 164 prohibiting the Commissioner for SARS from pursuing the summary action despite the taxpayer's objection to the assessment outcome or the taxpayer not being aware of the Commissioner's deliberate recovery actions is a further cause for concern and uncertainty.

There are also economic implications on the business of the taxpayer who might be owing SARS. To a certain extent, the implementation of the principle endangers jobs and future tax payments. Take for instance a situation within which SARS in the process of recovering the tax amount due goes on to sequester the business of the taxpayer despite the tax amount owed being subject to a tax dispute before the court and the taxpayer comes out of the court victorious.

In this respect, Croome & Olivier asks whether the Commissioner for SARS may proceed to liquidate or sequester a taxpayer even before the finalisation of the dispute by the court and

¹⁶⁴ *Ibid* see note 56 pg 375.

¹⁶⁵ *Ibid* see note 56 pg 375.

¹⁶⁶ *Ibid* see note 56 pg 375 and 376.

¹⁶⁷ *Ibid* see note 56 pg 376 and 377.

under such circumstances, the court rules in the taxpayer's favour, what will happen under such circumstances?¹⁶⁸

Reference was further made to the Australian case of *Deputy Commissioner of Taxation v Broadbeach Properties (Pty) Ltd* [2008] HCA 41. In this case, the High Court of Australia upheld statutory demands for tax debts against three related property development companies.¹⁶⁹ The Commissioner had disallowed the objections and proceeded with the recovery of debts from taxpayers.¹⁷⁰ Broadbeach ended up being wound up as it was unable to settle the tax debts owed.¹⁷¹ The court held that the operations of the receiver laws could not be avoided by an application regarding s 459G to delay the statutory demand by the Commissioner.¹⁷²

It is regrettable that taxpayers in Australia do not enjoy the protection of their rights as is the case in SA where the Bill of Rights caters for such rights, write Croome and Olivier.¹⁷³ Under similar circumstances, one can only hope that an SA court can reach a different conclusion when faced with the same issue in the Australian court in Broadbeach.

In SA, the Commissioner for SARS is obliged to act reasonably and in compliance with the Constitution. Although SA courts have not adjudicated on a case similar to the Australian case, the obligation to pay an amount of tax due and the right of SARS to collect the tax amount are not suspended due to the noting of an objection and appeal by the taxpayer, just like in Australia.

SARS is concerned with the fact that, there are instances where assets can be dissipated before it recovers a tax amount and this concern is legit. However, there are also cases where a taxpayer's business might be going through some financial difficulties and in such instances, it is true that SARS might have a legitimate concern on the possibilities of recovering the tax amount owed.

Whether the payment or guarantee thereof of the tax amount in dispute will cause irreparable financial hardship to the taxpayer depends on the circumstances. Take, for instance, a situation

¹⁶⁸ *Ibid* see note 56 pg 377.

¹⁶⁹ *Ibid* see note 56 pg 377.

¹⁷⁰ *Ibid* see note 56 pg 377.

¹⁷¹ *Ibid* see note 56 pg 377.

¹⁷² *Ibid* see note 56 pg 377.

¹⁷³ *Ibid* see note 56 pg 377.

within which the taxpayer holds assets that cannot be readily turned into cash and SARS was to force the taxpayer into liquidation before the dispute is resolved, writes Croome & Olivier.¹⁷⁴ In such a case, if the court finds in the taxpayer's favour, the taxpayer will find it substantially difficult to recoup those assets. Surely this provision requires a careful interpretation and implementation thereof.

In instances similar to the example given above, the taxpayer, despite having a good ground of disputation, will be forced to give in to SARS recovery process due to lack of funds to take the matter forward. It will not be easy for the taxpayer to show its financial hardship unless SARS is willing to meet the taxpayer halfway instead of extracting funds and forcing the taxpayer to sell the only assets they want to use to save their business from liquidation. Some of the taxpayer's assets might have been held as an investment for some time and realising them under forced circumstance might expose the taxpayer into financial hardships.¹⁷⁵ At times the assets might not be enough to pay off the debt to SARS.

Another shortfall with the current setting of s164 is that it presumes that the taxpayer's defence is frivolous and just a waste of time. There is no such presumption in general law. The presumption by s 164, which the taxpayer is wrong, is one of the aspects of our current tax system that only caters mainly for SARS.

Furthermore, the tax system constantly requires interpretation due to its complexity. It takes long for taxpayers to recover their money from SARS. The lengthy refund process has not been addressed. Not forgetting the issues dealt with earlier in this paper about the threat of forced liquidation.

(g) *SIMILAR CHALLENGES IN OTHER JURISDICTIONS BUT VARYING APPROACHES*

The purpose of this comparison is simply to depict how the law in other countries has been enacted to address the problem of tax recovery pending an objection and an appeal. The contrast will add to the conclusion that would perhaps instigate the SA legislators into taking another look at the implementation of the 'pay now, argue later' principle in SA. The law to

¹⁷⁴ *Ibid* see note 56 pg 379.

¹⁷⁵ *Ibid* see note 56 pg 379.

be considered would be for the following countries, UK, Australia, United States, New Zealand and Canada respectively.

(i) UK

The UK legislation frequently provides for ‘recovery of taxes not in disputes’.¹⁷⁶ Section 55(2) of the Taxes Management Act, 1970("TMA") provides that, *"notwithstanding that an appeal is pending, such part of the assessed tax as appears to the Commissioner not to be in dispute shall be collected and paid in full respects as if it were tax charged by an assessment in respect of which no appeal was pending, and on determination of an appeal, any balance of tax chargeable in accordance with the decision shall be paid, or any tax overpaid shall be repaid, as the case may be."*¹⁷⁷

The taxpayer and the Commissioner in the UK can also enter into an agreement in respect of the tax amount that is due.¹⁷⁸ The provision also caters for the transfer of the dispute from the Commissioner to another body for a resolution.¹⁷⁹ This other body is chaired by the so-called Commissioners whose determination shall be final. Should the taxpayer opt to take the matter forward, at this stage, notwithstanding an appeal, the taxpayer shall pay the amount pending the final decision by the High Court as determined by the Commissioners.¹⁸⁰

The principle is also used on backdated taxes by HM Revenue & Customs (“HMRC”).¹⁸¹ This system is aimed at wealthy tax dodgers. In this respect the principle allow HM Revenue & Customs to demand backdated taxes to be paid, in full, within a three-month deadline. This also relates to backdated taxes from many years ago.¹⁸²

Previously, HMRC was forced indulge in court battles in pursuit of the missing tax monies owed to HMRC by taxpayers prompting the Government to approve the legislation in 2014.¹⁸³ The passing of the legislation was to prevent the expenditure incurred by the UK government in fighting court battles with taxpayers.

¹⁷⁶ Section 55 of Taxes Management Act 1970.

¹⁷⁷ Section 55(2(a)-(b) of the TMA.

¹⁷⁸ Section 56(6) of the TMA.

¹⁷⁹ Section 55(7) of the TMA.

¹⁸⁰ Section 56(9) of the TMA.

¹⁸¹ K Palmer, “HMRC uses new powers on contractors and freelancers: ‘I was told to pay £30,000 within 90 days’”. 20 September 2015. <http://www.telegraph.co.uk/finance/personalfinance/tax/11865618/HMRC-uses-new-powers-on-contractors-I-was-told-to-pay-30000-within-90-days.html> last accessed 21 October 2016.

¹⁸² *Ibid* see note 181.

¹⁸³ *Ibid* see note 181.

A current rule, mainly known as 'schedule 39' has been introduced in the UK and enables HMRC to assess income taxes from 4 years ago unless it can prove that the taxpayer was careless, in which case the time-limit is six years. HMRC has far longer, 20 years if it can demonstrate you are a 'deliberate' tax avoider.¹⁸⁴ The process is a fair and just as the HMRC does not have a platform to abuse its powers. It has to prove that the taxpayer was deliberate before the court of law.

Therefore, in the UK, the HMRC has to show before it exercises power to enforce the principle that the taxpayer is a deliberate tax avoider. To the contrary, in SA, the burden is on the taxpayer who has to prove why the principle has to be suspended and SARS after due consideration of the taxpayer's circumstances will grant or refuse to suspend the application of the principle.

(ii) AUSTRALIA

In Australia, the position is more or less similar to the SA position. The liability to pay tax, additional tax or any tax amount that is due and payable is not suspended due to the noting of a review or an appeal. Section 14ZZM of the Tax Administration Act, 1953 provides as follows, "*The fact that an investigation is pending concerning a taxation decision does not in the meantime interfere with, or affect, the decision and any tax, additional tax or another amount may be recovered as if no review were pending.*"

More so, there are time limits in respect of lodging an appeal with the Federal Court against an objection decision which is 60 days after the person appealing is served with notice of the decision.¹⁸⁵

However, in Australia, the Commissioner is not forced by any legislation to re-pay the tax amount until all of his rights have been exhausted. Despite successive wins by the taxpayer within lower courts, the Commissioner will not re-pay the tax amount until the highest court has held otherwise.¹⁸⁶

Croome & Olivier note in their book that, the uncertainties of unfounded appeals are a significant distress to the revenue authority in Australia as well.¹⁸⁷ To address this, the

¹⁸⁴ *Ibid* see note 181.

¹⁸⁵ Section 14ZZN of the Tax Administration Act, 1953.

¹⁸⁶ Section 14ZZL and ZZQ of the Tax Administration Act, 1953.

¹⁸⁷ *Ibid* see note 56 pg 376.

Australian Taxation Office (“ATO”) introduced a so-called ‘Compliance Model’ in 1998.¹⁸⁸ The ATO Compliance Model was introduced as a means to improve Australian management of taxpayer compliance processes.¹⁸⁹

In summary, the ATO's methods of recovering tax were thoroughly criticised during the 1990s with the inclusion of media reports on/about ATO's poor practices.¹⁹⁰ Bully-boy tactics and accusations of excessive and unfair use of their power in the attempt to collect the tax amount.¹⁹¹ The criticism regarded as a direct attack on their tax system and its future as the ATO was accused of lacking understanding of many taxpayer's positions.

The ATO responded to the criticism by introducing the Compliance Model which endeavored to replace their previous ‘command and control enforcement’ approach to a program of active and inclusive tax implementation.

The ATO began to give consideration to contemporary, and future compliance as this was not given consideration by their previous bureaucratic approach.¹⁹² The ATO officers were now inclined to show more patience and tolerance rather than the regulatory authority for the aim was not to punish taxpayers but to secure long-term voluntary compliance by taxpayers.¹⁹³ Obtaining current and future tax payments from the same taxpayers became a goal in Australia.

