A critical analysis of the application of section 31(3) of the Income Tax Act 58 of 1962 where the investor is an emigrant from South Africa – a case study

by

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

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Abstract

Section 31(3) of the Income Tax Act 58 of 1962 ('the Act') is an area of the law that has not been explored by the South African courts. By way of a case study, this dissertation examined an application of the so-called 'thin capitalisation' rules embodied in section 31(3) where the non-resident lender is an emigrant from South Africa. Specifically, the following questions were addressed in the context of the case study:

1. Was the South African Revenue Service ('SARS') justified in applying section 31(3) and if so, was its application thereof correct?
2. Should the emigrant's status as a South African resident at the time of granting financial assistance affect the application of section 31(3)?
3. Could objections be raised to the application by SARS of section 31(3), and if so, on what basis?
4. How might section 31(3) be applied prospectively on the facts of this case?

In respect of the first research question, but for three matters of principle, SARS appeared to have suitable justification to apply section 31(3) on the facts of the case. The three matters of principle raised were considered separately as grounds for objection to the application of section 31(3).

In respect of the second research question, both the literal and purposive interpretations of section 31(3)(a) seem to offer the taxpayer companies in this case study cogent grounds for objection. The evident ambiguity associated with the use of 'is not a resident' with 'has granted financial assistance' should result in the interpretation of the section *contra fiscum*.

Over and above the objection raised in the context of the second research question, the third research question considered further questions in respect of :

(a) whether or not the independence of the board of trustees interposed between the investor and the recipient could prevent the application of section 31(3); and

(b) the manner in which and extent to which the Commissioner had exercised his discretion in terms of section 31(3).

It was concluded that neither of these issues would result in robust or defensible objections.

Finally, the review of the fourth research question determined that, given the proposed amendments tabled in the draft Taxation Laws Amendment Bill 2010, the investor would no longer enjoy exemption from taxation on the interest paid to him by the trusts, and that the trusts themselves (instead of the companies) might well be subject to the application of section 31(3). These observations would certainly prompt any one or more of (i) a change to one or more of the structures used in the case study, (ii) a revision of the investment strategy and instruments used, or (iii) the payment of the exchange control exit levy. It was noted, however, that the limitation of the interest exemption to non-residents seemed at odds with the original rationale for the introduction of thin capitalisation rules.

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Preamble: The facts of the case study

Mr X, a South African resident, was the sole shareholder in Eureka (Pty) Ltd, which was registered in and operated from South Africa, selling services to a worldwide clientele.

Mr X sold all of his shares in Eureka to Mega, an unrelated third party company listed in the United States of America, in exchange for shares in Mega. The terms of Mr X's agreement with Mega imposed no restrictions regarding the disposal by the investor of his duly acquired shares in Mega and so he immediately liquidated his entire holding of those shares.

During February 2001, the following transpired:

1. In terms of South African exchange control regulations, the proceeds of Mr X's sale of Mega shares were repatriated to South Africa and were maintained in cash accounts at local banks.
2. Two trusts (Trust A and Trust B) were founded in South Africa, and the trust deeds made provision for Mr X to be a trustee and a beneficiary of each trust, although he was neither the sole trustee nor the sole beneficiary of either trust. Both trusts had financial years ending in February.
3. Concurrently with the establishment of Trust A and Trust B, two companies (Company A (Pty) Ltd and Company B (Pty) Ltd) were incorporated. Trust A held 100% of the nominal issued share capital of Company A and Trust B held 100% of the nominal issued share capital of Company B. The companies also had financial years ending in February. Mr X was never a director of either company, nor did he ever derive any emoluments or other remuneration from those companies. The objects of the companies were worded as broadly as possible.
4. Mr X concluded agreements with each of Company A and Company B, in terms of which he loaned part of the proceeds arising from the sale of his shares in Mega ('the proceeds') to each of the companies, such that the aggregate amount of the loans to the companies equalled the total of the proceeds. The loans were unsecured and bore interest at the rate of the prime overdraft rate plus two percent per annum, or such lesser rate as agreed between the parties (inasmuch as any cash balances not invested in trading portfolios could not be expected to

generate the required rate of interest on the loans). The funds were advanced from the Mr X's bank accounts directly to the bank accounts of the companies upon signature of the agreements.

Later in February 2001, Mr X ceded to Trust A and Trust B respectively the loans that he had made to Company A and Company B in exchange for loan agreements between himself and Trust A and Trust B respectively on the same terms as his loans to the companies had been.

On 28 February 2001, Mr X emigrated from South Africa to the United Kingdom (where he became resident, but not domiciled for tax purposes) and he subsequently spent no more than ninety days in South Africa in any subsequent year of assessment. As a consequence of his emigration, the proceeds of the sale of his shares in Mega were held in a blocked Rand account in terms of exchange control regulations.

Interest on the loans from Mr X to the trusts was to be remitted to an offshore bank account in his name. The offshore bank account was held in a so-called 'tax haven' where no double taxation agreement with South Africa existed.

During the course of the year ending 28 February 2002, the companies concluded investment management mandates with various fund managers in South Africa. The mandated portfolios were to be managed as bespoke, segregated portfolios; at no time were they ever invested in any collective investment scheme. Furthermore, the fund managers' mandates were to maximise profits by the management of trading portfolios in South African listed shares. On average, approximately 50% of the shares held by the fund managers in such segregated, trading portfolios were held, in the discretion of those fund managers, for periods in excess of three years. However, the mandates to trade in shares were never altered, and the companies never made any election in terms of section 9B of the Income Tax Act.

One of Mr X's stated, but undocumented, intentions in setting up the structures incorporating the trusts and the companies was to maximise the interest allowed to be remitted to the offshore bank account in terms of South African exchange control regulations, so as to effect a more appropriate geographic diversification of his wealth. Per agreement with the South African Reserve Bank's ('SARB') exchange control authorities, interest could only be remitted to the extent it had accrued, only to the extent that the underlying origin of such interest was trading profits, and only in an amount that would not compromise the initial balance in the blocked Rand account;

hence, the SARB waived its insistence on a 3:1 debt to equity ratio in favour of the agreed remittance policy. Also, the SARB sanctioned the use of the interest rate of prime plus 2% per annum.

Furthermore, the need for a parallel or duplicated structure (Trust A holding Company A and Trust B holding Company B) was predicated (although never documented) on the management of risk: in the event of some catastrophic event affecting one of the structures, the hope was that the other would be insulated.

In 2007, Mr X resigned as a trustee of both trusts, but remained a beneficiary of each.

Mr X's last will and testament provided for the donation of his loans to each of Trust A and Trust B to those respective trusts upon his death.

No dividends were ever paid by the companies to the trusts.

In the tax returns for each of the tax years ending 2002 to 2009, the trusts and the companies deducted the full amount of interest on the loans (the trusts having declared the interest received from their respective wholly owned companies as gross income). Furthermore, the share portfolios were treated as trading stock per section 22 of the Income Tax Act.

In January 2006, the Commissioner issued revised assessments for each of the companies in respect of the 2002, 2003 and 2004 years of assessment, disallowing in each instance and on the basis of section 31(3)(a) of the Income Tax Act so much of the interest deductions as related to the proportion of the loans that exceeded the financial assistance to fixed capital ratio per SARS Practice Note 2. Furthermore, the Commissioner deemed the interest so disallowed to be a dividend in terms of 64C(2)(e), and levied Secondary Tax on Companies ('STC') accordingly. Further still, the Commissioner sought to charge interest and penalties on the amounts of income tax, provisional tax and STC not paid by the companies. The Commissioner did not issue revised assessments for the trusts.

At no time had the companies approached or made application to SARS requesting the Commissioner to exercise his discretion regarding the application of section 31(3). The companies also successfully applied to the Commissioner for deferment of payment of the outstanding taxes, interest and penalties.

In subsequent years of assessment (i.e. from 2005), the companies continued to deduct the full amount of interest, and the Commissioner continued to issue revised assessments on the basis described above.

Extracts from the financial statements of the companies and the associated tax calculations, as well as the calculations pertaining to SARS's application of section 31(3) of the Income Tax Act are included in Appendix 1.

Chapter 1: Exordium

Section 31(3) of the Income Tax Act 58 of 1962 ('the Act') is directly relevant to the field of international tax.[1] The section seeks to prevent the avoidance of taxation in South Africa by limiting the extent to which interest on financial assistance from non-residents to South African residents may be deducted where such financial assistance is considered to be excessive relative to the other capital of the South African resident.[2]

The South African courts have never had occasion to test section 31(3) or its application. By way of a case study (which, whilst purportedly hypothetical, is based on the facts described in the Preamble and Appendix 1), this dissertation examines an application of the so-called 'thin capitalisation' rules embodied in section 31(3) to a South African emigrant's circumstances.

The research questions

The following questions are posed in the context of the case study:

1. Was the South African Revenue Service ('SARS') justified in applying section 31(3) and if so, was its application thereof correct?
2. Should the emigrant's status as a South African resident at the time of granting financial assistance affect the application of section 31(3)?

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[1] B Larking (ed) 'International Tax Glossary' (2001) 201 defines 'international tax' as follows: 'Traditionally international taxation refers to treaty provisions relieving international double taxation. In broader terms, it includes domestic legislation covering foreign income of residents (worldwide income) and domestic income of non-residents; domestic legislation and treaty provisions containing rules against international tax avoidance and evasion; domestic legislation and treaty provisions relieving international economic double taxation; EC Directives and domestic legislation concerning cross border direct taxation; and international rules and domestic legislation on the taxation of diplomats, consular officers and officials of intergovernmental organisations'. Section 31(3) is domestic legislation aimed at the prevention of the avoidance of tax on the amount of finance charges remitted to a non-resident lender.

[2] Without the limitations of section 31(3), the South African fiscus would be allowing a deduction in full of interest incurred by the South African resident and, owing to the exemption provided by section 10(1)(h), the non-resident recipient of such interest would not be taxed in South Africa on that receipt.

3. Could objections be raised to the application by SARS of section 31(3), and if so, on what basis?
4. How might section 31(3) be applied prospectively on the facts of this case?

Scope of the research

The scope of this dissertation is limited to the field of international taxation. Given that section 31(3) of the Income Tax Act applies only in instances of non-resident financial assistance to South African residents, it falls within the requisite ambit.

As a result of the focus on section 31(3), the dissertation will not consider any of the following:

- The application of general anti-avoidance rules in addition to or as an alternative to section 31(3), since section 31(3) is an anti-avoidance section in its own right.
- The administration of the Income Tax Act, except to the extent that questions arise relating to the Commissioner's exercise of his discretion in terms of section 31(3).
- Capital gains tax, donations tax and estate duty, since none of these taxes arise or are affected by the application of section 31(3).
- Secondary Tax on Companies ('STC'), since the levy of such tax in terms of section 64C(2)(e) is a consequence of the application of section 31(3) and not a factor influencing its application. *Post hoc ergo propter hoc.*
- Penalties and interest, for the same reasons given for STC.

It is not the objective of this study to examine the exchange control regulations in any detail, nor is there any intention to justify or criticise their use *per se*. Exchange control is accepted as an incumbent restriction on the movement of funds from South Africa.

Research method

The case study method provides the framework for the exploration of the research questions in this dissertation.

The case study method has particular application when considering a contemporary phenomenon in a real-life context.[3]

The notions that case studies do not allow for generalisation from a single case and that they are arbitrary and subjective have been refuted.[4] On the contrary, it is shown how case studies have specific application to the social sciences.[5]

The case study method has particular application to the field of law and legal research. It is trite that the courts often differentiate matters that come before them on the facts. As such, a consideration of a specific set of facts that illustrate circumstances on which the courts have not pronounced must be an entirely justifiable means of research.

Furthermore, the application of the law to a case study permits an examination of detailed circumstances that might otherwise escape an analysis conducted in more general terms.