As a result, the ATO has preferred to adopt an approach that will encourage self-regulation, or voluntary compliance by the taxpayers so as to build cooperation and lasting relationships with the taxpayers.¹⁹⁴

The above ATO Compliance Model has thus far been adopted by the UK¹⁹⁵ and the OECD has equally expressed some interest¹⁹⁶ in the Model. However, if SA is to do the same so as

¹⁸⁸ K Murphy, ‘Moving towards a more useful model of regulatory enforcement in the Australian Taxation Office’. Centre for Tax System Integrity, The Australian National University, Canberra. 2004 BTR: No. 6.

¹⁸⁹ *Ibid* see note 188.

¹⁹⁰ *Ibid* see note 188.

¹⁹¹ *Ibid* see note 188.

¹⁹² *Ibid* see note 188.

¹⁹³ *Ibid* see note 188.

¹⁹⁴ *Ibid* see note 188.

¹⁹⁵ For a public pronouncement on the adoption of the Compliance Model in the UK Inland Revenue see Inland Revenue – ‘The Government’s Expenditure Plans 2002 – 2004 (2002); see also *Inland Revenue Managing Customer Relationships: What does compliance mean in the Future?*’ Inland Revenue.

¹⁹⁶ S Hamilton, “Putting the client first: The emerging Copernican Revolution of Tax Administration (2003) *Tax Notes International*”, February, 569-576.

to ameliorate the principle, an extensive research must be conducted with the various stakeholders involved.

Therefore, although an accommodating approach will be adopted in Australia, a deterrence approach cannot then be abandoned as this might in the end work against the fiscus. Those who persist with non-compliance while the fiscus is creating a platform for collaboration should be penalised accordingly and harshly.

The ATO Compliance Model had included some success stories and experiences by the taxpayers, however, for purposes of this paper, such stories will not be discussed.

The discussion above has been just to provide an overview of what approach Australia has adopted in dealing with the non-compliant taxpayers and where or not they utilise a similar approach to SA.

(iii) THE UNITED STATES OF AMERICA

In the US, where a written request has been formally filed in the Tax Court for the non-payment of a tax amount due, the Internal Revenue Code (“IRC”) does not allow the revenue authority to collect the tax amounts due until the decision of the Tax Court has been Finalised.¹⁹⁷ The IRC goes to provide that *“the making of such assessment or the beginning of such proceeding or levy during the time the prohibition is enforced may be enjoined by a proceeding in the proper court”*.¹⁹⁸

However, what has been stated above is the US' general position, and as it is known in law, there is mainly an exception to every general legal status. The noteworthy exception being if the revenue finds that a taxpayer intends to depart from the United States quickly or to remove his/her property or to do any other act which would render ineffectual proceedings to collect income tax.¹⁹⁹

(iv) NEW ZEALAND

The New Zealand tax administration law caters for taxpayers who lodge a competent objection. As such, s 128(2) of the Tax Administration Act, 1994 provides as follows, *“a taxpayer is not liable to pay the deferrable tax relating to any tax in dispute; or a shortfall penalty, where the penalty is payable in respect of any tax in dispute; or the interest accruing under Part 7 on*

¹⁹⁷ United States Code Title 26 section 6213.

¹⁹⁸ United States Code Title 26 section 6213.

¹⁹⁹ United States Code Title 26 sections 6213, 6851.

that deferrable tax or that gap penalty, until the due date for payment of that deferrable tax." Therefore in New Zealand, whether or not the amount of tax which must be paid subject to an appeal is determined by whether the taxpayer made a 'competent objection' or not.

Apart from ss 128(2) above, ss 128(2B) provides that, should the Commissioner be of the opinion that there is a noteworthy risk that the tax in dispute will not be paid should the taxpayer not succeed in objection proceedings, the Commissioner may require the taxpayer to pay such amount.²⁰⁰ An amount of tax not in dispute is payable.²⁰¹

Should the demand for the deferrable payment by the Commissioner place the taxpayer's business or personal circumstances in prejudice, the Commissioner may opt to waive the tax amount provided there is no risk to the revenue in waiving such payment.²⁰²

(v) CANADA

The Canadian Income Tax Act reads as follows in section 225.1(1), *"If a taxpayer is liable for the payment of a amount assessed under this Act, other than an amount determined under subsection 152(4.2), 169(3) or 220(3.1), the Minister shall not, until after the collection-commencement day with regard to the amount, do any of the following for the purpose of collecting the amount:*

- *commence legal proceedings in a court;*
- *certify the amount under section 223;*
- *oblige a taxpayer to make a payment under subsection 224(1);*
- *need an institution or a person to make a payment under subsection 224(1.1);*
- *require a person to turn over money under ss 224.3(1); or*
- *give notice, issue a certificate or make a direction under subsection 225(1)."*

The law in Canada was formally similar to that of Australia, an amount of tax subject to a dispute was due and payable notwithstanding the noting of an appeal by the taxpayer.

However, just like in New Zealand above, in Canada, the revenue authority can collect the tax amount immediately if it can prove that the ability to raise would be jeopardised by any objection and appeal.

²⁰⁰ Section 128(2B) of the Tax Administration Act, 1994.

²⁰¹ Section 128(1) of the Tax Administration Act, 1994.

²⁰² Section 128A of the Tax Administration Act, 1994.

Should the taxpayer bring a frivolous appeal and the revenue authority becomes successful, a penalty will be levied as this would be viewed as a tactic to delay the payment of tax owing.²⁰³ Section 179.1 of the Income Tax Act, 1985 provides that, "*Where the Tax Court of Canada disposes of an appeal by a taxpayer in respect of an amount payable under this Part or where such an appeal has been discontinued or dismissed without trial, the Court may, on the application of the Minister and whether or not it awards costs, order the taxpayer to pay to the Receiver General an amount not exceeding 10% of any part of the amount that was in controversy in respect of which the Court determines that there were no reasonable grounds for the appeal, if in the opinion of the Court one of the primary purposes of instituting or maintaining any part of the appeal was to defer the payment of any amount payable under this Part.*"

(vi) REMARKS

The legal position discussed above only portray how other countries have endeavoured to balance the public interest and the powers of their respective revenue authorities. The legislators have attempted to limit the credentials of their respective tax authorities, and as such, taxpayers have some remedies as their rights have been recognised and protected to a certain extent.

The approaches adopted cannot in any way be viewed as absolving taxpayers who seek to delay they payment of the tax amount from a penalty.

Therefore, it is possible to balance the powers of the revenue authority, public interest and the rights of the taxpayers. Courts as always play a significant role in resolving the disputes. Apart from Australia, the UK, Canada, US, and New Zealand respectively require the revenue authority to prove why an amount of tax or part thereof should be paid pending the determination of an objection and an appeal, something that lacks within SA.

²⁰³ Section 179.1 of the Income Tax Act, 1985.

V. CONCLUSION

Once upon a time, a billionaire, Dave King, once said, “*I might have the resources to fight it out in court, but what about the man in the street who can’t? Many times, taxpayers are paying taxes they genuinely do not believe they owe, simply because the consequences of standing up to the receiver are too onerous.*”

SARS indeed has a valid concern in respect of taxpayers having to lodge an objection aimed at delaying tax payments. With a compelling need of revenue by the Government of SA, the susceptibility of the tax system to fraud and evasion, it was necessary to enact legislation that enables SARS to secure the tax revenue without any undue delays by taxpayers. The Constitutional status of the principle was validated by the Constitutional Court in *Metcash* as it is believed that the VAT Act by its nature is self-regulatory and taxpayers might be inclined to defraud the state of its revenue. This Constitutional validation from a VAT does not set a precedent for ITA matters as the two Acts are distinguishable.

The judiciary for that matter has not set any precedent, and therefore guidance can be derived from various court cases. The Constitutional Court in *Metcash* validated the Constitutionality of the principle, i.e. the principle is necessary. However, the question of whether SARS is the right party to implement the principle remains. The SCA in *Singh* case made a distinction between the objection and appeal phases. The SCA further held that the decision by SARS is not a judgement, while the provision in s 172 provides otherwise. *Mokoena* and *Capstone* case differed in their interpretation. However, varying circumstances influenced the different approaches by the courts. There remains a limited guidance in respect of the implementation of the principle.

SARS has been vested with a discretionary power to decide on a disputable matter. Whether or not SARS is the right party to implement the principle remains debatable. The implementation of the principle has dire consequences for the taxpayers. SARS has targets to meet and will do all it can to be successful in recovering the revenue from the taxpayer. Therefore, taxpayers will remain vulnerable. SARS cannot be a judge in a matter to which it is also a party.

Some taxpayers might not have the financial capacity to take the issue further on review. The refund process remains a lengthy and costly process for taxpayers; therefore, taxpayers who have a competent objection and are in a position to service the tax amount due should be

evidently protected by the legislation. SARS should in this respect provide proof why the amount should be payable immediately.

The current legislation does not give taxpayers hope. The Commissioner for SARS is not required to prove the underlying facts of the assessment, such as the particulars of the taxpayer, assessable income, allowable deductions, rebates and credits. Evaluation and the amount due is presumed to be correct by the TAA. Lack of limits to these discretionary power is also a cause for concern and require revision.

Therefore the provisions further place the Commissioner for SARS in a position in which he can independently bring the tax debt amount into existence. The Commissioner for SARS is not required to provide a detailed explanation of the legal basis of the assessment of the taxpayer and the burden of proof as to why the principle should be suspended is on the taxpayer.

A balance has to be placed on enforcement of tax laws and the rights of taxpayers. As much as SARS wants to collect money on behalf of the government, taxpayers are also contributing towards assisting the government by creating employment and other benefits towards the economy. Treating the taxpayer as guilty until proven innocent does not make the taxpayer less relevant to the economy.

The powers vested within SARS must continue to exist; however, the enforcer of those powers must be independent of SARS and the taxpayer. Having an independent party enforcing the provisions of s 164 would give hope to the taxpayers as SARS is currently an adjudicator in a case to which SARS is a party. The taxpayer will always have hope towards the fiscus in this respect. Perhaps the office of the Tax Ombud can exercise this s 164 discretionary powers to avoid additional court cases.

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2. International Tax Paper:

Limitation of interest deduction in South Africa: a suggested approach to the application of sections 31 and 23M of the Income Tax Act 58 of 1962 to debt and equity business financing methods

By

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To my family and my late Uncles: Joseph and Phillip Tseisi, I dedicate this paper to you.