Contribution to the field of tax law

The use of a case study in this dissertation will demonstrate the application of the law to a known set of facts. As such, the case study will be able to canvas responses to concrete issues and possible conundrums that might escape consideration in a general discussion of thin capitalisation rules as a phenomenon.

In Chapter 3 an assessment of the first research question sets out the basis upon which SARS could apply section 31(3) on the unique facts of this case. Particular difficulties are identified which could inform the drafting of future legislation or practice notes.

In Chapter 4 the analysis of the second research question considers the substance and possible outcome of any debate pertaining to the application of section 31(3) financial assistance granted by South African residents who change their residency status subsequently. This analysis also has implications for the drafting of tax legislation

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[3] R Yin 'Case Study Research' (1994).

[4] B Flyvbjerg 'Five Misunderstandings About Case-Study Research' (2006) *Qualitative Inquiry* 12(2) at 219 to 245.

[5] *Ibid.*

or practice notes, and it also highlights a potential opportunity for planning the affairs of emigrants.

Chapter 4 also examines in more detail the other potential grounds for objection arising from the analysis in Chapter 3 of SARS's application of section 31(3). The viability of these grounds as bases for objection can be of value to tax practitioners confronted with circumstances akin to the facts of this case.

The consideration of the fourth research question in Chapter 5 may be of value to tax practitioners, taxpayers, non-resident investors and emigrants alike as they structure their affairs and design their investment strategies, given the proposed deletion of section 10(1)(h) and its replacement by section 10B, and the proposed amendments to section 31(3).

Chapter 6 provides summary conclusions to all of the research questions, makes recommendations and offers areas for further research arising from the facts of the case study and from the analysis of section 31(3).

Chapter 2: The origins of and rationale for section 31(3)

Sulaiman (2010: 1) encapsulates the rationale for section 31(3) succinctly: 'During the 1980's, multinational companies were aggressively engaging in tax abusive thin capitalisation practices whereby they would finance companies through a high proportion of debt in relation to equity funding and thereby claim huge tax deductions in high-tax jurisdictions and shift profits to low-tax jurisdictions. Internationally countries swiftly enacted thin capitalisation rules to counter these practices. South Africa ("SA") only followed suit after it re-entered the international community in 1994 and pursuant to the recommendations of the SA Katz Commissions of Inquiry'.

Section 10(1)(h) of the Income Tax Act provides that interest received by or accrued to a non-resident[6] is entirely exempt from taxation.

Prior to 1997, the exchange control regulations were onerous and all but outlawed foreign loans to South African residents. In his budget speech on 12 March 1997, then Minister of Finance Trevor Manuel announced several measures to relax exchange control, including allowing South African corporations to raise foreign funding on the strength of their South African balance sheets: this necessarily implied permitting the outflow of interest on such foreign funding. The legitimate fear, duly anticipated, was that the relaxed rules regarding outflows would lead to fiscal abuse: the fiscus would be subsidising the deduction of interest by South African companies that were capitalised with large amounts of foreign debt with no concurrent receipt of tax on interest income (owing to the section 10(1)(h) exemption).

Section 31(3) therefore sought to prevent the avoidance of tax in this manner.

<u>International context</u>

Thin capitalisation rules are not unique to South Africa, nor are they only legislated in reaction to the relaxation of exchange controls. An unpublished survey[7] shows how over one-third of eighty seven nations surveyed have thin capitalisation rules. Safe

[6] Provided that where such non-resident is a natural person, he or she is physically absent from the Republic for more than 183 days in aggregate during the relevant year of assessment and, for all persons, that such person does not conduct business in the Republic through a permanent establishment.

[7] Deloitte. 2010. *Thin Capitalisation Survey 2009*. Unpublished survey.

harbour[8] debt to equity ratios range from 1:1 to 7:1 with an average of 3.1:1.[9] In almost every instance, the tax impact of non-compliance with the guideline debt to equity ratios is the disallowance of the deduction of the affected excessive interest; most countries include other restrictions too.[10]

The fiscal impact of not preventing thin capitalisation abuses has been recognised, as well as 'non-tax reasons for debt financing'.[11] It is clear that the international community is cognisant of the fact that not every debt transaction is necessarily a tax avoidance scheme.

The tax treatment of dividends is related to the incentive to provide loan capital, in that the lower the rate of corporate tax (on both profits and dividends), 'the smaller the incentive to provide the company with loan capital'.[12]

However, it has been questioned whether thin capitalisation rules are effective at actually securing higher taxes for affected nations and it has been asserted that additional tax revenue brought in by such rules is minimal.[13] Furthermore, thin capitalisation rules 'lead to relatively few conflicts between tax authorities and taxpayers';[14] however, such conflicts tend to be negotiated and settled before a court is required to hear the matter.[15]

Notwithstanding the apparently relatively insignificant impact of thin capitalisation rules on revenue collection and conflict management, none of the 29 countries surveyed by Piltz planned to abolish such rules.[16]

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[8] The ratio of debt to equity below which the taxing authorities will not apply the thin capitalisation rules.

[9] SARS's safe harbour ratio is 3:1, which is comparable with the surveyed global average.

[10] The Income Tax Act, 1962 provides for amounts disallowed to be deemed dividends, attracting the associated Secondary Tax on Companies charge; interest on unpaid taxes and associated penalties also have application.

[11] D Piltz 'General Report – International aspects of thin capitalization' (1996) *Cahiers de droit fiscal international*, 81b at 92.

[12] *Ibid* 93.

[13] *Ibid* 137.

[14] *Ibid* 138.

[15] *Ibid.*

[16] *Ibid* 139.

The Organisation for Economic Co-operation and Development ('OECD')

Although the OECD Articles Of The Model Convention With Respect To Taxes On Income And On Capital[17] have no express reference to thin capitalisation rules, the OECD Model Tax Convention On Income And On Capital (Condensed Version) ('the OECD Commentaries') contain several such references, specifically regarding the application of Article 9 (associated enterprises),[18] Article 10 (dividends),[19] Article 11 (interest),[20] Articles 23A and 23B (the exemption and credit methods of eliminating double taxation),[21] Article 24 (non-discrimination)[22] and Article 25 (mutual agreement

[17] Organisation for Economic Co-operation and Development. 2008. *Articles Of The Model Convention With Respect To Taxes On Income And On Capital.*

[18] Article 9(1) of the Model Convention provides for the inclusion in taxable profits of amounts that would have accrued to what is effectively a connected person were the transaction to have been at arm's length. The Commentaries (2008: 146) indicate that Article 9 does not prevent the application of domestic thin capitalisation rules where the effect of such rules is to assimilate arm's length profits that did not accrue; also, the Article also has application in determining whether the form of capital in question should be regarded as a loan or something else, were it to have been advanced at arm's length. Critically, the Commentaries (2008: 147) note that the effect of applying thin capitalisation rules should not have the effect of increasing taxable profits to a level greater than arm's length.

[19] Article 10(2) of the Model Convention prescribes limits on the taxation of dividends. The Commentaries (2008: 153) note that where an amount is classified as a dividend as a result of the application of thin capitalisation rules (provided that the essential characteristic of the loan is that it is tantamount to equity given the risk exposure of the lender), the value of the loan giving rise to such reclassified amount should itself be reclassified as 'capital' as it is understood in company law (i.e. as share capital or premium, but not as reserves). The Commentaries (2008: 155) further recommend that Articles 10 and 11 of the Model Convention do not prevent the reclassification of interest as dividends under thin capitalisation rules.

[20] Article 11(3) of the Model Convention defines 'interest'. The Commentaries (2008: 175) specifically exclude from 'interest' any amounts dealt with in Article 10 following the application of thin capitalisation rules. Effectively, the Commentaries indicate that an income item arising in a thin capitalisation situation may be classified as dividends or as interest, but not as both.

[21] Article 23B(1) details how the credit method may be used to avoid double taxation. The Commentaries (2008: 279) notes that in circumstances of thin capitalisation, the Model Convention permits the classification of interest as dividends (see footnote 19 above); as a consequence, a procedure is recommended for the determination of the appropriate credit to be applied to the amount reclassified.

[22] Article 24(4) requires that amounts should be similarly deductible, unless the provisions of Articles 9(1), 11(6) or 12(4) apply. The Commentaries (2008: 301) note that this paragraph does not prevent the application by a state of its domestic thin capitalisation rules, provided that these comply with Articles 9(1) or 11(6); however, were domestic rules are not compliant with the aforementioned Articles, then the application of the thin capitalisation rules is prohibited. Article 11(6) pertains to the deductibility only of arm's length amounts of interest, with any excess being taxable. Article 24(5) prohibits different tax treatment of non-residents in a contracting state. The Commentaries (2008: 303) note specifically that Article 24(5) is not contravened if thin capitalisation rules prevent the deduction by a resident of interest paid to a connected non-resident, provided that the same treatment would be meted out where an independent non-resident similarly made a loan to a resident. Sulaiman (2010: 119) concluded that the South African thin capitalisation rules do not constitute such prohibited discrimination.

procedure).[23]

Sulaiman (2010: 8) notes that '[t]he majority of SA tax treaties are based on the OECD MTC [Model Tax Convention]'. Furthermore, Sulaiman (2010: 11)[24] notes that '[e]ven though SA is not a member of the OECD, because it has adopted the wording of the OECD MTC in most of its tax treaties, it has implicitly bound itself to the wording of the OECD MTC, as interpreted by the Commentaries'.

In terms of section 108(2) of the Income Tax Act, 1962, the provisions of any double taxation agreement entered into between South Africa and another state have the force of law as if enacted by the Income Tax Act. In *Secretary for Inland Revenue v Downing*,[25] Corbett JA (as he then was), said:

> The terms of the convention are evidently based upon a model convention contained in the 1963 report of the fiscal committee of the Organization for European Economic Co-operation and Development (OECD). This model has served as the basis for the veritable network of double taxation conventions existing between this country and other countries and between many other countries *inter se*.

In *ITC 1503*[26] the court cited the abovementioned quotation from *Secretary for Inland Revenue v Downing*[27] in justifying its reliance on the OECD Commentaries.

In both of the aforementioned cases, the OECD Commentaries were of relevance because the avoidance of double taxation was governed by a double taxation agreement ('DTA') entered into between South Africa and another state. In this case study, however, no applicable DTA exists;[28] hence it is submitted that the OECD Commentaries would have no application or persuasive value in this instance.

[23] Article 25(1) and 25(2) set out the basis upon which two contracting states should reach a conclusion in preventing double taxation where a person experiences a result 'not in accordance with the provisions of this Convention'. The Commentaries (2008: 306) note that the tax treatment by the respective contracting states of reclassified interest and dividends arising from the application of thin capitalisation rules arises commonly in the mutual agreement procedure.

[24] Citing (Clegg, 2008: 60 & Haupt & Huxham, 2009: 440).

[25] 37 SATC 249 at 255.

[26] 53 SATC 342 (T)

[27] See note 25.

[28] Interest was paid by the South African resident companies to South African resident trusts, which in turn paid interest to accounts held by the investor in a so-called 'tax haven' jurisdiction with which South Africa had not concluded a double tax agreement.

The United Nations ('UN')

Whilst United Nations published a draft model on tax treaties in 1980, '[t]he view is often held that the UN MTC does not make a significant contribution to tax treaties'.[29] Given both the absence of an applicable DTA in the case study and the lack of credibility of the UN MTC, it will not be considered any further in this dissertation.

The Katz Commission of Inquiry

In its 1994 report, the Katz Commission noted that relaxation of exchange controls was under consideration, and that whilst the decision to effect such relaxation 'should not be influenced by tax considerations', the Commission tabled the tax considerations in respect of (a) the removal of the dual currency system and (b) the removal of other exchange control constraints on residents, including the requirements for a 3:1 shareholder debt to equity ratio and practices regarding transfer pricing.[30] The Commission did not table any recommendations regarding the removal of controls on South African residents, nor the removal of constraints on emigrants.

Noting the fiscal effects of potential over-gearing in the wake of the relaxation of the relevant exchange controls, the Commission concluded that the prevention of avoidance should not be effected by reimposing tax on interest in the hands of non-residents and also noted several problems with the introduction of thin capitalisation rules.[31] These problems informed the Commission's conclusions with the result that it recommended a combination of a debt to equity formula approach and an arm's length approach.[32] The Commission also recommended a statutory safe harbour ratio (a ratio of 5:1 was recommended), whilst still providing that investors should retain the opportunity to present objective evidence that any excess over such safe harbour ratio was justifiable on an arm's length basis.[33]

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[29] L Olivier and M Honiball *International Tax A South African Perspective* (2008) 10.

[30] Katz Commission *Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (1994) 228.

[31] *Ibid* 229.

[32] *Ibid* 230.

[33] *Ibid.*

The Commission also favoured the treatment of excess interest as a dividend, with the associated Secondary Tax on Companies charge being suitably applied.[34]

The Second Interim Report of the Katz Commission tabled more specific recommendations regarding thin capitalisation, going so far as to draft the wording of both proposed legislation and a proposed practice note.[35]

Barring some minor differences, the recommendations of the Katz Commission were implemented by SARS in section 31(3) and in Practice Note 2.

Exchange Control

Exchange control has existed in South Africa in one form or another since 1939 with the present exchange control regulations having been enacted in 1961 with subsequent amendment.[36]

For emigrants, amounts remaining after the maximum export allowances have been used create 'so-called blocked assets' which may (since 2003) be transferred offshore subject to the payment of a 10% levy on the amount so remitted.[37]

Furthermore, the exchange control requirement that Rand-denominated foreign loans to South African residents may only bear a rate of interest exceeding the prime rate upon application to and approval by the South African Reserve Bank, in which instance an increment over the prime rate of up to three percent may be permitted.[38]

Section 31(3)

Section 31(3) of the Act had its genesis in the 1994 Interim Report of the Katz Commission, with the wording of the section having been suggested in the Appendix to

[34] *Ibid* 231.

[35] Katz Commission *Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (1995).

[36] 'The present control measures were introduced by way of the Exchange Control Regulations, as promulgated by Government Notice R1111 of 1 December 1961 and amended up to Government Notice No. R.885 in Government Gazette No. 20299 of 23 July 1999 and Orders and Rules 1961, as published in Government Notice R1112 of 1 December 1961 and amended up to Government Notice R.791 in Government Gazette No. 18970 of 5 June 1998, issued in terms of the Currency and Exchanges Act, 1933 (Act No. 9 of 1933).' (SA Exchange Control, 2010).

[37] Olivier & Honiball (note 29) at 539.

[38] *Ibid* 541.

the 1995 Second Interim Report of the same Commission. The section was promulgated in 1995[39] and, barring some small amendments in 2000,[40] it has not been altered since.

Section 31(3) exists because section 11(a) does not limit the deduction of interest. Furthermore, as noted under 'The Katz Commission of Inquiry' above, the continued exemption from taxation of interest paid to non-residents offers an additional justification for the existence of section 31(3).[41]

What is not clear is whether the legislature intended section 31(3) to have application to loans made by non-residents from the proceeds of a blocked Rand account, particularly considering that the Katz Commission's considerations did not specifically include the application of thin capitalisation rules to emigrants.[42]

Practice Note 2

SARS issued Practice Note 2 on 14 May 1996 to offer some clarity on how SARS applied section 31(3). Barring an amendment to the maximum acceptable rate of interest in 2000,[43] it too has not been altered since inception.

With this background duly considered, the next chapter analyses the application by SARS of section 31(3) to the facts of the case study.

[39] Section 23 of the Income Tax Act 21 of 1995 which substituted section 31 of the Income Tax Act 58 of 1962.

[40] Act No. 59 of 2000

[41] Olivier & Honiball (note 29) at 486.

[42] Katz Commission (note 30) at 228.

[43] Government Notice 746 of 2002, which reduced the increment over the relevant interbank rate on a foreign currency denominated loan from a non-resident to a South African resident to 2% from 4%.

Chapter 3: The application of section 31(3) by SARS

This chapter addresses the issue of whether the South African Revenue Service ('SARS') was justified in applying section 31(3) and if so, whether its application thereof was correct.

Whilst it may not have been the vision of the Katz Commission that the thin capitalisation rules of section 31(3) were to be applied to emigrants,[44] the section as it is worded does not differentiate between emigrants and others. Hence, it is fair to presume that SARS would have applied the section literally, which is in accordance with the rules of interpretation used by the South African courts. Indeed, in *Welch's Estate v Commissioner, SARS*[45], Zulman JA said:

> I do not believe that it is correct to generalise about the intended reach of revenue legislation. Its reach must be determined by the language which the Legislature has chosen to express its will.

However, following the judgment in *Commissioner, SARS v Airworld CC & Another*[46], SARS might also choose (where, with respect, it might suit SARS to do so) to apply a purposive approach to the interpretation of the Income Tax Act. In the aforementioned judgment, Hurt AJA said:

> Most of the rules of interpretation have been devised for the purpose of resolving apparent ambiguity and arriving at an interpretation which accords as well as possible both with the language which the Legislature has used and with the apparent intention with which the Legislature has used it. In recent years Courts have placed emphasis on the purpose with which the Legislature has enacted the relevant provision. The interpreter must endeavour to arrive at an interpretation which gives effect to such purpose. The purpose (which is usually clear or easily discernable) is used, in conjunction with the appropriate meaning of the language of the provision, as a guide in order to ascertain the legislator's intention.[47]

What follows is a stepwise application of section 31(3) to the facts of the case study.

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[44] See the discussion on page 13 in Chapter 2.

[45] 2005 (4) SA 13 (SCA) at 89.

[46] 2008 (3) SA 335 (SCA).

[47] *Ibid* at 25.

Non-resident lender

On the facts of the case, it appears that the investor (hereinafter referred to as 'the investor' or 'the emigrant') was not a resident at the time that SARS applied section 31(3). However, the investor was resident in the Republic at the time that the loans were granted. Whether or not this precludes, or may be offered as an objection or defence against, the application of section 31(3) is discussed in detail in Chapter 4. It is clear that if SARS applied section 31(3) in this case, the Commissioner considered that the investor's emigrant status fell squarely into the ambit of the phrase 'who is not a resident'.

Grant of financial assistance

It is evident that the investor had granted financial assistance in the form of loans.[48] The loans had been made to South African resident trusts,[49] which in turn had made similar loans to South African resident companies.

The timing of the grant of the loan may be an issue of contention. On the facts of the case, the investor was a South African resident at the time at which the loans were granted to the trusts. In applying the section to the companies, SARS clearly had no regard to the investor's residence at the time of granting the financial assistance. The section has the words '… is not a resident has granted …' (emphasis added). It can be inferred that SARS applied the literal meaning of the word 'is' which denotes the present tense; inasmuch as the investor was indeed non-resident in the years of assessment that SARS applied the thin capitalisation rules, their justification for doing so in this instance must be in the very literal meaning of the verb.

This interpretation is not necessarily very clear, and hence it is also considered in more detail in Chapter 4.

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[48] Section 31(1) defines 'services' to include 'financial assistance', which in turn includes 'a loan, advance or debt, and the provision of any security or guarantee'.

[49] Paragraph (b) of the definition of 'resident' in section 1 of the Income Tax Act, 1962 includes any 'person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic'. The definition of 'person' includes 'any trust'.

Direct or indirect financial assistance

It is equally evident that the investor had granted loans directly to the trusts. The trusts, in turn, loaned the whole amounts so received directly to their respective wholly owned companies on substantially the same terms and conditions.

The question arises as to whether SARS was correct in considering the loans made by the trusts to the companies to be loans made indirectly by the investor to the companies. Stated differently, was SARS correct in applying the rules of section 31(3) to the companies, or should the rules have been applied to the trusts?

Difficulty quantifying the permanent capital of a trust

In the first instance, it is clear why SARS might not have chosen to apply the rules to the trusts, as the determination of 'excessive'[50] financial assistance would be difficult considering that a trust has no permanent or fixed capital. 'A trust … does not have share capital or share premium, and in most cases will have no permanent owners capital, in the sense that the capital of the trust is to be distributed to the beneficiaries at some time in the future'.[51]

The literal meaning and application of 'indirectly'

Secondly, the literal meaning of 'indirectly' includes 'through some intervening person or thing'.[52] The trusts may be construed correctly as such given their interposition between the emigrant and the taxpayer companies and most especially considering the *post factum* cession to the trusts of the loans made by the emigrant to the companies in favour of similar loans from the investor to the trusts. However, the nature and extent of such interposition should be considered carefully.

For SARS effectively to have looked through the trusts in this instance implies that the Commissioner either had no regard for or did not consider the independence of the trustees, or that the Commissioner simply did not consider the trustees to be independent as it did not appear that there had been a conscious and considered

[50] Section 31(3)

[51] D Clegg & R Stretch 'Income Tax in South Africa' (2009) at 24.12.3.

[52] 'indirectly, adv.²' The Oxford English Dictionary, 2nd ed, 1989, OED Online. Oxford University Press, 15 May 2010 <http://dictionary.oed.com/cgi/entry/50115396>.

decision on the part of any trustee (but particularly an independent one) to interpose him- or herself between the investor and the companies. Stated differently, SARS did not consider that and decisional node resulting from trustee independence would, in any way, frustrate application of the word "indirectly".

On the facts of the case, it appears that, but for the loans to the companies, the trusts had no other assets; equally, but for the loans from the investor, the trusts had no other liabilities; the liabilities of the trusts exactly equalled the amount of the assets of the trusts, and the trusts did not appear to have any other activities. Whilst the investor was both a trustee and a beneficiary of both trusts (but neither the sole trustee nor the sole beneficiary), SARS appears to have considered that the trusts were merely alter egos for the investor to give effect to his loans to the companies.

There is case law to support SARS's apparent view. In *Badenhorst v Badenhorst*,[53] Combrink AJA stated:

> … whilst the de iure control of a trust is in the hands of the trustees, 'very often the founder in business or family trusts appoints close relatives or friends who are either supine or do the bidding of their appointer. De facto the founder controls the trust. To determine whether a party has such control it is necessary to first have regard to the terms of the trust deed, and secondly to consider the evidence of how the affairs of the trust were conducted…[54]

In *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust*[55], the Appellate Division (as it then was) Smalberger JA stated *obiter dictum* that:

> [I]t is arguable that any intention or contemplation of a profit accruing to the Trust could only have been that of the founder of the Trust, viz Stores. The fact that the Trust, in effect, is the alter ego of Stores would seem to demonstrate this proposition. In that context, it is consistent that provision is made, on termination of the Trust, for any surplus to be paid over to Stores.

In the context of this case study though, it is only the independence of the trustees that should be considered, as all amounts paid to the investor were paid to him in his capacity as lender rather than as beneficiary. The imperative question is whether the loans made by the trusts to the companies were made at the investor's bidding (or more specifically, whether the cession of the investor's loans to the companies in favour of the trusts in exchange for similar loans from the investor to the trusts was executed at

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[53] 2006 (2) SA 255 (SCA).

[54] Cited in Surtees, P. 2007. Focus on trusts in the courts. Taxgram, August. [Online]. Available: http://butterworths.uct.ac.za.ezproxy.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu [25 April 2010].

[55] 54 SATC 271(A).

the investor's behest). SARS appears to have answered that question in the affirmative; on the facts given, the Commissioner's position may be warranted, but it does not appear to be unassailable, and it is possible that the taxpayer companies could mount a credible defence to this notion.