ABSTRACT

The South African income tax system acknowledges the financing of resident companies by a related non-resident company through the use of debt and equity. However, the use of debt financing method is a cause for concern to the South African Revenue Services as it results in the base erosion and profit shifting of taxable profits through mispricing and excessive interest deductions. Section 31 and 23M were inserted into the South African Income Tax Act 58 of 1962 to address excessive debt levels and interest deductions.

The objective of this paper is to analyse the rationale behind the use of debt and equity financing methods. This paper will also discuss the application of both s 31 and s 23M. Due to the close connection of s 31 and s 23M to debt transactions, an approach on how the two sections can be applied is suggested.

This paper finds that the provisions of both s 31 and s 23M are applicable to the same set of facts. The paper also finds that s 31 provisions are applied to determine if a company has excessive debts taking into account the arm's length principle while s 23M provisions are applied to limit interest deductions. The paper suggests that the legislature should provide guidance on the interplay of the two provisions and in the absence of any guidance, the provisions of s 31 should be applied first followed by the provisions of s 23M.

I. BACKGROUND

(a) OVERVIEW

For many years and long before the G-20 and the launch of the Organisation for Economic Cooperation and Development's ("OECD") Base Erosion and Profit Shifting Project ("BEPS), the actual tax treatment of interest payments has proven to be a challenge for revenue authorities.²⁰⁴ The issue stemming from basic questions like, what is 'debt or equity'? And other practical tax administrative concerns on the determination of interest deductions from related party debt.

Internationally, interest is generally deductible for income tax purposes, while dividends are generally not deductible. Dividends are payable only after the company has made profit whilst interest is mainly payable even though the company does not have any taxable income.²⁰⁵ This led Multinational companies into preferring to fund their overseas operations by way of debt instead of equity.²⁰⁶

Debt transactions produce a tax deductible interest return while dividend only produces an after-tax investment return.²⁰⁷ The use of debt financing led countries into introducing legislative provisions in an attempt to limit interest deductions pertaining to the debt and also the amount of debt funding in relation to equity funding, these provisions are commonly known as 'thin capitalisation' rules.²⁰⁸

With effect from 19 July 1995, South Africa introduced s 31²⁰⁹ into the Income Tax Act 58 of 1962 (the "Act") with its primary focus on transfer pricing in South Africa. Arnold & McIntyre define transfer pricing as follows:²¹⁰ *"A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example, company A manufactures goods in country A and sells them to its foreign affiliate, company B, the price at which that sale takes place is called a transfer price. A transfer price is usually contrasted with a market*

²⁰⁴ Peter Barnes, "Limiting Interest Deductions: Papers on Selected Topics in Protecting the Tax Base of Developing Countries." 23 September 2014 Accessed at

http://www.un.org/esa/ffd/tax/2014TBP2/Paper_LimitingInterestDeductions.pdf last accessed 12 December 2016.

²⁰⁵ L Olivier & M Honiball, 'International Tax: A South African Perspective 2011'. 5th ed Siber Ink CC pg 649.

²⁰⁶ *Ibid* note 205 pg 649.

²⁰⁷ *Ibid* note 205 pg 649.

²⁰⁸ S Webber, 'Thin capitalisation and interest deduction regulations'. December 2011. Copenhagen Research Group on International Taxation – CORIT Discussion paper no 8 2010. Accessed at <http://corit-academic.org/wp-content/uploads/2011/12/CORIT-8-Thin-Capitalization-and-Earnings-Stripping-Regulations-2-1.pdf> last accessed 11 December 2016.

²⁰⁹ National Treasury, 'Explanatory Memorandum on the enactment of s 31 of the Income Tax Act 58 of 1962,' 1999, page 16 and 17. Accessed at <http://www.osall.org.za/docs/2011/02/1999-Revenue-Laws-Amendment-Billpdf> last accessed 13 November 2016.

²¹⁰ Arnold & McIntyre, 'International Tax Primer'. 2002 pg 55.

price, which is the price set in the marketplace for transfers of goods and services between unrelated persons.” De Koker writes that the definition of transfer pricing is broad and would include, ‘thin capitalisation’.

De Koker further defines thin capitalisation as follows:²¹¹

"Thin capitalization, often regarded as a category of transfer pricing, relates to the funding of business with a disproportionate degree of debt in relation to equity so as to provide the foreign investor with the benefit of having the interest income derived therefrom exempt. While, at the same time, conferring upon the company the tax advantage relating to the deductibility of interest payments on the debt (as opposed to the non-deductibility of dividends distributed on equity capital). Consequently, thin capitalisation provisions are applied to limit the deductibility of interest on the excessive debt funds, thereby protecting the South African economy against distortion resulting from heavily geared foreign investments".

Until 19 July 1995, thin capitalisation rules were applied to foreign investors by the Exchange Control Department of South African Reserve Bank in terms of the Exchange Control Act (“ECA”).²¹² The ECA provisions catered for debt to equity ratio of 3:1.²¹³ However, following an advice from the Katz Commission, s 31 was introduced into the Act. In terms of s 31, two adjustments towards the limitation of interest deduction and the amount of debt offered were provided: namely, the transfer pricing adjustment mechanism which is aimed at the interest rate charged by the non-resident creditor to a related party and the thin capitalisation rules as an adjustment mechanism which was aimed at the amount of debt in relation to the equity of the relevant investment company.²¹⁴

Commencing from 1 October 2011, s 31 was significantly amended. The provisions of the amended s 31 are wider and capture both direct and indirect funding arrangements for transfer pricing purposes. The new amendments abolished the safe harbour provisions for thin capitalisation and now uses the arm's length principle to determine the permissible interest rate and debt amount. The disallowed portion of interest will then be subjected to s 31(3), namely the secondary adjustment. If the receiver of the interest which is subject to the

²¹¹ De Koker, ‘*Silke on South African Income Tax*’, Volume III (2016) LexisNexis. Para 17.54.

²¹² *Ibid* note 205 pg 650.

²¹³ *Ibid* note 205 pg 650.

²¹⁴ *Ibid* note 205 pg 651.

secondary adjustment provision is a company or a person, that portion will be deemed to be a dividend or a donation respectively.

In a nutshell, the new s 31(2) necessitate the taxpayer to make a transfer pricing adjustment in determining its taxable income. The transfer pricing adjustment ensures that the transaction entered into between connected taxpayers in relation to each other conforms to the arm's length principle. The arm's length principle will be applied in this respect to determine if any term or condition of the transaction is consistent with what would have existed had those connected persons been independent persons dealing at arm's length.

With effect from the years of assessment commencing on or after 1 January 2015, s 23M was also introduced into the Act.²¹⁵ The purpose of s 23M of the Act as set out in the explanatory memorandum is to limit interest deductions payable by a resident taxpayer to a non-resident creditor who is in a controlling relationship with the South African taxpayer.²¹⁶

The explanatory memorandum further provides that the transfer pricing methods that seek to limit excessive interest owed to exempt persons were largely incomplete.²¹⁷ However, the explanatory memorandum refers to the old s 31 safe harbour provisions on the formula based approach of fixed capital to debt.²¹⁸ It does not address how the current s 31(2) transfer pricing provisions of s 31(2) will interact with s 23M towards limiting interest deductions in South Africa.²¹⁹

The explanatory memorandum does, however, address the fact that, interest withholding tax is mainly halted by tax treaties by reducing the imposed withholding tax rate from 15 per cent to zero per cent. Apart from this, s 50E²²⁰ of the Act does not deal with the issue of limitation of interest deductions. But for the scope of this paper does not cover the discussion of s 50E, therefore, the provisions will not be discussed further. The focus of this paper will be mainly on the application of the provisions of s 31 and s 23M to debt and equity financing methods.

²¹⁵ See s 61 of the Tax Law Amendment Act, 2013.

²¹⁶ National Treasury, 'Explanatory memorandum on the taxation laws amendment, Bill: Limitation of Interest Deduction in respect of debts owed to persons not subject to tax.' 24 October 2013. Para 2.6. accessed at <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2013-02%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202013.pdf> last accessed 15 November 2016.

²¹⁷ *Ibid* note 216.

²¹⁸ *Ibid* see note 216.

²¹⁹ *Ibid* see note 216.

²²⁰ Section 50E provides as follows: "subject to subsection (2) and (3), any person who makes payment of any amount of interest to or for the benefit of a foreign person must withhold an amount of withholding tax on interest calculated at the rate contemplated in section 50B(1) from that payment."

(b) PROBLEM STATEMENT

Non-resident taxpayers are exempted from paying normal tax on interest income received from South Africa in terms of s 10(1)(h) of the Act. This results with taxpayers preferring debt financing method whilst the South African Revenue Services (“SARS”) view this as a threat to South Africa’s tax base.

The introduction of s 23M while there is s 31 of the Act has been controversial. What creates the controversy is the fact that there is no guideline on the application of s 23M and 31(2) to debt transactions.

(c) INTRODUCTION

William E Simon, a former Secretary of Treasury of the U.S and a philanthropist once said, *"The nation should have a tax system that looks like someone designed it on purpose."* The description of debt and equity financing methods will be provided. The paper will also analyse the purpose and application of s 31 and s23M of the Act. A brief discussion on how the s 31 and s 23M can be applied on a similar transaction will be analysed. The paper will conclude with a discussion on the suggested interplay between s 31 and s 23M on a debt transaction between related parties.

II. BUSINESS FINANCING

(a) OVERVIEW

There are two ways in which non-residents can finance their domestic subsidiary operations in South Africa, namely by the injection of debt or equity or both debt and equity.

Peter Barnes defines debt financing as a debt instrument classically known as a loan or a bond entitling the creditor a fixed, periodic return, regularly called interest.²²¹ The creditor does not have holding interest in the borrower, therefore the creditor does not share in the profits of the debtor.²²² The creditor has preference ahead of shareholders in a business in the event of insolvency and any default.²²³

Equity, on the other hand, portrays an ownership interest.²²⁴ Equity financing is the raising of funds by issuing shares.²²⁵ Shareholders participate in the risks as well as the profits of the business.²²⁶ Shareholders rank below creditors in case the business goes into bankruptcy or liquidation.²²⁷ The shareholder will receive payments in the form of dividends from the business.

For South African income tax purposes, interest expense is viewed as an ordinary business expense and is allowed as a deduction by the South African Revenue Services in determining the taxpayer's taxable income.²²⁸ And the interest payment is treated as income for tax purposes in the hands of the non-resident creditor.