The purposive meaning and application of 'indirectly'

Thirdly, even if SARS were to have applied a purposive interpretation of the word 'indirectly' in the context of section 31(3), it is likely that the application of the section to the taxpayer companies would have been warranted still. The purpose of the legislature in enacting the section was to curb the avoidance of tax by resident companies.[56] The effect[57] of the transactions entered into between the investor and the trusts, and between the trusts and the companies, was to avoid liability for taxation through the use of 'excessive' debt financing. SARS may have been circumspect of the rationale for the *ex post facto* interposition of the trusts between the investor and the companies after the advance of the loans by the investor to the companies. It may appear that the trusts were interposed to avoid the application of section 31: had they not been so interposed, the loans made by the investor (presuming no question of residence as referred to on page 17) may have fallen squarely into the scope of section 31.[58] This notion too, whilst advanced seemingly fairly on the facts, may also be subject to rebuttal by the taxpayer companies.

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[56] Tax would be avoided by the deduction by resident companies of interest on loans from non-residents, which interest would be exempt from tax in the hands of such non-residents by virtue of section 10(1)(h).

[57] Although an anti-avoidance section, section 31(3) makes no mention of the consideration by the Commissioner of the <u>purpose</u> of a transaction, bar that the Commissioner should have 'regard to the circumstances of the case' (which does not expressly nor necessarily imply that the purpose should be considered). But for that consideration by the Commissioner, the notion of the taxpayer's purpose in receiving excessive financial assistance from a non-resident is not at issue.

[58] In the absence of any third party shareholder of the companies (and presuming that the investor would have held the shares in the companies instead of the trusts, in their absence) the investor would have been capable of participating in more than 25% of the dividends, profits or capital of the companies, or of exercising more than 25% of the votes in those companies. Hence the investor, a non-resident, would have granted financial assistance directly to resident companies in amounts far in excess of (certainly more than three times) those companies' permanent capital. The application of section 31 would have been beyond doubt.

<u>Resident connected person</u>

The investor loaned amounts to the trusts, which in turn loaned amounts to the companies. Section 31(3)(a)(i) requires that the financial assistance from the non-resident must have been provided to a resident connected person in relation to that non-resident.[59] What must be determined is whether the investor is a connected person in relation to the affected taxpayer companies.

Investor connected to trusts

Paragraph (a)(ii) of the definition of 'connected person' in the Act specifically indicates that a trust of which a natural person is a beneficiary is a connected person in relation to such natural person.

Paragraph (b)(i) of the definition of 'connected person' in the Act identifies any beneficiary of such trust to be a connected person in relation to such trust. There can be no question of differentiation based on whether the beneficiary is a discretionary or vesting one: the use of the word 'any' removes all doubt.

Hence, given that the investor is a beneficiary of each of the trusts, he is unequivocally a connected person in relation to the trusts and the trusts are connected persons in relation to him. Had he not been a beneficiary of the trust, but merely a lender to it, the definition of 'connected person' might not have been satisfied. However, this would also have necessitated that none of the investor's relatives could have been beneficiaries of the trusts either, which may have been entirely counter to the objective of the structure.

Trusts connected to companies

Paragraph (d)(iv) of the definition of 'connected person' in the Act includes

> 'any person, other than a company as defined in section 1 of the Companies Act, 1973 (Act No. 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the company's equity share capital or voting rights'.

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[59] The alternative recipient of the financial assistance is covered by section 31(3)(a)(ii), which is discussed under the heading 'Any other resident person in whom the investor has an interest'. It is important to note that <u>either</u> section 31(3)(a)(i) must be applied, <u>or</u> section 31(3)(a)(ii) must be applied – the Commissioner does not have to satisfy the requirements of both.

The definition of 'person' in section 1 of the Act includes 'any trust'.

In this case, the trusts own 100% of the equity share capital of their respective subsidiary companies. Clearly, the trusts are connected persons in relation to the companies.

The connected person relationship is reciprocal: 'In other words, when "B" is defined as a connected person "in relation to" "A", "A" is simultaneously a connected person "in relation to" "B": more simply, "A" and "B" are connected persons'.[60] By implication, then, the companies are connected persons in relation to the trusts.

Investor connected to companies

All that remains to be determined is whether the investor is a connected person in relation to the companies. The provisions of both paragraphs (bA) and (e) of the definition of 'connected person' in the Act apply in this instance.

In terms of paragraph (bA), the investor is a connected person in relation to the trusts, and so is a connected person of 'any other person who is a connected person in relation to such trust'. In respect of paragraph (bA), '[i]n other words, if "A" is a connected person in relation to a trust and "B" is a connected person in relation to the same trust, "A" is a connected person in relation to "B": more simply, beneficiaries of the same trust are connected persons'.[61] With respect, the definition is worded sufficiently widely that it is not limited only to beneficiaries of the same trust. It follows from a consideration of paragraph (bA) that the investor is connected to the subsidiary companies of each trust.

In terms of paragraph (e), the investor is a connected person in relation to the trusts, and so is 'a connected person in relation to any other person [*viz* the companies] in terms of the foregoing provisions of this definition'.

There can be no doubt that SARS's application of this part of section 31(3) was entirely appropriate.

[60] A de Koker 'Silke on South African Income Tax' (2009) at 1.16B.

[61] *Ibid.*

Any other resident person in whom the investor has an interest

Whilst superfluous given the satisfactory application of section 31(3)(a)(i) to the facts of the case study, it is illuminating to consider whether section 31(3)(a)(ii) might have been applied.

Per section 31(3)(a)(ii), the recipient of the financial assistance must be a person other than a natural person in whom the non-resident 'investor' has a direct or indirect interest.

'Company' is not specifically added as an additional inclusion in the definition of 'person' in section 1 of the Income Tax Act. However, paragraph (b) of the definition of 'person' in the Interpretation Act, 1957[62] includes 'any company incorporated or registered as such under any law'. The definition of 'person' in the Income Tax Act includes the persons so defined in that Act; it follows that such inclusions are in addition to those already included in the Interpretation Act.

The issue to be determined is whether or not the investor has an interest in the companies, and whether, by virtue of such interest, he is entitled to not less than 25% of the 'dividends, profits or capital of the recipient' or, in the alternative, whether he is 'entitled, directly or indirectly, to exercise not less than 25 per cent of the votes of the recipient'. As was also discussed under 'Direct or indirect financial assistance' previously, the independence of the trustees of the trusts would have to be considered in relation to the investor's entitlements or his ability to exercise the votes in those companies.

The application of section 31(3)(a)(ii) would have required some specific and additional enquiry regarding the independence of the trustees and the discretionary or vesting nature of the investor's benefits, but the issue is moot as section 31(3)(a)(i) applies in the first instance.

[62] Act No. 33 of 1957.

Requirement for the Commissioner to have regard to the circumstances of the case in reaching his opinion

Section 31(3)(a) enjoins the Commissioner to 'hav[e] regard to the circumstances of the case' when forming his opinion as to whether or not the financial assistance granted by the non-resident is excessive.

The purported rationale of the structure implemented by the investor[63] was to effect the maximum permissible remittances offshore in terms of the South African Reserve Bank's ('SARB') exchange control regulations so as to achieve an appropriate and adequate geographic diversification of the investor's aggregate assets.[64] To that end, the investor had concluded agreements with the SARB to enable a rate of 2% over the prime overdraft rate[65] to be applied to the loans made to the trusts, and to permit the remittance of all such interest so accrued provided that the initial amount of the blocked Rand account was not compromised; the SARB effectively waived application of its preferred 3:1[66] debt to equity ratio.[67] The investor had engaged with the SARB in the first instance (and had not similarly engaged with SARS). This may be illustrative (but certainly not conclusive) of his imperative to achieve his purported investment objective without any regard for the avoidance of tax.

The Commissioner's discretion

By the use of the words 'the Commissioner is … of the opinion that …', section 31(3)(a) confers a discretion on the Commissioner to determine the amount of excessive financial assistance granted by a non-resident lender to a resident satisfying the

[63] That is, the loans from the investor to the trusts, and the loans by the trusts to their respective wholly owned subsidiary companies.

[64] Per the facts of the case study, the considerable bulk of the investor's assets were in a blocked Rand account in terms of the Exchange Control regulations.

[65] South African Reserve Bank. 2009. Exchange Control Manual. Pretoria: Government Printer. p O9 6.1.7.3.

[66] The parallel between the SARB's preferred debt to equity ratio (see South African Reserve Bank, Exchange Control Manual, 2004: Q3 6.2.1.3) and SARS's guideline ratio is not coincidental: the thin capitalisation rules were enacted in anticipation of the relaxation of Exchange Control; furthermore, paragraph 4.1 of SARS Practice Note 2 states that '[t]his approach will ensure a degree of continuity as it will, to some extent, correspond with the current practice of the Exchange Control Authorities'.

[67] It may have been difficult for the SARB to apply this ratio to an individual natural person in any event. Clegg (2009: 24.12.3) points out that '[a]n individual, for example, does not have share capital, share premium, or accumulated profits. His or her fixed capital may therefore only consist of so-called permanent owners capital, the meaning of which is not at all clear'.

requirements of section 31(3)(a)(i) or (ii). The nature of the Commissioner's discretion in principle is clarified by noting that '[t]he words "in the opinion of" are equivalent to the words "the discretion of the Commissioner" or "when the Commissioner is satisfied"'.[68] On the Commissioner's 'satisfaction', it has been held that:

> The very fact that he has to be 'satisfied' implies the performance of an act from which legal consequences flow. The performance of that act involves the exercise of an administrative discretion. [69]

The exercise of such discretion and reliance on practice

Paragraph 6 of SARS Practice Note 2 ('PN2')[70] is entitled 'Commissioner's discretion' and sets out SARS's preferred practice in the exercise by the Commissioner of his discretion regarding section 31(3). PN2 requires taxpayers to 'approach the Commissioner, to exercise his discretion in terms of section 31' where 'a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate may be applicable as a result of transactions and agreements entered into for commercial and economic reasons rather than to obtain tax advantages'.

The taxpayer companies in this case did not make any application to the Commissioner for such exercise of his discretion, and SARS applied the guideline 3:1 ratio per PN2 to the financial assistance given to the companies.

The Commissioner's stipulation of a default or guideline position in PN2 and the requirement per PN2 that the taxpayer should approach the Commissioner to exercise his discretion may be construed as an abdication by the Commissioner of his responsibility to properly apply his mind.[71] Furthermore, the taxpayer companies may have grounds for objecting to the Commissioner's reliance on PN2 at all.[72]

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[68] De Koker (note 60) at 18.29 citing *COT v AB Company Ltd* (Botswana Court of Appeal) (December 1982), 45 SATC 78 at 83, which dealt with a foreign statute; *ITC 1448* (1988) 51 SATC 58 at 62.

[69] De Koker (note 60) at 18.29 citing Leveson J, President of the Special Court for Hearing Income Tax Appeals, in *ITC 1470* (1989) 52 SATC 88 at 92.

[70] South African Revenue Service *Practice Note: No. 2 – Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic* (1996).

[71] See Chapter 4.

[72] *Ibid.*

Quantification of excessive financial assistance

Section 31(3)(a) of the Act requires the Commissioner to consider whether the amount of financial assistance is 'excessive in relation to the fixed capital (being share capital, share premium, accumulated profits, whether of a capital nature or not, or any other permanent owners capital, other than permanent capital in the form of financial assistance as so contemplated'. It is submitted that the bracketed list of descriptors following the words 'fixed capital' in section 31(3)(a) is exhaustive (by virtue of the use of the present participle 'being' rather than 'including'), but that the inclusion of 'share capital' and 'share premium' in the list of descriptors does not imply that only a company may have the fixed capital so described, since other persons may also have one or more of the other forms of fixed capital listed.

The Commissioner's decision to apply the provisions of section 31(3) to the companies as opposed to the trusts has already been considered under 'Direct or indirect financial assistance' above.

It is trite that on the facts of the case study, share capital and share premium were only nominal amounts.

What Practice Note 2 clarifies regarding quantification

Section 31(3) is worded broadly, and neither 'excessive' nor 'accumulated profits' are defined terms, nor is the method of quantifying 'excessive' financial assistance described. To this end, PN2 sets out:

1. The 'safe harbour' guideline ratio of financial assistance to fixed capital (3:1), below which SARS will not apply the provisions of section 31(3). Financial assistance in excess of such guideline ratio will be considered to be 'excessive', subject to the exercise of the Commissioner's discretion on application by the taxpayer (PN2, paragraphs 4.1 and 6);
2. The formula for calculating ratio of financial assistance to fixed capital (PN2, paragraph 4.1);
3. Clarification of the meanings of the components of the ratio calculation (PN2, paragraphs 4.2 to 4.5)

The meaning of 'accumulated profits'

'Accumulated profits' must refer to 'accumulated profits as determined under a framework of generally accepted accounting practice'.[73] Various Statements of Generally Accepted Accounting Practice prescribe that adjustments to fair value of the assets of a reporting entity are passed through the income statement (and, consequently, reflected in 'accumulated profits'); as a result, 'accumulated profits' and hence 'fixed capital' could be subject to considerable volatility, particularly in circumstances akin to those of the case study.

Revaluation reserves and losses

Paragraph 4.3 of PN2 requires that 'fixed capital' be 'reduced by any reserves and increased by any losses, resulting from the revaluation of assets' even though such adjustments are not necessarily implied by the descriptors of 'fixed capital' in the wording of section 31(3) of the Income Tax Act. In the same paragraph of PN2, the Commissioner also permits 'annual net trading losses sustained during the current and immediately preceding two years of assessment, limited to losses sustained for years of assessment during which the investor has granted financial assistance to the resident or recipient, [to] be added back to fixed capital'.

From the facts of this case study, it is clear that there were three sources of 'trading profit' in the companies: dividends received from investee companies, realised gains and losses from trading shares and unrealised gains and losses from marking the trading portfolios to market. Certainly, given the trading nature of the share portfolios, all profits and losses (whether realised or otherwise) would have been reflected in the income statements of the companies (and consequently, in the retained income or accumulated profits of those companies); no explicit and separate reserve for revaluation gains or losses would have been created for the unrealised profits and losses.

PN2 does not make it clear whether the reserves and losses from the revaluation of assets include the unrealised profits and losses on the marking to market of a trading portfolio. Given De Koker's (2009: 17.60) observation that 'accumulated profits' must be determined in accordance with Generally Accepted Accounting Practice, it is submitted that the adjustments for revaluation reserves and losses required by PN2 have

[73] De Koker (note 60) at 17.60.

no application in this instance, and therefore such adjustments would not have been made by the Commissioner.[74]

Adjustments for 'annual net trading losses'

On the facts of the case and in terms of PN2, the Commissioner would have made adjustments for the losses sustained by the taxpayer companies in the 2003 and 2009 tax years;[75] paragraph 4.3 of PN2 refers to 'annual net trading losses' in this instance.

It is unclear whether 'trading losses' refers to the result before or after the deduction of finance costs, given that it is the deductibility of some or all of those finance costs that is at issue in the application of section 31(3).

Furthermore, it is equally unclear whether such 'annual trading losses' are considered before or after taxation (and in that instance, whether the applicable taxation charge is before or after the disallowance of the interest deduction in question per section 31(3)). Clearly, a loss stated after the deduction of interest and taxation will be greater than a loss before such deductions. If the former method is used, then the addition to fixed capital would be greater than the latter and hence of more benefit to the taxpayer (since the ratio of debt to fixed capital would be lower).

'Accumulated profits' have been referred to specifically as 'an accounting definition', and notes in the context of 'accumulated profits' that 'as a concession [taxpayers] can add back current year and previous two years losses [*sic*]'.[76] This seems to indicate that SARS's expedient practice is to allow for the accounting result (net loss after interest and taxation, as stated in the taxpayer's financial statements) to be added back (to the retained income per those same financial statements) in the manner described in PN2.

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[74] The rationale for adjusting for such revaluation reserves or losses is clear: the Commissioner is attempting to prevent manipulation of the 'fixed capital' base by the taxpayer so as to ensure conformity with the safe harbour guideline ratio. Conceivably, in a year where financial assistance exceeds the guideline ratio, the taxpayer could create a revaluation reserve to increase fixed capital; in subsequent years, this revaluation reserve could be reversed. The modern imperative of fair value accounting makes such manipulation difficult where an objective valuation basis exists. With respect, unless such revaluation reserves have a subjective basis for their determination, they should not be excluded from the determination of fixed capital; it is considered that PN2 needs to be suitably amended to take cognisance of developments in financial accounting and reporting.

[75] See Appendix 1.

[76] J Rock 'SARS Approach to Thin Capitalisation' *Selected issues relating to loans* (2009).

Whether accrued interest amounts to financial assistance

Finally, it is worth considering whether accrued, but unpaid, interest would be included in the meaning of 'financial assistance', thereby increasing the ratio of such financial assistance to fixed capital. In the context of this case study, but for the exchange control restrictions on the remittance of interest, all interest would have been paid to the investor.[77] This begs the question whether the balance of accrued interest in this instance amounted to a further 'granting of financial assistance, including a loan, advance, or debt'[78] to the taxpayer companies.

That accrued interest amounts to a debt is not in issue, since the literal meaning of 'debt'[79] is undeniably clear. The verb 'grant', though, implies the giving of permission or an indulgence, or making a concession.[80] The investor had only allowed the unpaid interest to accrue because exchange control regulations forbade him from receiving it. The concession was forced upon him and not made of his own volition, and on this basis the taxpayer companies may argue for the exclusion of accrued interest from 'financial assistance'. On the facts of this case study it appears that interest accrued on such unpaid interest balances – to the extent that the lender is compensated for the taxpayer's use of money (and to the extent that the taxpayer companies continued to enjoy the use of such money). Hence, it might be equally compellingly argued that accrued interest should indeed be included as of financial assistance. Were the interest not to have accrued on such unpaid interest balances, the Commissioner's practice is clearly set out in PN2: paragraph 1.2 states that whilst a literal interpretation of section 31 would include such interest-free financial assistance with all other financial assistance, it is SARS's practice to include only interest-bearing financial assistance in the calculation of the debt-equity ratio; however, the interest-free financial assistance

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[77] The purported intention of the loan arrangements was to maximise, within the bounds of exchange control, the geographic diversification of the investor's assets. Where losses were incurred such that the remittance of interest would compromise the initial balance of the blocked Rand account, such payments of interest had to be deferred until the blocked Rand account had recovered. Pending payment, the accrued interest would have been maintained on the companies' (and the trusts') records as a liability.

[78] Per paragraph (c) of the definition of 'services' in section 31(1) of the Income Tax Act, 1962.

[79] 'A liability or obligation to pay or render something; the condition of being under such obligation' per 'debt, n.[2.a.]' The Oxford English Dictionary, 2nd ed, 1989, OED Online. Oxford University Press, 15 May 2010 <http://dictionary.oed.com/cgi/entry/50058413>.

[80] 'grant, v.[4.a.]' The Oxford English Dictionary, 2nd ed, 1989, OED Online. Oxford University Press, 15 May 2010 <http://dictionary.oed.com/cgi/entry/50097871>.

remains excluded from any 'permanent owner's capital'.

It is conceivable that to avoid the inclusion of accrued interest on the balance sheets of the companies, the companies could have paid interest to the trusts in full, leaving the trusts to carry the accrued interest balance. It is not clear from the facts of the case study whether this would have been permissible in terms of the investor's agreement with the South African Reserve Bank. It is submitted that SARB would have been indifferent to such an arrangement, as the limitations on the amounts that could have been remitted would have remained, irrespective.

Whilst PN2 purports to clarify the wide wording of section 31(3) somewhat, it is clear that it is possible to question aspects of the practical application of PN2 itself. On the facts of the case, SARS appears to have applied section 31(3) and the practice note suitably.[81] However, as with 'Requirement for the Commissioner to have regard to the circumstances of the case in reaching his opinion' above, the taxpayer may have a basis for attacking SARS's practice, but the effects of such an objection are unlikely to be material.

Back-to-back financing

Section 31(3)(b) of the Income Tax Act prevents the avoidance of the application of section 31(3) by a taxpayer where an independent third party (i.e. not a connected person) is interposed between the non-resident lender and the recipient such that that independent third party (e.g. a bank) loans money to the recipient given that a similar amount has been loaned to or deposited with the third party by the non-resident lender. This section has no application to the facts of the case study, as even if it was common cause that the trustees of the respective trusts were independent, they would still be connected persons to the investor given his status as a beneficiary.

[81] The calculations are shown in Appendix 1.

Imposition of penalties, interest and Secondary Tax on Companies ('STC')

The imposition of penalties, interest and STC is not codified in section 31. Rather, they are consequences of the application of section 31 in terms of sections 75,[82] 76,[83] 104,[84] 89*bis*,[85] 89*quat*[86] and 64C(2)(e)[87] of the Income Tax Act. As noted previously under 'Scope of the research' in Chapter 1, an analysis of the application of these sections is beyond the scope of this dissertation.

Concluding remarks

This chapter analysed the basis for the Commissioner's application of section 31(3) to the companies in the case study. Whilst apparently justified on the facts, uncertainty was apparent in three important instances:

1. Whether or not section 31(3) had application given that the loans were granted whilst the investor was still a South African resident;
2. Whether or not proof of the independence of the trustees of the trusts would have impeded the application of the section;

[82] Section 75 'Penalty on default' details actions that constitute an offence punishable on conviction by a fine or a period of imprisonment not exceeding 24 months. Section 75 has no application to the facts of the case study.

[83] Section 76 'Additional tax in the event of default or omission' has application to the case study. In terms of section 76(1)(c), the taxpayer companies, by failing to correctly apply Practice Note 2, would have made an 'incorrect statement' in their tax returns for the 2002, 2003, 2004, 2005 and 2006 years. As a consequence, they would have been required to pay an additional amount 'equal to twice the difference between the tax as assessed in accordance with the tax return made by him and the tax which would have been properly chargeable'.

[84] Section 104 'Offences and penalties' sets out how fraudulent activities or false statements constitute offences punishable on conviction by a fine or imprisonment for a period not exceeding five years. Section 104 has no application to the facts of the case study.

[85] Section 89*bis* imposes interest on the overdue payments of provisional tax, amongst others. Given the understatement of their taxable income as a result of the non- or misapplication of section 31(3), the taxpayer companies in this case would have understated their provisional tax payments, rendering the balance overdue and subject to interest.

[86] Section 89*quat* similarly imposes interest on the amount of normal tax still unpaid after assessment. This section too has application to the facts of this case study.

[87] Section 64C(2)(e) deems a dividend to have been declared by a company where 'that amount represents additional taxable income or reduced assessed loss of that company by virtue of any transaction with the shareholder or a connected person in relation to such shareholder, the consideration of which is adjusted or any amount of interest, finance charge or other consideration is disallowed as a deduction in accordance with the provisions of section 31'. Clearly, this section has application to the facts of the case study.

3. Whether or not the Commissioner had properly exercised his discretion, and whether or not he could rely on departmental practice in this regard.

The next chapter considers whether and how these uncertainties could constitute bases for adequate objections by the taxpayer companies.

Chapter 4: Criticisms of the application of section 31(3) by SARS

The previous chapter considered SARS's application of section 31(3) to the facts of the case study. This chapter sets out the grounds for objection to SARS's assessments, which in turn would inform the defences that the taxpayer companies might mount were the matter to come before a court.