With regard to equity, the dividend payment is not regarded as an ordinary business expense and a deduction is not allowed for income tax purposes.²²⁹ The payment of dividend represents the amount of profit left after tax has been deducted on a capital investment.²³⁰ The tax implications of a dividend payment will depend on the domestic tax system or double tax agreement ("DTA") applicable between the taxpayer and non-resident creditor or investor. South Africa applies a withholding tax on the dividends paid to non-resident investors,

²²¹ Peter Barnes, "Limiting Interest Deductions: Papers on Selected Topics in Protecting the Tax Base of Developing Countries." 23 September 2014 Accessed at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_LimitingInterestDeductions.pdf last accessed 12 December 2016.

²²² *Ibid* see note 221.

²²³ *Ibid* see note 221.

²²⁴ Who Owns Whom Dictionary, "Securities Market Terms." 2008/9 ed pg 37.

²²⁵ *Ibid* see note 224 pg 37.

²²⁶ *Ibid* see note 224 pg 37.

²²⁷ *Ibid* see note 224 pg 37.

²²⁸ See section 1 of the Act on the definition of 'taxable income' and Part I of Chapter II of the Act.

²²⁹ *Ibid* see note 221.

²³⁰ *Ibid* see note 221.

although this largely depends on the rates provided by the provisions of the applicable DTA.²³¹ Therefore foreign investors have the option of using debt or equity to fund their subsidiaries in South Africa.

(b) *DEBT AND EQUITY FINANCING*

Most non-residential multinational companies prefer using the debt financing method to their South African subsidiary operations.²³² There are various tax and non-tax reasons attached to this method of financing.²³³ A business may choose to borrow money to expand their operations for various reasons, namely:²³⁴

- Some businesses may be in need of some financial assistance in order to expand without the dilution of their ownership or control thereof, and debt financing is the only way to achieving this; and
- To enable the initial investors to increase the pool of available capital and this can only be achieved by bringing more funds by injecting a debt in order for the initial investors to be paid before equity investors receive a return on their investments.

Whether the debt was sourced to grow certain parts of the business operations such as buying property or credit facility in an attempt to support their working capital, the interest expense incurred in respect of the debt will be treated as a normal business expense and will be allowed as a deduction against the business' taxable income.²³⁵

(c) *RELATED PARTY DEBT FINANCING*

For purposes of this paper, debt and equity financing transactions to be discussed will be those between related parties for South African income tax purposes.

It has been noted that non-residents multinational companies prefer using debt in order to assist their subsidiaries.²³⁶ Debt at times can be used in relation to the capitalisation of a company.²³⁷ For example, a company can provide debt funding and equity to a newly incorporated subsidiary. See the example provided below:

²³¹ Annet Wanyana Oguttu, 'An overview of South Africa's withholding tax regime'. 10 February 2014 accessed at <http://www.thesait.org.za/news/160184/An-overview-of-South-Africas-withholding-tax> last accessed 11 October 2016.

²³² National Treasury, 'Base Erosion & Profit Shifting: Interest Deductibility, Action 4'. 25 May 2016 accessed at <http://discover.sabinet.co.za/webx/access/policydocuments/policies16/DP051266.pdf> last accessed 21 November 2016.

²³³ *Ibid* see note 221.

²³⁴ *Ibid* see note 221.

²³⁵ *Ibid* see note 221.

²³⁶ Michael C Durst, 'Limitation on Interest Deductions: A Suggested Perspective for Developing Countries'. ICTD Working Paper 36. June 2015 accessed at www.ictd.ac last accessed 19 December 2016.

²³⁷ *Ibid* see note 236.

Example: Connecto Limited (“UKCo”), a software company residing in the UK, realises that its African customer base has grown and is struggling to provide efficient services from the UK. UKCo approaches South African Tax Consultant working for one of the big four accounting firms for an advice on the incorporation of a South African company. Acting on the advice of their Tax Consultant, UKCo decides to incorporate a subsidiary in South Africa, Domino (Pty) Ltd (“SACo”), to help with servicing customers in Africa.

As part of the advice, the Tax Consultant had generally highlighted the tax implications of incorporating a subsidiary in South Africa with a special mention of the funding methods that UKCo must choose from to assist SACo with commencing with its operations. These funding methods are debt and equity.

UKCo can inject equity capital in exchange for shares from SACo. However, UKCo is not sure if SACo will make profits enough to pay dividends in its first five years of operating, so it considers funding SACo with debt as well.

Tax considerations are some of the issues multinationals would want to understand before they invest in a particular country although there are also non-tax considerations that entice foreign investors.²³⁸

Whether or not UKCo can provide debt or equity funding to SACo will depend on South African tax implications. There are many other factors that influence whether or not a company can use debt or equity, including the type of business they intend to incorporate, i.e. a branch or a subsidiary. However, for purposes of this paper, the factors will not be discussed because they are not part of the scope.

On the one hand, if UKCo uses equity funding, as in, invest R100m in assisting SACo to commence with its South African operations, the only return on its investment will be in the form of dividend income. This kind of return is subject to SACo making profits and can be received by UKCo once or twice a year. For income tax purposes, SACo will be required to withhold tax on dividend payments to UKCo, subject to the treaty provisions between South Africa and the United Kingdom.

And on the other hand, if UKCo selects to use debt and equity simultaneously, i.e. invest R100m debt and R70m equity, then the UKCo can then receive guaranteed interest income

²³⁸ *Ibid* see note 221.

from the debt and dividend income if SACo makes profits. Assuming that the interest meets s 24J requirements, for income tax purposes, the interest expenditure incurred by SACo will be deductible, thereby reducing the corporate income tax expense for SACo in South Africa.

Because SACo is a subsidiary of UKCo, the deduction of interest is regarded as a desirable effect as they are related parties. However, for the South African Revenue Service, this is bad news because they do not have the right to tax the interest income. UKCo cannot be taxed in South Africa because the interest income in the hands of UKCo is exempted in terms of s 10(1)(h) of the Act.

(d) *PROFIT SHIFTING INTEREST PAYMENTS*

It is noted that SACo would be entitled to deduct interest expenditure paid to UKCo which might result in SACo paying less or no tax from its taxable income in South Africa. As illustrated, UKCo will not pay income tax on its interest income in South Africa. This will result in base erosion and profit shifting in South African.

Base erosion and profit shifting payments have been described by Hugh J as follows:²³⁹

“Where, as is usually the case, rates on business income is taxed on a net basis are higher than rates on deductible gross basis taxed payments, taxpayers have an incentive to reduce the net basis tax base as much as possible. This is particularly true where treaties reduce or even reduce the gross basis taxation. In response to this, a number of countries have imposed restrictions on the deductibility of such base-eroding payments. The focus here is on restrictions that are exclusively or primarily aimed at non-resident-owned domestic operations. The most common problem is debt financing of domestic operations by non-residents with the attendant interest deduction reducing the income of the domestic subsidiary. Here special debt-equity rules are sometimes applied to non-resident-owned domestic operations. Other provisions limit the extent of the interest deduction if interest payments are deemed excessive in relation to the domestic income. These ‘earnings stripping’ rules are also typically focused on payments to non-residents.”

The problem in respect of the transaction between SACo and UKCo, the pricing and the deductibility of interest in respect of the debt is that SACo might not be in a position to get the same amount of debt from a third party. Therefore the transaction will be subject to the arm's length principle to determine if the terms and conditions would have been similar had

²³⁹ Hugh J et al, ‘Comparative Income Taxation: A Structural Analysis’. 3rd Ed 2010 Kluwer Law International BV, the Netherlands pg 517 and 518.

the parties been independent parties transacting on an arm's length basis or to determine if the parties wanted to derive any tax benefit from the transaction with each other.

Furthermore, SACo might not have any taxable income against which to deduct the interest expenditure.

(e) USE OF EXCESSIVE DEBTS

The contentious issue is one of the excessive levels of debts and interest payments to a related party that is a non-resident.²⁴⁰ Take, for instance, the example of SACo and UKCo delineated above. The interest payments in respect of that example might have risen on the formation of SACo and the issue is how much debt UKCo can give to SACo, and also how much equity capital is acceptable for South African income tax purposes.

UKCo in addition to assisting SACo as a start-up might subsequently serve as a regular source of funding, either through fixed loans or as a line of credit.²⁴¹ Holding companies are often required to offer a guarantee for their subsidiaries on certain financial agreements.²⁴²

Peter Barnes explicitly puts the issues of interest paid to related parties as follows:²⁴³

“Related party payments are a concern only when the related party receiving the interest is outside the country of the party that is paying the interest. If the two related parties are in the same country, and each company is subject to local country tax, there should be no concern. But, when the related party receiving interest is located outside the country of the interest payer, the debt and associated interest payments are viewed as a major risk for improper ‘base erosion’.”

As illustrated through the example of UKCo and SACo, debt financing normally results in excessive interest expenditure by taxpayers and the subsequent interest deductions against their taxable income.

The South African Revenue Services cannot prohibit the taxpayers from using excessive levels of debt but can regulate the rate of interest charged and further limit the amount of

²⁴⁰ *Ibid* see note 221.

²⁴¹ *Ibid* see note 221.

²⁴² Dennis P. Bedell, ‘Limitations on the Interest Deductions’ (1975). William & Marry Annual Tax Conference. Paper 457. <http://scholarship.law.wm.edu/tax/457> last accessed 11 January 2017.

²⁴³ *Ibid* see note 221.

interest expenditure allowable as a deduction for income tax purposes.²⁴⁴ A measure can be imposed to inflict whether a company's related party debt excessively exceed its equity.²⁴⁵

Sections 31 and 23M are regarded as necessary measures as they bar excessive debt, and the thin capitalisation rule and limitation of interest deductions prevent taxpayers from obtaining so much debt that the South African tax base is disintegrated.

Issues that the legislator had in mind in enacting either s 31 or 23M are as follows:

- As opposed to the market-related loans or loan from third parties, related party loans are mainly not subjected to market conditions. The debt amount given may be more than what a third party is willing to offer. The debt amount may be subject to less stringent conditions than what a third party would impose. There can also be some manipulation of terms and conditions in respect thereof; and
- The resolution by a company to offer a debt to a related party can be complicated to understand due to the manner in which various companies plan and execute their transactions. On a number of occasions, payments of interests have tax advantages to the creditor and the debtor compared to equity investment.

The example between SACo and UKCo wherein UKCo select to finance SACo either with debt and equity sets a skeleton for the discussion of the provisions of transfer pricing arm's length rules and limitation of interest deductions. Furthermore, it is in reference to this example that the suggested application of the two provisions will be discussed.

²⁴⁴ Sections 31 and 23M of the Act.

²⁴⁵ Section 31(2) of the Act.