The three issues arising from SARS's application of section 31(3) (and hence, the three grounds for objection) were identified in Chapter 3 as follows:

1. That the loans had been granted by the investor while he was still a South African resident;
2. That the trustees of the trusts were independent and hence that the loans from the investor were not made to the companies indirectly; and
3. That the Commissioner had failed to properly exercise his discretion in giving due consideration to the unique circumstances of the case.

Section 82 of the Income Tax Act places the burden of proof regarding the deduction of the interest in question on the taxpayer companies. A requirement of the section is that the Commissioner shall not reverse or alter his decision upon hearing an appeal by a taxpayer unless the taxpayer can show that the Commissioner's decision is wrong.

The taxpayer is required to prove 'on a preponderance of probabilities' or 'on a balance of probabilities' that a 'deduction, set-off, exemption or exclusion falls within the scope of the appropriate sections of the Act'.[88] 'The onus is discharged if the court has no reason to disbelieve the taxpayer and his evidence is not contradicted by objective facts' and hence that '[t]he burden of proof applies only to questions of fact. It cannot arise on questions of law'.[89]

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[88] De Koker (note 60) at 18.27.

[89] *Ibid.*

Residence at the time of granting the loan

Section 31(3)(a) opens as follows: 'Where any person who is not a resident … has granted financial assistance'. The uncertainty identified in Chapter 3[90] pertains to the relevance of the investor's resident status at the time that the financial assistance is granted.

Clegg raises the issue briefly, stating:

> It is unclear whether the financial assistance must be "granted" in a year in which the creditor under a loan is non-resident or whether the non-residence of the creditor in any year is sufficient to trigger the section in respect of that year. This matter is particularly relevant in the case of individuals who may easily migrate residence during the subsistence of a loan agreement. It is considered that on a proper reading, the date of "grant" of a loan is the critical date upon which residence status must be determined.[91]

Given this assertion, the taxpayer companies may have sought to object to SARS's application of section 31(3) on the basis that the investor was resident at the time that the financial assistance was granted, and that he only became non-resident (as a result of his emigration) afterwards.

In Chapter 3, it was noted that SARS would have had to apply the literal meaning of the word 'is' (which denotes the present tense) to apply section 31(3); hence, SARS would have justified their application of the thin capitalisation rules on the basis that the investor was non-resident at the time of such application. This issue therefore turns on the correct and appropriate interpretation of the opening clauses of section 31(3)(a).

Rules of interpretation

A cardinal rule of the interpretation of fiscal legislation was expressed by Lord Cairns in *Partington v Attorney General*[92] as follows:

> [i]f a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can

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[90] See page 17.

[91] Clegg (note 51) at 24.12.3.

[92] (1869) L.R. 4 H.L. 100 at 122.

simply adhere to the words of the statute.

The 'golden rule' in interpreting statutes is as follows:

> [t]he most important (golden) rule of statutory construction is to ascertain the intention of the legislature. This was to be done by taking the language of the instrument, or of the relevant portion of the instrument as a whole and where the words are clear and unambiguous to place upon them their grammatical construction and to give them their ordinary effect. Under certain circumstances it would, however, be permissible to depart from the ordinary meaning of the words.[93]

The circumstances affording grounds for departure from the ordinary meaning of the words include where an absurdity would result or when ambiguity is present.[94] Where such ambiguity is present, the relevant provision should be interpreted *contra fiscum*.[95]

Of equal import, though, is whether or not reliance may be placed on a purposive approach to the interpretation of fiscal legislation. Hurt AJA's comments in *Commissioner, SARS v Airworld CC & Another*[96] favoured a purposive approach. The *Airworld dictum* was approved by the court in *Metropolitan Life Ltd v Commissioner for the South African Revenue Service*[97], where it was stated that:

> [the Act and its amendments should be] interpreted purposively and holistically and that provisions should be given a clear meaning whenever plausible.

The 'object of statutory interpretation is to establish the "intention of the legislature", albeit that this is an artificial construct to be ascertained principally, if not exclusively, from the wording of the statute itself. There is therefore a place for a purposive approach, purpose being allied to intention'.[98]

Literal interpretation

Firstly, in analysing the interpretation of section 31(3)(a) in this instance, regard must be had to the use of the verb 'is' in the present tense so as to establish the precise literal interpretation of the word. In *Ben Richards (Proprietary), Ltd v Commissioner For Inland*

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[93] P Dachs 'The Law of Unintended Consequences And Section 24J' *The Taxpayer* (2010) 59(4) 66 citing *Venter v R* 190 TS 910.

[94] Dachs (note 93) at 66.

[95] *Glen Anil Development Corporation Ltd v Secretary For Inland Revenue* 37 SATC 319 at 334.

[96] *Commissioner, SARS v Airworld CC & Another supra* (note 46).

[97] 70 SATC 162.

[98] Dachs (note 93) at 67.

Revenue[99] (a judgment of the then Transvaal Provincial Division) Maritz J, when considering the application of a proviso after a stipulated date, held that as the conditional clause in such proviso was couched in the present tense and not in the past, it must be construed having application in any year subsequent stipulated date. However, in *Boshoff's Estate v Commissioner For Inland Revenue*[100] , Schreiner JA said:

> But, apart from considerations of probability as to the intention of Parliament, it seems to me that, speaking generally, when property is described by reference to a transaction relating to it, and when part of the description consists of a factor that may vary from time to time, the factor should in the absence of contrary indication, be taken as at the time of the transaction. ... No doubt the decisive factor is the particular context, so that no clear guidance is obtainable from the importance attached in Eaton v Basker, 7 Q.B.D. 529, to the use of the present tense (cf. per Bramwell, L.J., at 531). Yet it seems to be worth pointing out that in that case it was thought to accord with ordinary usage to read:
>
> 'Every contract . . . whereof the value or amount exceeds fifty pounds, shall be in writing . . . ',
>
> as if the words 'at the time of making it' had been included. … the present participle 'exceeding' is, I think, equivalent to 'which exceeds' and equally associates the value with the time of the transaction. It seems to me that in applying section 3(4)(f) it is the value of the property as at the date of the donation that is decisive.

Whilst the circumstances are certainly distinguishable[101] on the facts, the *Boshoff's Estate*[102] *dictum* seems to give credence to the notion that where a factor is variable (in this instance, the investor's residence), that factor must be considered 'as at the time of the transaction'.

Secondly, the nature of the services supplied must be considered. It would be incorrect to apply paragraph (b)[103] of the definition of 'services' in section 31(1) to section 31(3); section 31(3) applies to 'financial assistance', which is expressly defined in paragraph (c)[104] of section 31(1).[105]

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[99] 11 SATC 116.

[100] 19 SATC 34 at 44.

[101] *Boshoff's Estate* dealt with the timing and valuation of donated assets in an estate for the purposes of determining Estate Duty.

[102] Note 100 *supra*.

[103] '[T]he making available of any facility or advantage'.

[104] '[T]he granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee';

[105] The draft Taxation Laws Amendment Bill 2010 proposes a separate definition of 'financial assistance' (rather than including it in the definition of 'services') which corroborates this view.

Notwithstanding this distinction, it must still be determined whether or not the supply of financial assistance is a single or continuing supply. If such supply is single or 'once-off', then it follows that the resident status of the lender at the time of making the supply is critical; if the supply is continuing or ongoing, then section 31(3) would be applicable to relevant financial assistance in existence whilst the lender is non-resident, irrespective of the lender's resident status at the time that such financial assistance was granted.

A loan of money may be characterised as a loan for consumption.[106] In a loan for consumption, it is a duty of the lender to transfer possession and title of the thing lent.[107] Such transfer must be construed as a single act. Furthermore, the absence of a defined repayment date does not alter the nature of the agreement as that of a loan for consumption.[108] Consequently, the nature of the supply should be similarly unaffected.

In *Commissioner for Inland Revenue v Lever Brothers & Unilever*[109] characterised a loan as a 'supply of credit' in exchange for interest analogous to the letting of property for rental.[110] Whilst the court gave no pronouncement on whether such supply was once-off or ongoing, the characterisation of a loan as a supply of credit seems more akin to an ongoing than a once-off supply, and interest may be considered to be a regular payment in exchange for such continuous service.

However, it is submitted that this interpretation is not correct when applied to the facts of the case study. In *Cactus Investments (Pty) Ltd v Commissioner for Inland Revenue*[111] the court distinguished between the supply of credit as a service and 'ordinary loans for consumption … with money actually paid to borrowers'.[112] The court endorsed the concession made by counsel for the appellant that 'no physical performance was required of [the lender] apart from paying the amount of each loan to the borrower'[113]

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[106] D J Joubert 'Loan' (2010) 15(2) *LAWSA* at 296.

[107] *Ibid* 299.

[108] *Ibid* 301.

[109] 14 SATC 1.

[110] *Ibid* at pages 9 and 10.

[111] 61 SATC 43.

[112] *Ibid* at page 46.

[113] *Ibid.*

and noted that counsel was 'unable to explain the content of the continuing obligation for which he contended'.[114] The court concurred with the court *a quo* that:

> [T]he [lender's] right to claim interest was not subject to any further performance of any obligation by the [lender].[115]

The court expressly rejected the notion that 'a lender indeed has a continuing obligation apart from paying the borrower the amount of the loan'.[116] It seems reasonable to conclude that the granting of financial assistance is indeed a once-off supply.

As corroboration, paragraph 10 of Practice Note 2 states that '[t]he provisions of section 31 shall *inter alia* only apply to any services supplied on or after 19 July 1995. As already mentioned, the supply of services includes the granting of financial assistance. Interest incurred after that date on a loan or advance received or debt incurred before that date will, therefore, not be subject to the provisions of section 31'. SARS Practice Notes 2 and 7 imply that 'the provision of a loan is a once-off supply, as opposed to a continuous or annual supply'.[117] This must be correct: a continuous or ongoing supply would be incapable of exclusion if made before a certain date. This is further confirmed in Practice Note 2 by the exclusion of 'the weighted average of all interest-bearing financial assistance granted prior to 19 July 1995'[118] from the determination of disallowable interest arising from excessive financial assistance.[119]

A literal interpretation of section 31(3)(a), amplified by case law and by the necessary implications of SARS practice, suggests that because the investor was resident at the time that the loans (which were once-off supplies) were granted, section 31(3) had no application in this instance.

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[114] *Ibid* at page 47.

[115] *Ibid.*

[116] *Ibid.*

[117] Olivier and Honiball (note 29) at 516.

[118] Practice Note: No. 2 – Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic (1996) at 4.1.

[119] Section 23(2) of the Income Tax Act, No. 21 of 1995 (which enacted section 31(3) of the Income Tax Act, 1962) determined that '[s]ubsection (1) shall come into operation on the date of promulgation [19 July 1995] of this Act and shall apply to any goods or services supplied or acquired after that date'. Hence, the date stipulated in Practice Note 2 has the authority of statute.

Purposive interpretation

It is submitted that whilst an unambiguous and sensible interpretation of the legislature's intention is evident from the language of section 31(3), it is worth considering the application of the purposive approach for the sake of completeness in the event that such an approach were to be favoured by SARS or the courts. The purposive approach begs the question whether the legislature could have contemplated the application of section 31(3) to a situation where the investor's residence changes after the granting of financial assistance. Such a change in residence is not expressly contemplated in the reports of the Katz Commission, nor in SARS's Practice Notes or explanatory memoranda, nor in the legislation itself.

The 'clear and discernable'[120] purpose of section 31(3) is to be found in its origins, which were discussed in Chapter 2. In short, section 31(3) was conceived to prevent the abusive practice of thin capitalisation and its associated prejudice to the South African fiscus. The effects of the various structures and agreements established in this case study are to avoid the payment of taxation in South Africa by entities deploying the investor's funds whilst simultaneously exempting the investor from the payment of taxation on the revenue stream earned by the deployment of his funds; hence, the South African fiscus is deprived of tax revenue from both sources. Whilst tax avoidance was not the purported motive of the taxpayer companies, the various structures and agreements certainly would have had that effect.

In the *Airworld* [121]case, Hurt AJA made the point that purpose was to be used 'in conjunction with the appropriate meaning of the language of the provision, as a guide in order to ascertain the legislator's intention'. The legislature's purpose in preventing the abusive practices of thin capitalisation is clear, but the effect of the investor's change in residence is similarly clear. What remains is to consider whether the wording of the legislation gives effect to such purpose. In expressing its intention, the legislature chose to use the words 'is not a resident' in section 31(3)(a). Had the legislature contemplated the application of the section after a change in an investor's residence, it is submitted that the wording may have contained, at the very least, the qualification 'or is no longer a resident'.

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[120] *Commissioner, SARS v Airworld CC & Another* note 46 *supra*.

[121] *Ibid.*

A counter-argument to the submission above might be found in the court's *dictum* in *Caltex Oil (SA) v SIR*[122], where Botha JA held that:

> [e]vents which may have an effect upon a taxpayer's liability to normal tax are relevant only in determining his tax liability in respect of the fiscal year in which they occur …

Although the facts and issues in the *Caltex* case are entirely distinguishable[123] from the facts of this case study, the court's *dictum* may lend credence to the assertion that the use of the words 'is not a resident' is sufficient to validly apply the provisions of section 31(3) in each year of assessment subsequent to the investor's emigration, since he would have been non-resident in each of those years. However, the words 'is not a resident' are used in conjunction with 'has granted financial assistance'. Given the nature of a loan as a once-off supply[124] and the imperative to read the legislation holistically,[125] one cannot infer that the act of granting the loan, and the residency status of the person granting it, should be reviewed annually; rather, the imperative is to establish the residency of the investor at the time that the loan is granted.

Concluding remarks

Both the literal and purposive interpretations of section 31(3)(a) seem to offer the taxpayer companies in this case study cogent grounds for objection. Given too the existence of exchange controls guarding against the unbridled outflow of capital from South Africa, it is submitted that the legislature could have contemplated only the provision of financial assistance by persons or entities already non-resident at the time that such financial assistance was granted. It is further submitted that purpose should be distinguished from effect, however unintended that effect is. Clegg's assertion[126] appears to be justified. In any event, the evident ambiguity associated with the use of 'is not a resident' with 'has granted financial assistance' should result in the interpretation of the section *contra fiscum*.

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[122] 1975 (1) SA 665 (A) at 677.

[123] The *Caltex* case was concerned with how expenditure and associated liabilities denominated in foreign currency should be brought to account and determined at year-end.

[124] See discussion from pages 36 to 37 above.

[125] *Metropolitan Life Ltd v Commissioner for the South African Revenue Service* 70 SATC 162

[126] Clegg (note 51) at 24.12.3.

Independence of trustees

As noted in Chapter 3, in applying section 31(3) to the respective companies, SARS would have had to consider the loans from the investor to have been made indirectly via the trusts. This begs the question whether the independence of the trustees (and their consequent autonomy in making decisions affecting the trust) would have provided a basis for an objection to the application of section 31(3) by the removal of the indirect link or the creation of a discrete and separable decisional node between the investor and the companies.

In the facts of the case study, there is little detail on the composition of the trustees of the respective trusts, nor is there any exposition of the terms of the trust deeds. Notwithstanding that, it is useful to consider whether or not the taxpayer companies might raise a credible objection on the basis that the trustees were independent, that they had exercised their minds as such in accepting the loans from the investor and advancing the loans to the companies, that the decisions to assume the loans from and loan funds to the companies were distinct and consequently that the investor could not have been seen to have loaned the funds to the companies indirectly.

The case law supporting SARS's view was discussed in Chapter 3. On the facts of those cases the trusts were considered to be alter egos of the founders under *de facto* control of such founders. What remains to be considered is whether SARS's view can be refuted.

The nature of trustee independence

The ideal trustee has been described as 'someone who, with proper realisation of the responsibilities of trusteeship, accepts office in order to ensure the trust functions properly, that the provisions of the trust deed are observed, and that the conduct of trustees who lack a sufficiently independent interest in the observance of substantive and procedural requirements arising from the trust deed can be scrutinised and checked. Such an outsider will not accept office without being aware that failure to observe these duties may risk action for breach of trust'.[127] In fact, a trustee must have at least a

[127] W van der Westhuizen 'Wills and Trusts' in *Wills and Administration of Estates* (2009) at B6.2.2 quoting Cameron JA's judgment in *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) at 90C–D.

certain degree of independence.[128] Furthermore, where 'all the beneficiaries are related and some or all of them are also the only trustees the Master has to insist on the appointment of the "independent outsider", who then could be a person related to the other trustees, provided such person is not a beneficiary to the trust'.[129]

The preference for an independent trustee in circumstances such as those of the case study (where the founder is also a trustee and a beneficiary) is clear. The *Badenhorst*[130] and *Jordaan*[131] cases 'are confirmation that an independent outsider trustee may not be enough protection against an individual trustee as part of a larger board of trustees who ignores the other trustees and treated the trust assets as if it were his own, thus also ignoring the stipulations of the trust deed'.[132] However, a founder is no prevented from having wide powers in the administration of a trust.[133]

On the facts of the case study, there is little to confirm or deny that the investor ignored the other trustees or the stipulations of the trust deed, or that he treated the trust assets as if they were his own. However, what is clear is the following:

1. The investor had originally loaned substantially all of his assets to the companies.
2. The investor later ceded those loans to the trusts in exchange for similar loans to the trusts.
3. The trusts received interest from the companies, and paid these amounts to the investor (in his capacity as lender, not beneficiary) in their entirety (or to the extent permitted by the exchange control regulations).

On these facts, the question arises whether even predominantly independent boards of trustees would have made the autonomous decision to accept cession of the loans to the companies and simultaneously enter into loan agreements with the investor on exactly the same terms and conditions. Furthermore, one must question the rationale for and defensibility of the *post factum* cession of the loans by the investor.

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[128] Cameron, Edwin *et al Honoré's South African Law of Trusts* 5ed (2001) at 11.

[129] *Ibid* B6.2.3.1.

[130] *Badenhorst v Badenhorst supra* note 53.

[131] *Jordaan v Jordaan* 2001 (3) SA 288 (C).

[132] Van der Westhuizen (note 127) *supra*.

[133] Cameron (note 128) *supra* at 89.

Does independence frustrate "indirectly"?

Were the trustees to have had a prerogative to reject the *post factum* cession of the loans to the trusts, then it may be argued that such a decision, independently made, could thwart the application of the indirect link between the investor and the companies.

However, the basis of the decision to accept the cession (and so to interpose the trusts between the investor and the companies) would have to be justifiable.

The basis for the interposition of the trusts

Whilst *inter vivos* trusts have inherent advantageous tax implications, they should be used in a 'holistic manner in well-structured estate plans where sufficient provision is made for proper financial risk protection plans and family relationship plans'.[134] If risk management was the rationale for using the trusts in the case study, then it is worth considering a possible worst case scenario to examine their efficacy and so to test the *bona fides* of that purported motivation. Were the underlying investments of the companies to fail utterly, the companies would be unable to pay interest or capital on the loans from the trusts. This, in turn, would render the trusts unable to pay interest or capital on the loans from the investor, nor would the trusts be able to effect any payments to beneficiaries as the entire asset base of the trusts would have been compromised.

Conceivably, the trusts could have had the discretion to recall the loans to the companies and otherwise deploy the funds to earn a return. In this instance, the loans from the investor to the trusts would remain unaltered and the trusts would continue to be obliged to service the interest on the loans out of earnings. Given too that the tax rates applicable to trusts are higher than those applied to companies[135], this eventuality is unlikely to have transpired.

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[134] *Ibid* B1.

[135] Since the 2002/2003 tax year, trusts (other than special trusts) have been taxed at a flat rate of 40% of taxable income. Between 1 March 2000 and 28 February 2002, the maximum marginal rate for trusts was 42%. Between 1 March 1998 and 29 February 2000, the maximum marginal rate for trusts was 45%. The corporate tax rate was set at 30% in the 1999/2000 tax year, reduced to 29% in the 2005/2006 tax year This was further reduced to 28% in the 2008/2009 tax year.

It seems highly improbable that the interposition of the trusts between the investor and the companies had any motivation or effect other than the avoidance of taxation. With respect, it seems that the interposition of the trusts was not merely incidental, but rather a proactive effort to remove the direct relationship between the investor and the companies.

Concluding remarks

Notwithstanding any other rationale that may have existed for the interposition of the trusts between the investor and the companies, the facts suggest that the interposition was contrived so as to avoid tax (particularly given the *post factum* cession transactions). Furthermore, it is questionable whether independent trustees would have reached the decision on an arm's length basis to accept the cession transaction, given the ramifications of a possible worst case scenario. There is little to suggest that the purported or actual independence of the trustees would have offered a sufficiently robust objection to or defence against the notion that financial assistance had been granted indirectly.

<u>Exercise of the Commissioner's discretion</u>

Section 31(3)(a) requires that the Commissioner should have regard to the circumstances of a case when forming his opinion regarding the excessive nature of financial assistance.

It was noted in Chapter 3 that SARS has set out a guideline safe harbour position in Practice Note 2, and further that Practice Note 2 places the onus on taxpayers to approach the Commissioner to exercise his discretion. Certainly, in terms of Practice Note 2, SARS's actions in applying section 31(3) without regard to the taxpayer companies' special circumstances appears warranted given the taxpayers' failure to approach SARS. However, the following grounds for objection are considered:

1. The Commissioner cannot rely on departmental practice, however codified, in applying section 31(3); and
2. The requirement per Practice Note 2 that the taxpayer should approach SARS regarding the exercise by the Commissioner of his discretion amounts to an

abdication by the Commissioner of his responsibility to properly apply his mind to the circumstances of the case; and

3. The Commissioner had not properly regarded the unique circumstances of the case.

Reliance by SARS on departmental practice

Practice Note 2 sets out how SARS applies section 31(3). The Practice Note is freely available and it has been largely unaltered since its publication in 1996.

'The interpretation by SARS of any provision of the Act will not influence the courts to place a construction upon that provision that the language of the section will not allow'.[139] In *ITC 1572*,[140] Zulman J said:

> Departmental practice is not necessarily, of course, an indication of what the law means. However, it seems to me that the departmental practice is a very sensible approach to what should be done in this type of case. Plainly the procedure and the practice laid down by the Commissioner in that regard, is, if nothing else, commercial wisdom and good sense.

SARS's practices (and the practice notes in which such practices are recorded) 'do not have the force of law', and where the Commissioner's practices 'have not been endorsed by the courts', such practices 'are open to challenge by taxpayers through the usual objection procedure'.[141]

Chaskalson CJ (as he then was) noted the following[142] regarding the admissibility of explanatory memoranda and similar background material for the purposes of interpreting the law:

> [W]here the background material is clear, is not in dispute, and is relevant to showing why particular provisions were or were not included in the Constitution, it can be taken into account by a Court in interpreting the Constitution.

The courts have also sounded warnings regarding the reliance by taxpayers on SARS's practice notes. In *ITC 1675*[143], Wunsch J regarded the practices of the Commissioner circumspectly, stating:

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[139] De Koker (note 60) at 25.16.

[140] (1993) 56 SATC 175

[141] R Williams, 'Income Tax in South Africa: Law and Practice' (2006) 16.