III. SECTION 31 OF THE INCOME TAX ACT

(a) OVERVIEW

To counter transfer pricing practices which may have adverse tax implications on the South Africa tax base, including the use of excessive debt levels compared to fixed equity capital, s 31 of the Act was introduced with effect from 19 July 1995.²⁴⁶ This initial version of s 31 of the Act consisted of both ‘transfer pricing’ and ‘thin capitalisation’ rules.²⁴⁷ Section 31(1) and (2) contained the measures to combat transfer pricing schemes while s 31(3) contained the provisions aimed at countering businesses that had excessive levels of debt funding.²⁴⁸

The initial version of s 31 was revised. Currently, the amended s 31 requires the taxpayer to an affected transaction²⁴⁹ entered into between such taxpayer and a non-resident connected party in relation to the taxpayer, to make a transfer pricing adjustment in terms of s 31(2)²⁵⁰ in determining the South African taxpayer’s taxable income. This is referred to as the primary adjustment. South African taxpayers who receive ‘financial assistance’²⁵¹ from a non-resident connected party are equally required to make an adjustment in terms of s 31(2).

²⁴⁶ The Republic of South Africa, *Explanatory Memorandum on the Taxation Laws Amendment Bill*, 1998, page 19, clause 37. Accessed at <http://www.osall.org.za/docs/2011/02/1998-Taxation-Laws-Amendment-Bill.pdf> last accessed 13 December 2016.

²⁴⁷ See the Old s 31 provisions.

²⁴⁸ *ibid* note 246.

²⁴⁹ Section 31(a) provides as follows: “for purposes of this section – ‘affected transaction’ means any transaction, operation, scheme, agreement or understanding where –

- (a) That transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both –
 - (i) (aa) A person that is a resident; and (bb) any other person that is not a resident; and
 - (ii) (aa) a person that is not a resident; and (bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;
 - (iii) (aa) a person that is not a resident; and (bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates or
 - (iv) (aa) a person that is a resident; and (bb) any other person that is controlled foreign company in relation to any resident; and those are connected persons in relation to one another; and
- (b) Any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm’s length;”

²⁵⁰ Section 31(2) provides as follows: “where –

- (a) Any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and
- (b) Any term or condition of that transaction, operation, scheme, agreement or understanding –
 - (i) Is a term or condition contemplated in paragraph (b) of the definition of ‘affected transaction’; and
 - (ii) Results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding,
The taxable income or tax payable by any person contemplated in paragraph (b) (ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm’s length.”

²⁵¹ ‘Financial assistance’ has been defined by s 31(1) and “includes any –

- (a) Debt; or
- (b) Security or guarantee.”

Pieter van der Zwan writes that, “*in the context of debt funding, a transfer pricing adjustment may be triggered in the hands of the borrowing South African entity if the amount of interest incurred in relation to the funding advanced by the foreign [connected person] is considered excessive based on either the rate of interest or the level of debt, the latter being commonly referred to as thin capitalisation [My underlining]*”.²⁵²

For the purposes of this paper, the terms, related parties, connected persons and associated enterprises should not be construed differently. They differ depending on the context within which they are used. They all refer to companies that form part of the same group of companies.²⁵³ In South Africa, the term connected person is used, while the term related party is normally used by other countries.²⁵⁴ The OECD uses the term ‘associated enterprises’ when referring to companies that are related to each other.

The tax implications on the use excessive debt funding for South Africa were discussed in chapter II of this paper. The South African Revenue Services will disallow a portion of interest deductions incurred in the hands of the South African borrower when determining the borrower’s taxable income. To the extent that a portion of interest of the affected transaction does not conform to the arm's length principle, the interest will be disallowed as a deduction in terms of s 31(3) and will be treated as a dividend or donation paid to that non-resident connected party.²⁵⁵

²⁵² Pieter van der Zwan, “*Transfer Pricing Adjustments: Too many layers of tax?*” The SAIT, News and Tax Talk. Accessed at <http://www.thesait.org.za/news/326196/> last accessed 12 February 2017.

²⁵³ See s 41 of the Act on the definition of the 'group of companies' and s 1 of the Companies Act, 2008 which defines 'group of companies' as "means two or more companies that share a holding company or subsidiary relationship".

²⁵⁴ See s 1 of the Act on the definition of 'Connected person'. Section defines 'connected persons' to mean, “*in relation to a company, 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 paragraph (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”.*”

²⁵⁵ Section 31(3) provides as follows: “*to the extent that there is a difference between –*

- (a) *Any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and*
- (b) *Any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (a),*

The amount of that difference must if that person is a resident and the other person to the affected transaction is a person as contemplated in paragraph (a) (i) (bb) or (a) (iii) (bb) of the definition of "affected transaction" –

- (i) *If that resident is a company, be deemed to be a dividend consisting of a distribution of an asset in specie declared and paid by that resident to that other person; or*
- (ii) *If that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person,*

On the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made: provided that where the amount of that difference was prior to 1 January 2015 deemed to be a loan that constitutes an affected transaction, so much of that loan as has not been repaid before 1 January 2015 must –

- (a) *If that resident is a company, be deemed to be a dividend consisting of a distribution of an asset in specie that was declared and paid by that resident to that other person; or*
- (b) *If that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person,*

(b) *THIN CAPITALISATION*

In South Africa, and around the world, 'thin capitalisation' is a term preferred for the position in which a taxpayer's business is determined to have an excessive level of debt compared to the equity capital of the business.²⁵⁶ Excessive debt funding in respect of the taxpayer's business is a cause for concern to the South African Revenue Services because the taxpayer will pay large amounts of interest to the non-resident connected party that expanded the debt.²⁵⁷ The South African Revenue Services will not have the right to tax the foreign investor, however, the South African taxpayer will undertake to deduct interest expenditure relating to the debt from its income tax amount payable to SARS.²⁵⁸

Expanding on the above point, because the investor is a related party in relation to the South African borrower, the business will be thinly capitalised as its equity capital is exceeded by its debt amount.²⁵⁹ To the extent that the debt does conform to the thin capitalisation safe harbour rules, the interest payments by the South African borrower to the non-resident creditor will not be deductible for South African income tax purposes

More so, in terms of the initial s 31 provisions, the South African Revenue Services relied on safe harbour rules to determine if a taxpayer has an excessive level of debt compared to equity capital. Section 31(2) currently uses the arm's length principle to determine if the rate of interest charged in respect to the debt funding from a connected party is more or less similar to what an independent party would have charged.

(c) *THE ARM'S LENGTH PRINCIPLE – s 31(2)*

Taxpayers are now required in terms of s 31(2) to make an adjustment to ensure that the terms and conditions of an 'affected transaction' conform to the arm's length principle.²⁶⁰ In terms of the OECD's Glossary of Statistical Terms, the arm's length principle has been defined to mean, "The valuation principle which is normally applied to commercial and financial transactions between related companies. The principle demands that transactions should be valued as if they had

On 1 January 2015."

²⁵⁶ OECD Tax & Development, 'Thin capitalisation legislation, a background paper for country tax administrations'. Page 2 accessed at http://www.oecd.org/ctp/tax-global/5.%20thin_capitalization_background.pdf. Last accessed 19/09/2016.

²⁵⁷ *Ibid* see note 256.

²⁵⁸ See s 10(1)(h) of the Act.

²⁵⁹ *Ibid* see note 256.

²⁶⁰ Silke on South African Income Tax, 'Thin Capitalisation', accessed at LexisNexis Library. Note 17.60 subscription required.

been carried out between unrelated parties, each party acting in his own best interest. [My underlining]".²⁶¹

Adding to the OECD's definition, for South African tax purposes, the main question is whether any affected transaction between connected persons as defined in s 1 of the Act contains any term or condition that is different from what "*would have existed had those connected persons been independent persons dealing at arm's length*".²⁶²

If the terms and conditions of an affected transaction are considered not to conform to the arm's length principle, and a South African 'tax benefit' arises for one of the parties are that:²⁶³

- the transaction will be adjusted to what it would have been had the arrangements been at arm's length;²⁶⁴ and
- the disallowed interest will be deemed to be a dividend consisting of a distribution of an asset in specie or a donation by a South African taxpayer to the non-resident connected party.²⁶⁵

The arm's length principle is wide and applies also to the supply of goods and services between connected parties.

A debtor who is not in a position to borrow from third parties is faced with business realities imposed by market forces as follows:²⁶⁶

- Third parties often enquire as to the creditworthiness of the debtor;
- Third parties impose bargains and time limits for the payment of the debt amount, thereby limiting debtor's ability to borrow a certain amount of cash for a particular period; and
- The creditworthiness of every debtor is reviewed so as to avoid giving a loan to a debtor who will fail to service the loan or whose business might undergo liquidation.

²⁶¹ OECD, 'Glossary of Statistical Terms: Arm's Length Principle'. Accessed at <https://stats.oecd.org/glossary/detail.asp?ID=7245> last accessed 19 December 2016.

²⁶² Michele Benetello, Chapter 10: "*Transfer Pricing and Thin Capitalisation*" 'The arm's length principle' point 10.3 (7.3) LexisNexis Library. Subscription required.

²⁶³ Practice Note No. 2 dated 14 May 1996, "*Income Tax: Determination of Taxable Income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic*". Accessed at www.sars.gov.za.

²⁶⁴ See s 31(2) of the Act.

²⁶⁵ See s 31(3) of the Act.

²⁶⁶ PwC, '*Clarifying the rules: A practical guide to managing financial services transfer pricing*'. Accessed at <https://www.pwc.com/gx/en/tax/assets/pwc-clarifying-the-rules.pdf> last accessed 11 December 2016.

In terms of paragraph 1 of Article 9 of the OECD Model Tax Convention deals with the arm's length principle. Article 9 of the OECD Model Tax Convention reads as follows:²⁶⁷

“when terms and conditions are made or imposed between two ‘associated enterprises’ in their commercial or financial relations which differ from those which would have been made by and between independent enterprises, then any profits which would have, but for those terms and conditions, have accrued to one of the enterprises, but, by reason of those terms and conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

The term ‘associated enterprises’ has been defined by Article 9 of the OECD Model Tax Convention as a situation within which:²⁶⁸

- an enterprise of a contracting state participates directly or indirectly in the management, control or capital of an enterprise of the other contracting state; or
- the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state.

The issue is how ‘associated enterprises’ should determine what price would have arisen if transactions between its members were subject to market factors. The solution advanced by the OECD is that a comparable transaction between independent parties, an uncontrolled transaction, should be used as a benchmark against which to appraise the multinational's prices, the controlled transaction.²⁶⁹ Any difference between the transactions can be identified and adjusted. An arm's length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.

(d) GRANTING OF FINANCIAL ASSISTANCE

Affected transactions regulated by s 31(2) includes financial assistance that has been or was granted by the non-residents to the connected person through a bank or other institutions and also guarantees in respect thereof.²⁷⁰

The definition of ‘financial assistance’ provided by s 31(1) of the Act is limited to debt, security or guarantee. On a literal interpretation, one can interpret the concept of ‘financial assistance’ as including, not only interest-bearing financial assistance but also interest-free

²⁶⁷ OECD Committee on Fiscal Affairs, ‘Model Tax Convention on Income and on Capital’, Volume I and II as it read on 22 July 2010. Article 9 1-2.

²⁶⁸ *Ibid* see note 267.

²⁶⁹ *Ibid* see note 267.

²⁷⁰ *Ibid* see note 267.

financial assistance.²⁷¹ However, the application of s 31 will be limited only to interest-bearing financial assistance.

Holding companies and/or certain companies can also provide financial assistance to their related/connected companies indirectly by using a third party (a bank or co-investors).²⁷² Take for instance the following:

- UKCo grants a debt to a non-South African bank with a condition that the bank further lend the funds to SACo, the transaction will be treated as a transaction between UKCo and SACo for purposes of s 31(2) of the Act; and
- Where SACo goes to the bank to apply for a loan and the bank request for a guarantee. If UKCo provides a guarantee to the bank and the bank in return provides the loan to SACo, the terms and conditions of the affected transaction, being the guarantee and loan transaction should conform to the arm's length principle.

The use of the term 'indirectly' refers a situation within which a related party does not directly contract with the SA related party resident in granting financial assistance. Thus the term 'financial assistance granted indirectly' includes back-to-back arrangements through independent parties or co-investors as illustrated by the two examples above.²⁷³

(e) SECONDARY ADJUSTMENT

If s 31(2) adjustment is applied successfully to a resident by the Commissioner for SARS, the consequences are such that the interest expenditure in relation to the excessive financial assistance will be disallowed as a deduction in the determination of taxable income of the SA taxpayer resident.²⁷⁴

Where the interest amount was paid to a company, the disallowed interest amount will be subject to the provisions of s 31(3)(a) and will be deemed to be a dividend in terms of s 64C(2)(e)²⁷⁵ of the Act for purposes of levying a withholding tax on dividends. Section

²⁷¹ See Silke on 'Determination of excessive financial assistance', note 260 as referred to above.

²⁷² See s 31(4) of the Act which reads as follows: "for purposes of subsection (2), where any transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or affected as contemplated in that subsection in respect of (a) the granting of any financial assistance."

²⁷³ AJ Jansen van Nieuwenhuizen, "Thin Capitalisation – SARS' new interpretation". The SAIT. Accessed at <http://www.thesait.org.za/news/132237/Thin-Capitalisation--SARS-New-Interpretation.htm> last accessed 14 December 2016.

²⁷⁴ See s 31(3)(a)-(b) of the Act.

²⁷⁵ Section 64C deals with certain amounts distributed deemed to be dividends and provides in s 64C(2)(e) – "for purposes of section 64B[Levy and recovery of secondary tax on companies], an amount shall, subject to the provisions of subsection (4), be deemed to be a dividend declared by a company to a shareholder, where –

(e) that amount represents the greater of –

(i) the difference between – (aa) the taxable income or assessed loss of that company; and (bb) the taxable income or assessed loss of that company without regard to section 31(2); and

64C(2)(e) will be applied, despite the fact that the resident does not have profits and reserves which are available for distribution.

Where the interest amount was paid to an individual, the disallowed amount will be deemed to be a donation in terms of s 31(3)(b) for purposes of Part V²⁷⁶ of the Act.

(f) CONCLUDING REMARKS

Through an in-depth analysis of s 31, it is noted that s 31(3) inevitably takes s 31(2) a step further by codifying thin capitalisation rules within the framework of transfer pricing provisions in South African tax framework. Therefore, s 31(2)&(3) of the Act will be applied by the Commissioner for the South African Revenue Services to determine if the terms and conditions of the financial transaction conform to the arm's length principle. To the extent that the terms and conditions do not conform to the arm's length principle, the disallowed interest will be adjusted and classified as a dividend or a donation for South African income tax purposes.

(ii) *nil.*"

²⁷⁶ Part V of the Act deal with the levying of donations tax and s 54 in respect thereof provides as follows: "*subject to the provisions of section 56, there shall be paid for the benefit of the National Revenue Fund (in this Act referred to as donations tax) on the value of any property disposed of (whether directly or indirectly and whether in trust or not) under any donation by any resident (in this Part referred to as the donor).*"

IV. SECTION 23M OF THE INCOME TAX ACT

(a) OVERVIEW

Section 23M²⁷⁷ was inserted into the Act by the Government Gazette no 37158 and came into effect on the year of assessment which began on or after 1 January 2015. The objective of s 23M is to limit interest deductions. Section 23M applies on interest expenditure paid by a South African debtor to a non-resident creditor who is in a controlling relationship with the South African debtor.

It is broadly accepted that debt capital is an important tool for investment, however, it can also create opportunities for profits shifting and base erosion in South Africa.²⁷⁸ Based on the accounting ‘matching principle’ every deduction should have a matching inclusion. The Act caters for this principle in the provisions of s 23H. However, s 23H will not be discussed in this paper as the provisions do not form part of the scope.

Section 23M is applied to a non-resident creditor who is not subject to tax in South Africa.²⁷⁹ As defined in s 1 of the TAA, the term ‘tax’ includes a tax, duty, levy, royalty, fee, contribution, penalty, interest and any other amounts of money imposed under tax legislations.²⁸⁰ However, the Act has its own definition of ‘tax’ in s 1 of the Act which is defined as a tax or penalty imposed in terms of the Act.²⁸¹ The application of s 23M ensures that the interest expenditure allowable as a deduction does not exceed the taxpayer’s adjusted taxable income.²⁸²

²⁷⁷ Section 23M(2) provides as follows: “where an amount of interest is incurred by a debtor during a year of assessment in respect of a debt owed to –

- (a) S creditor that is in a controlling relationship with that debtor; or
- (b) A creditor that is not in a controlling relationship with that debtor, if that creditor obtained funding for the debt advanced to the debtor from a person who in a controlling relationship with that debtor, and the amount of interest so incurred is not during that year of assessment –
 - (i) (aa) subject to tax in the hands of the person to which the interest accrues; or (bb) included in the net income of a controlled foreign company as contemplated in section 9D in the foreign tax year of the controlled foreign company commencing or ending within that year of assessment;
 - (ii) Disallowed under 23N,
The amount of interest allowed to be deducted may not exceed the amount determined in accordance with subsection (3).”

²⁷⁸ National Treasury, ‘Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2014’ 17 July 2014 page 21 unit 2.3.

²⁷⁹ See s 23M(2)(a) of the Act.

²⁸⁰ See s 1 of the Tax Administration Act 28 of 2011.

²⁸¹ *Ibid* see note 278.

²⁸² Section 23M(3) provides as follows: “the amount of interest allowed to be deducted in respect of all debts owed as contemplated in subsection (2), in respect of any year of assessment must not exceed the sum of –

- (a) The amount of interest received by or accrued to the debtor; and
- (b) A percentage of that adjusted taxable income of that debtor to be determined in accordance with the formula – A equals B multiply by C divide by D
In which formula –
 - (a) “A” represents the percentage to be determined;

The OECD Model Commentary discussed the concept of ‘liability to tax’ and noted that the term can be interpreted differently in different countries.²⁸³ The phrases ‘subject to tax’ and ‘liability to tax’ should not be construed differently for purposes of the discussion in this paper.

It was then concluded that this will only include amounts that are actually taxed, not amounts that fall within the scope of the taxing legislation, whether exempted or not. According to the OECD’s discussion, notwithstanding that an amount of interest may, for example, constitute gross income, it will not be regarded as being subject to tax if it is exempted.²⁸⁴

(b) APPLICATION OF S 23M PROVISIONS

The application of section 23M for purposes of this paper will be discussed in light of the UKCo and SACo example enunciated in this paper. In addition to the example given on UKCo and SACo, we assume the following:

- UKCo holds 59% of equity shares in SACo;
- The remaining 41% of equity shares are held by minority shareholders; and
- UKCo does not have a permanent establishment in South Africa.

(i) MEANING OF INTEREST INCURRED – S 24J

The first step is to determine if the interest expense incurred by SACo in respect of the debt means interest for purposes of s 24J of the Act.²⁸⁵ The agreement between UKCo and SACo

(b) “B” represents the number 40;

(c) “C” represents the average repo rate plus 400 basis points; and

(d) “D” represents the number 10.

But not exceeding 60 per cent of the adjusted taxable income of that debtor, reduced by so much of any amount of interest incurred by the debtor in respect of the debts other than debts contemplated in subsection (2) as exceeds any amount not allowed to be deducted in terms of section 23N.”

²⁸³ OECD Commentaries on the Articles of the Model Tax Convention. Article 1- 6.2.

²⁸⁴ *Ibid* note 283.

²⁸⁵ Section 24J(1) provides as follows: “for purposes of this section unless the context otherwise indicates – “interest includes the-

(a) Gross amount of any interest or similar finance charges, discounts or premium payable or receivable in terms of or in respect of a financial arrangement;

(b) Amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and

(c) Absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full terms of such arrangement to which such person is a party,

Irrespective of whether such amount is –

(i) Calculated with reference to a fixed rate of interest or a variable rate of interest; or

(ii) Payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.”

is a lending arrangement²⁸⁶ for purposes of s 24J(1) as SACo is obliged to return the money with interest thereof. The definition of ‘instrument’²⁸⁷ in s 24J(1) includes a debt.

The above paragraph is a clear illustration of the fact that the terms and conditions of the lending arrangement must to a large extent mirror the terms and conditions of group-wide lending arrangement, i.e. Loan arrangement between a bank and a debtor. Therefore SACo should be clear on whether the additional amount payable to UKCo qualify as interest for purposes of 24J. The implementation of the lending arrangement must conform to the form of the lending arrangement.

(ii) RESIDENCE STATUS OF THE DEBTOR – S 23M(1)

The facts of the example are clear in respect of the tax residency of SACo. Section 23M(1) applies to a debtor who is a resident or a debtor who has a permanent establishment in South Africa.²⁸⁸ Therefore, SACo is a tax resident of the Republic of South Africa for purposes of applying s 23M.

(iii) CONTROLLING RELATIONSHIP

In order for s 23M to apply to a lending arrangement between a debtor who is a tax resident and a non-residence for purposes of applying s 23M, the two parties must be in a ‘controlling relationship’ in relation to each other.²⁸⁹ UKCo holds 59 per cent of equity shares in SACo and for purposes of s 23M, UKCo would be required to hold at least 50 per cent of equity shares or 50 per cent of the voting rights is exercisable in SACo by UKCo. Therefore for purposes of s 23M, UKCo qualifies as a party in a ‘controlling relationship’ in relation to SACo.

Expanding on the above statement, it is worth mentioning that, from a practical point of view, an analysis of whether or not, a controlling relationship exist between the companies might be

²⁸⁶ A lending arrangement has been defined in terms of s 24J(1) as follows: “means any arrangement or agreement in terms of which –

- (a) A person (in this section referred to as the lender) lends any instrument to another person (in this section referred to as the borrower); and
- (b) The borrower in return undertakes to return any instrument of the same kind and of the same or equivalent quantity and quality to the lender.”

²⁸⁷ An ‘instrument’ has also been defined by s 24J to include “any-interest-bearing arrangement of debt.”

²⁸⁸ Section 23M defines the debtor as follows: “‘debtor’ means a debtor who is –

- (a) A person that is a resident; or
- (b) Any other person who is not a resident that has a permanent establishment in the Republic in respect of any debt claim that is effectively connected with that permanent establishment.”

²⁸⁹ The term ‘controlling relationship’ has been defined in s 23M(1) as follows: ““controlling relationship” means a relationship where a person directly or indirectly holds at least 50 per cent of the equity shares in a company or at least 50 per cent of the voting rights in a company is exercisable by a person.”

more complicated than the controlling relationship that exists in the given example between SACo and UKCo. This is mainly the case because in practice they are various shareholders, some holding the majority or equity shares while some hold the minority of the voting rights.

Section 23M would still be of application even if UKCo lent the money to a bank and/or a third party with a condition that this money is in return lent to SACo. This is classified as a back to back lending arrangement.

(iv) INTEREST RATE NOT EXCEEDING THE OFFICIAL RATE OF INTEREST

For purposes of this discussion, it is therefore assumed that the interest rate charged between UKCo and SACo does not exceed the official rate of interest increased by 400 basis points. Should the interest rate exceed the official rate of interest, then the transfer pricing provisions might be of application to determine the actual chargeable interest rate. However, it has to be noted that there is no guidance as to the interaction of the provisions of s 23M and the transfer pricing provisions in s 31. As such, each case would have to be decided based on its circumstances.

(v) INTEREST NOT SUBJECT TO TAX

In order for s 23M to be applicable, the interest payable to UKCo should not be subject to tax in South Africa. The requirement of 'subject to tax' addresses the discrepancy between the tax treatment of the interest expenditure in the hands of SACo and the interest income earned by UKCo that results in a risk of eroding the South African tax base. The interest payable reduces the taxable income of SACo because the interest income payable to UKCo will only be taxable in terms of the United Kingdom's domestic tax laws. This is so because of s 10(1)(h) which exempts a non-resident from paying income tax on interest income paid to the non-resident by a South African resident taxpayer.

For purposes of this paper, it is important to look at what is meant by subject to 'tax'. The term 'tax' has been defined in s 1 of the Act to mean tax or penalty imposed in terms of the Act.

South Africa introduced the withholding tax on interest provisions, but these provisions do not seem to find any application in our current example since the UKCo will be exempted from paying tax in terms of s 10(1)(h) of the Act. Therefore the withholding tax on interest provisions cannot be invoked in respect of the transaction between the UKCo and SACo.

The DTA has been incorporated as part of our Act in terms of s 108(2).²⁹⁰ The DTA between South Africa and the United Kingdom, however, reduces the interest rate accrued in South Africa and paid to the UKCo residing in the United Kingdom to nil for South Africa income tax purposes.²⁹¹

Therefore, the amount of interest incurred by UKCo is not subject to tax for South African tax purposes and as such, the deduction of payable interest should be subject to the provisions of s 23M(3). Interest not deductible after the calculation in terms of the formula may be carried forward to the next year of assessment and must be deemed to be interest incurred in that year of assessment.

(c) *SECTION 23M - EXEMPTIONS*

There are certain exemptions to s 23M which should also be considered for purposes of this paper. The provisions of s 23M do not apply to interest incurred by the debtor where, the creditor-funded the debt advanced to the debtor with funding granted by a lending institution that is not in a controlling relationship with the debtor, and the interest is determined with reference to a rate not exceeding the official rate of interest as defined in para 1 of the 7th Schedule to the Act plus 100 basis points.²⁹²

Expanding on the above point, s 23M also applies to any interest incurred by a debtor in respect of a linked unit held by a creditor as contemplated in s 23M(2), where the creditor is a long-term insurer, a pension fund or a provident fund. The provisions of s 23M were enacted in line with the OECD's BEPS action point 4 on interest deductions and other financial payments.

²⁹⁰ Section 108(2) of the Act provides as follows: "as soon as may be after the approval by Parliament of any such agreement[DTA], as contemplated in section 231 of the Constitution, the arrangement thereby made shall be notified by publication in the Gazette and the arrangements so notified shall thereupon have the effect as if enacted in this Act."

²⁹¹ Article 11(1) of the Double Tax Agreement between South Africa and the United Kingdom reads as follows: "interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State, if such resident is the beneficial owner of the interest."

²⁹² Paragraph 1 of the Seventh Schedule to the Act defines 'official rate of interest' as follows:

"official rate of interest" mean –

- (a) In the case of debt which is determined 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 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."

On its presentation dated 25 May 2016, the National Treasury emphasised that the South African rules follow the same approach as that recommended, but are more targeted to particular transactions, i.e. instances where the corresponding interest income is not taxable and reorganisation and acquisition transactions.²⁹³

(d) BEPS ACTION POINT 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

Many institutions and countries have long debated about regulating excessive interest deductions, with various countries implementing their own domestic rules to tackle the challenge of excessive interest deductions that has an adverse impact on their domestic tax base.²⁹⁴ The OECD has been committed to providing recommendations on the approach countries can choose from when drafting their domestic tax rules on the limitation of interest deductions. As such the OECD introduced BEPS action point 4 which encompass such recommendations.²⁹⁵ The OECD proposed a 'group-wide' approach to the limitation of interest deductions issue.²⁹⁶

In terms of the 'group wide' approach, only loans obtained by related parties from unrelated third parties would generate deductible interest.²⁹⁷ The deductible interest would be allocated amongst related parties based on their respective levels of economic activities.²⁹⁸ Enacting appropriate domestic tax rules to address interest deductions issue is a challenge to many countries as the implementation will involve the use of various resources which some developing countries might not have. Because of the challenge many countries still rely on their domestic tax rules. However, some countries have positively responded to the OECD's BEPS action point 4 (UK and India have both indicated an intention to enact new laws to tackle limitation of interest deductions in light of the BEPS action point 4).²⁹⁹

²⁹³ Ibid see note 232.

²⁹⁴ OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris.

DOI: <http://dx.doi.org/10.1787/9789264268333-en> last accessed 31 December 2016.

²⁹⁵ Ibid see note 294.

²⁹⁶ Ibid see note 294.

²⁹⁷ Ibid see note 294.

²⁹⁸ Ibid see note 294.

²⁹⁹ See HM Revenue & Customs Policy Paper, 'Corporation Tax: tax deductibility of corporate interest expense'. <https://www.gov.uk/government/publications/corporation-tax-tax-deductibility-of-corporate-interest-expense/corporation-tax-tax-deductibility-of-corporate-interest-expense>; and Indian 2017 Budget: Limit on interest claims for global firms accessed at <http://www.livemint.com/Politics/rA3UbZSvFhTVZEF5uT7MmM/Budget-2017-Limit-on-interest-claims-for-global-firms.html> last accessed 10 February 2017.

(e) CONCLUDING REMARKS

Section 23M seems to be a work in progress as it differs to a large extent with the BEPS Action point 4's recommended approach. Although the centre point of this paper is on the application of s 31 and s 23M of the Act, it was fit to discuss BEPS Action point 4, in a nutshell, to determine to what extent the legislature intends for the provisions of s 23M to conform to the approaches as recommended by BEPS. As this is a work in progress, the current s 23M provisions can still be applied with the provisions of s 31 to a similar transaction, provided the transfer pricing provisions as provided in s 31 of the Act are applied first to the transaction and then followed by s 23M provisions to limit the interest deductible.

V. APPLICATION – A SUGGESTED APPROACH

(a) OVERVIEW

Based on the discussion of the application of s 31 and s 23M of the Act, it remains unclear as to which of the two should be applied first to debt transactions. Some writers argue that s 31 should be applied first and then s 23M after.³⁰⁰ It is on this basis that an approach is suggested in this paper on the application of s 31 and 23M of the Act.

Section 31 is understood to encompass thin capitalisation rules.³⁰¹ Thin capitalisation rules only allowed taxpayers to have certain acceptable levels of debt compared to their equity in respect of debt transactions from connected parties. Interest expenditure falling within the acceptable debt levels were fully deductible in terms of s 31's thin capitalisation rules. However, s 31 no longer uses the so-called thin capitalisation rules to restrict taxpayers' debt levels but now uses the arm's length principle. Section 23M will be applicable to determine interest expenditure the taxpayer can deduct taking into account the taxpayer's adjusted taxable income.³⁰²

Adding to the above point, if an adjustment is made to a transaction that does not conform to the arm's length principle, the disallowed portion of interest expenditure will be classified as a dividend or a donation for purposes of s 31(3). It would, therefore, follow that the remaining interest expenditure conforming to the arm's length principle will be subject to the provisions of s 23M of the Act.

As discussed in this paper, s 23M was introduced in line with BEPS action point 4 on the limitation of interest deductions and other financial payments. Section 23M applies to deduction of interest expenditure not subject to tax in South Africa. To a certain extent the provisions of s 23M although the terminology differs, are similar to the provisions of s 31.

(b) COMPARABLE ASPECTS OF S 31 AND S 23M

(i) RESIDENT DEBTOR AND NON-RESIDENT CREDITOR

³⁰⁰ John Jones, 'Interest deductibility – those new provisions to keep in mind'. RSM South Africa 25 September 2015. accessed at <https://www.rsm.global/southafrica/news/interest-deductibility-those-new-provisions-keep-mind> last accessed 12 February 2017 and Des Kruger, 'Interest – Deduction Limitation'. Business Tax and Company Law Quarterly, Volume 6, Issue 1, Mar 2015, pg 11 – 21. Accessed at http://journals.co.za/docserver/fulltext/btclq/6/1/btclq_v6_n1_a3.pdf?expires=1490169305&id=id&acname=58026&checksum=99572C3876713C885B3FC9807FDF3C3C last accessed 12 October 2016.

³⁰¹ Okkie K & Esther G, 'The thin capitalisation provisions of section 23M and further amendments proposed thereto'. 20 November 2014. Accessed at <http://www.sataguide.co.za/the-thin-capitalisation-provisions-of-section-23m-and-further-amendments-proposed-thereto/> last accessed 20 December 2016.

³⁰² Section 23M(3) of the Act.

On the one hand, s 23M applies to a transaction where the debtor is a South African resident. If the debtor is a non-resident, such debtor must have a permanent establishment in South Africa regarding any debt claim that is connected to that permanent establishment.³⁰³ However, s 23M has not provided for the residence status of the creditor and one can only assume that the creditor has to be a non-resident because s 23M is applicable to interest expenditure that is not subject to tax in South Africa.³⁰⁴ If the interest, either in the hands of the debtor or in the hands of the creditor, is subject to tax in South Africa, the provisions of s 23M will not apply.

But on the other hand, s 31 has explicitly provided that the affected transaction must be between a resident and a non-resident in order for the provisions of s 31 to be of application to the transaction.³⁰⁵

(ii) CONTROLLING RELATIONSHIP OR CONNECTED PERSON

In order for s 23M to find application to a transaction, the transaction must be between a debtor and a creditor who are in a controlling relationship with each other. Although there is no interpretation on this, this requirement seems to be comparable to the requirement of ‘connected persons’ in s 31. The definition of ‘connected person’ is broad and includes a ‘controlling relationship’. Parties cannot be in a controlling relationship with each other without being connected persons for purposes of s 31 of the Act.

(iii) TAX AVOIDANCE

The transaction should result in both parties deriving a tax benefit on the interest expenditure. As provided by s 31(2) of the Act, the affected transaction will be adjusted in terms of the s 31(2) to determine if the party to the affected transaction will derive any tax benefit from the interest charged. This requirement has not been expressly included in s 23M but the section illustrates that the interest income must not be subject to tax in South Africa which then

³⁰³ S 23M(1) has defined ‘debtor’ to mean –

- (a) “A person that is a resident; or
- (b) Any other person who is not a resident that has a permanent establishment in the Republic in respect of any debt claim that is effectively connected with that permanent establishment”.

³⁰⁴ Section 23M – Limitation of interest deduction in respect of debts owed to persons not subject to tax.

³⁰⁵ For purposes of s 31, “an ‘Affected transaction’ means any transaction, operation, scheme, agreement or understanding where –

- (a) That transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both –
 - (aa) a person that is a resident; and
 - (bb) any other person that is not a resident or any other person that is a resident but has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates.”

assume that there might be a tax benefit for the taxpayer or a detriment to the South African Revenue Services.

(iv) DEBT TRANSACTIONS

Section 23M is specifically applicable to a debt transaction between parties who are in a controlling relationship with each other. Such debt transaction must have been advanced by a creditor who is not subject to tax in South Africa. Similarly and in broad terms, s 31 applies to a debt transaction advanced by a non-resident to a resident in the form of ‘financial assistance’.³⁰⁶

The comparable aspects of both s 31 and 23M make the application of the two provisions to debt transactions confusing. One is faced with a question of whether to use s 31 or s 23M to determine interest expenditure that is allowable as a deduction for South African income tax purposes. There seems to be no guidance at the moment.

(c) SUGGESTED APPROACH

The two sections do not seem to be exclusive. There is nothing in s 31 excluding s 23M from applying to similar debt transactions. There is also nothing in s 23M excluding s 31 from applying to the same transaction. Section 31 does not expressly limit interest deductions, however, s 23M expressly limit interest that is deductible by a taxpayer. Regarding s 31 and the old thin capitalisation approach, the interest deductible by the taxpayer were not necessarily and expressly limited, the section only limited the levels of debts that the taxpayer may have from connected parties.

Let us take the following example towards the application of s 31 and s 23M of the Act:

UKCo grants SACo a loan amount of R100m with an interest rate of 40%. UKCo is SACo's holding company as it holds 70% of the voting and participation rights in SACo. The market-related interest rate at the time of the transaction was 12%. The South African Revenue Services assessed SACo and found that SACo had an excessive interest expenditure in relation to the transaction between SACo and UKCo. However, there was a dispute as to which provision the taxpayer should have considered first.

³⁰⁶ See s 31(1) on the definition of ‘financial assistance’.

In terms of the suggested approach, it is argued that s 31 should be applied first as it caters for the pricing of transactions in light of the arm's length Principle while s 23M caters only for the limitation of interest deductions. There is nothing in s 31 that caters for the deductibility of interest. If one is to argue for such, the provisions would have to be amended to explicitly provide for such and this will render s 23M nugatory. Taxpayers who do not have a taxable income will still attempt to deduct their interest expenditure for as long as they are able to prove that the transaction conforms to the requirements of the arm's length principle.

It is therefore suggested that s 31 should be applied first to the above debt transaction between UKCo and SACo followed by the application of s 23M.

(i) APPLICATION OF S 31 OF THE ACT – PRIMARY ADJUSTMENT

In order for s 31 of the Act to be applicable, the parties to the transaction must be connected parties as defined in s 1 of the Act. Section 1(d) of the Act defines 'connected persons' as follows, "*'connected person' means, in relation to a company – 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 paragraph (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".*³⁰⁷

UKCo holds 70 per cent of both the voting and participation rights in SACo. Therefore the two companies qualify as connected parties for purposes of applying the provisions of s 31 of the Act. SACo is therefore required to adjust the terms and conditions of the agreement in terms of s 31(2) to reflect the terms and conditions that would have been had SACo and UKCo been independent parties transacting on an arm's length basis. Therefore the interest rate between SACo and UKCo has to be adjusted.

The South African Revenue Services found that SACo paid interest amount of R40m to UKCo. However, due to the application of the provisions of s 31(2) as indicated above, it was found that the parties should have charged the interest rate of 12% and not 40% as per the terms of the debt transaction. After an adjustment by the South African Revenue Services, it was found that an arm's length interest amount payable to UKCo was R12m instead of R40m. After calculating the terms and conditions of the transaction, the South African Revenue Services realised that the interest would not have been 40% had those persons been independent persons dealing at arm's length. The interest amount payable was then

³⁰⁷ Section 1 of the Act.

reclassified to R12m in terms of s 31(2) of the Act. The excess interest amount not conforming to the arm's length principle was subjected to s 31(3).

The disallowed interest was then treated as dividend payments to UKCo by SACo for South African income tax purposes.

(ii) APPLICATION OF S 31 OF THE ACT – SECONDARY ADJUSTMENT

Section 31(3) of the Act requires that the difference must if that resident is a company, be deemed to be a dividend consisting of a distribution of an asset in specie declared and paid by that resident taxpayer to that other person. Section 31(3) adjustment has to be completed on the last day of the period of six months following the end of the year of assessment regarding the application of s 31(2).

Following the example is given in this paper, an amount of R28m will be deemed to be a dividend for purposes of s 31(3) of the Act. SACo will be required to withhold a dividends tax on the amount payable to UKCo, subject to the provisions of the double tax agreement between the United Kingdom and South Africa for the avoidance of double taxation. It is noted that s 31 of the Act does not necessarily limit the interest deductible by the taxpayer but rather evaluate if the interest rate charged conform to what would have been had the parties been independent parties transacting on an arm's length basis.

(iii) APPLICATION OF S 23M

In addition to the application of s 31 of the Act, s 23M will then be applied to limit the interest deductible by the resident taxpayer, which is SACo in the example given. However, in order for s 23M to apply, it has to be determined that UKCo and SACo are in a 'controlling relationship' for purposes of s 23M.

In terms of s 23M, a controlling relationship will exist if UKCo holds directly or indirectly at least 50 per cent of the equity shares or voting rights in a company. UKCo holds 70 per cent of the voting rights in SACo which is more than the minimum threshold of 50 per cent required for purposes of applying s 23M.

It is clear from the discussion above that the two provisions are independent of each other and can be applied to a similar debt transaction as they seem to serve a varying purpose. Section 31 focuses on transfer pricing of various transactions while s 23M focuses on the limitation of interest deductions where the interest income is not subject to tax in South Africa. If s 23M

was to be applied first, UKCo and SACo would get away with overcharging interest rate. The interest rate charged, therefore, should be adjusted to ensure that it conforms to market forces.

(d) CONCLUDING REMARKS

Clarity in the application of s 31 and s 23M to debt transactions is important to taxpayers. The common features between s 31 and s 23M as discussed in this chapter V can be confusing. Which of the two sections take precedent remains a question the legislature should provide clarity to avoid any varying interpretation. However, based on the suggested approach, it seems as though s 31's transfer pricing provisions would take precedent because the pricing of transactions remains a controversy worldwide. Thus the suggested approach seem reasonable and practical on debt transactions and the limitation of interest deduction regarding debt transactions.

VI. CONCLUSION

It is widely accepted that multinational companies are expanding and as such incorporate subsidiaries in various other countries. The expansion of multinational companies has posed a challenge to the South African Revenue Services as the tax planning by these multinational companies enable them to fund their respective related companies through debt or equity. The payment of interest expenditure results in excessive interest deductions.

South Africa enacted s 31 which addresses the issue. The arm's length principle is used to determine the terms and conditions of the affected transaction. If the taxpayers in an affected transaction charge an interest rate that does not conform to the arm's length requirements, s 31(2) will be applied to adjust the interest charged. The disallowed interest will then be deemed to be a dividend or a donation for purposes of s 31(3). Interest conforming to the provisions of s 31 will be fully deductible.

However, South Africa further enacted s 23M which seeks to limit interest deductions. Thus the interest expenditure conforming to the arm's length principle will still be subject to the provisions of s 23M. Nothing in s 31 prohibits the application of s 23M to a debt transaction that has been adjusted in terms of s 31(2).

It is clear within the provisions of s 23M that the section interacts with other provisions of the Act, i.e. s 9D and s 23N, but the legislator has not said anything about s 23M's interaction with s 31 of the Act.

South Africa should, therefore, consider revising the provisions of both s 23M and s 31 to include a guideline as to how the two provisions can be applied.

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