[142] In *Minister of Health and Another v New Clicks SA (Pty) Ltd and Others (Treatment Action Campaign and Innovative Medicines SA as* Amici Curiae*)* 2006 (1) BCLR 1 (CC) at 199

> [it] cannot always safely be assumed that he will consider himself bound by his own practice notes. I should add that the issue of a Practice Note to cover a case like the present is not good policy if the practice constitutes a departure from the provisions of the Act.

Centlivres CJ, citing *Rex v. Lloyd*[144] in *Ernst v Commissioner for Inland Revenue*[145] made it clear that:

> the meaning assigned for thirty years to a section of an Act by those responsible for its administration and by a Provincial Division of the Supreme Court
>
> "would not justify the placing of a construction on the section which the language would not allow; and if that language were clear such a view, though established for thirty years and upon which vested rights of various kinds must necessarily have become based, could not influence the construction."

Hence, it is trite that where the law is clear and practice is inconsistent with the law, it is the law that should be followed. Although departmental practice is not law, it has been viewed as a clarification thereof. The only caveats are that practice cannot be justified on any basis where is it inconsistent with the law, and that taxpayers should not necessarily place reliance on departmental practice. Subject to these caveats, there seems to be little evidence that the Commissioner may not place reliance on departmental practice.

There is support for any reliance placed by SARS on Practice Note 2 in that '[t]he section [31(3)] is extremely wide in its wording, and the granting of these very wide and vague powers to the Commissioner on what is an important decision for offshore investors contemplating local investments, is considered to be less than optimal. However, this has to a large extent been rectified by the issue of Practice Note 2'.[146]

It is improbable that the taxpayer companies would be able to object successfully to the reliance by SARS on Practice Note 2, except to the extent that discussed under 'Exercise of the Commissioner's discretion' below.

The need to approach the Commissioner to exercise his discretion

The exercise of discretion necessarily implies an act of commission rather than

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[143] 62 SATC 219

[144] 1920 AD 474.

[145] 1954 1 All SA 340 (A).

[146] Clegg (note 51) at 24.12.3.

omission.[147] Practice Note 2's requirement that the taxpayer should approach the Commissioner to exercise his discretion may imply that the Commissioner will not apply his mind to the circumstances of the case (as required by section 31(3)(a)) unless asked to do so.

With respect, this cannot be the case. Section 33 of the Constitution of the Republic of South Africa, 1996 gives everyone the 'right to administrative action that is lawful, reasonable and procedurally fair'. In this case, legislation[148] requires the Commissioner to exercise his discretion – it is submitted that failure to do so would be unlawful. It seems unreasonable and improbable that the Commissioner would allow a codified practice to have remained illegal since 1996. The discretionary powers of the Commissioner that have been made subject to objection and appeal are not open to constitutional attack.[149]

Paragraph 6 of Practice Note 2 should be more correctly interpreted as an invitation for the taxpayer to present additional information and justification to the Commissioner for the further exercise of his discretion in exceptional circumstances.

In any event, even if the Commissioner's practice amounted to a failure to properly exercise his discretion, the courts have previously simply referred the matter back to the Commissioner for proper consideration rather than preventing the application of the relevant section of the Income Tax Act.

It is submitted that an objection on this basis has little merit.

Proper regard for the circumstances of the case

For the Commissioner not to have had a proper regard to the circumstances of the case does not necessarily imply a failure to exercise his discretion. Rather, the implication must be that his discretion was exercised, but without due consideration of the relevant factors affecting the outcome.

'Where the legislature has conferred discretionary powers on the Commissioner

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[147] 'The action of discerning or judging; judgement; decision, discrimination' per 'discretion 2.' The Oxford English Dictionary, 2nd ed, 1989, OED Online. Oxford University Press, 15 May 2010 <http://dictionary.oed.com/cgi/entry/50065533>.

[148] Section 31(3)(a) of the Income Tax Act 58 of 1962.

[149] L van Schalkwyk 'The discretionary powers of the Commissioner for the South African Revenue Service – Are the constitutional?' (2004) *Meditari Accountacy Research* 12(2) 181.

it is not the function of the courts to restrict him in the exercise of those powers and they will interfere only if the Commissioner has acted *mala fide* or has <u>not exercised his discretion properly</u>; in other words, has <u>not applied his mind to the matter</u>.[150] The question is not whether the decision reached is right or wrong but whether the Commissioner has duly considered the matter. Thus where the matter is not subject to objection and appeal, the taxpayer may have recourse on the grounds that the Commissioner has acted improperly'[151] (emphasis added).

Any decision of the Commissioner under the provisions of section 31 is indeed subject to objection and appeal.[152] Consequently, an aggrieved taxpayer must, in the first instance, make use of the procedure for objections and appeals set out in Part III of the Income Tax Act. Only where the Commissioner has rejected the taxpayer's duly submitted objection may the taxpayer challenge in court the proper exercise by the Commissioner of his discretion in respect of both the original assessment and the objection. Where the matter comes before the Special Income Tax Court, 'proceedings amount to a rehearing of the matter and the Special Court is entitled to make its own finding'.[153] The onus is on the taxpayer to prove that the Commissioner failed to properly exercise his discretion.[154]

In this case, the taxpayers might aver that the Commissioner had failed to consider the unique circumstances of this case: the lender was not a foreign company, but an emigrant individual; the loan agreements, structures and interest rates had been approved by the South African Reserve Bank in the first instance, indicating the preoccupation with geographical diversification of the investor's assets rather than tax avoidance.

However, the Commissioner may well take issue with the purported lack of a tax avoidance motive. In his budget speech on 26 February 2003 (one year after the investor's emigration), Minister T.A. Manuel announced that:

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[150] Clegg (note 51) at 27.29) citing *Shidiack v Union Government* 1912 AD 642; *CIR v City Deep Ltd* 1924 AD 298, 1 SATC 18; *Rand Ropes (Pty) Ltd v CIR* 1944 AD 142, 13 SATC 1.

[151] Clegg (note 51) at 27.29) citing *CIR v City Deep Ltd* 1924 AD 298, 1 SATC 18 and also referring to *Rand Ropes (Pty) Ltd v CIR* 1944 AD 142, 13 SATC 1; *ITC 1478* (1990) 52 SATC 258 and *ITC 1527* (1991) 54 SATC 227, as well as *ITC 1582*, (1995) 57 SATC 27.

[152] Section 3(4)(b) of the Income Tax Act, 1962.

[153] T Emslie *et al* 'Income Tax Cases and Materials' (2001) 1076.

[154] Section 82 of the Income Tax Act, 1962.

> Holders of blocked assets wishing to exit more than R750,000 (inclusive of amounts already exited) must apply to the Exchange Control Department of the South African Reserve Bank to do so. Approval will be subject to an exiting schedule and an exit charge of 10 per cent of the amount. The same dispensation will apply for new emigrants.

Notwithstanding this dispensation, the structures established by the investor remained intact and operational with little or no benefit to the South African fiscus. Whilst not conclusive, this certainly dilutes the fervour with which the taxpayer companies may argue that tax avoidance was not a motive. Furthermore, the taxpayer companies' lack of action in approaching the Commissioner cannot equate to a refutation of the contemplation of tax avoidance. Certainly, the Commissioner would have been aware of the new exchange control dispensation and so might have been compelled to consider this case specifically.

In applying the provisions of section 31(3) to the taxpayer companies, SARS would have had knowledge of the fact that the investor was an emigrant (otherwise the section would not have been applied at all), and also of how the assets of the respective trusts and companies were deployed (that is, in trading equity portfolios). It is submitted that the Commissioner could (or perhaps even should) have considered the expected time that it might take for the debt-equity ratio to return to the preferred 3:1. An analysis which evaluates the average return on the South African equity market and the average prime rate plus 2% shows that the expected period of indulgence (before the debt to equity ratio recovered to the preferred 3:1) would be eight years (see Appendix 9).[155] It is highly unlikely that the Commissioner would have acceded to gearing in excess of the preferred ratio for this length of time, with or without any approach from the taxpayers.

In short, the argument that the Commissioner failed to have proper regard for the circumstances of the case is not credible. The taxpayer was afforded another option for geographic diversification by the relaxation of exchange controls in 2003, and it is unlikely that this fact would have escaped the Commissioner's attention. Furthermore, the Commissioner could only have exercised his discretion properly with a complete information set – given the taxpayer's failure to engage with SARS, it is likely that this information was absent. Finally, even if the Commissioner had been predisposed to evaluating the expected outcomes, it is likely that the resulting analysis would not have been in favour of the taxpayers.

[155] In fact, the debt to equity ratio recovered to below 3:1 after only five years. See Appendix 1.

<u>Concluding remarks</u>

The argument that the application of section 31(3) is only valid if the investor is non-resident at the time that the financial assistance is granted seems cogent and has merit. This conclusion has important ramifications for the application of section 31(3) to persons who change their resident status after financial assistance is granted.

The facts of the case and judicial precedent do not seem to lend support to the argument that financial assistance was not provided indirectly.

Objections based on the means by which the Commissioner exercised his discretion, or his failure to do so, are not robust and would be likely to fail. Were the matter to come before a court on this basis, it is likely that the court, if it found that the Commissioner had not properly exercised his discretion, would merely refer the matter to the Commissioner for due consideration. Given the result of the analysis in Appendix 9, it is submitted that the Commissioner would not offer any indulgence to the taxpayers.

Chapter 5: Prospective application – the Draft Taxation Laws Amendment Bill 2010

On 10 May 2010, the National Treasury released the Draft Taxation Laws Amendment Bill 2010 for public comment. It appears that section 10(1)(h) is to be replaced by a new section 10B, and several amendments are proposed to sections 31(3) and 64C(2)(e).

The proposed section 10B

The effect of section 10B (which purports to replace section 10(1)(h), although the draft bill does not expressly delete that section)[156] is to limit from 1 March 2011 the exemption on interest paid to non-residents insofar as such interest is not derived from:

- Government bonds,
- Listed bonds,
- Bank deposits,
- Debt owed by another non-resident,
- Trade debt and finance (for the purposes of import of export of goods),
- Investments in collective investment schemes, or
- Interest on a stockbroking trust or brokerage account.

The exemption does not apply to bank interest arising from back-to-back financing or to interest paid to a non-resident by another non-resident who is either a natural person physically present in South Africa for more than 183 days in a year, or a person carrying on business in South Africa through a permanent establishment.

On the facts of the case study, the exemption of interest paid by the trusts to the investor would no longer apply, since the loans from the investor to the trusts do not fall within the ambit of the proposed debt types.

[156] This is probably an oversight that will be corrected following the process of soliciting public comment.

The proposed amendments to section 64C(2)(e)

Section 64C(2)(e) makes amounts disallowed as deductions in accordance with section 31(3) subject to STC.

The draft bill proposes that section 64(2)(e) is substituted by the following:

'that amount represents

(i) additional taxable income of reduced assessed loss of that company as a result of a determination made by the Commissioner in terms of section 31(2); or

(ii) any amount of interest, finance charge or other consideration that is disallowed as a deduction in accordance with section 31(3);'.

The effect of this amendment is to render more specific the nature of the amounts subject to STC by the application of subsections (2) and (3) of section 31.

The proposed amendments to section 31 that pertain to section 31(3)

The draft bill proposes a specific definition in section 31(1) of 'financial assistance', following the proposed deletion of the definition of 'services'. The effect of this change is merely to define 'financial assistance' separately.

Following from the separate definition of 'financial assistance', the opening sentence of section 31(3)(a) is suitably amended.

Subparagraph (ii) to section 31(3)(a) is to be deleted.

A proposed subparagraph (iii) to section 31(3)(a) is proposed so as to include 'a permanent establishment in the Republic of any other person who is not a resident' as an affected destination of financial assistance by a non-resident. This has the effect of including foreign branches in the ambit of section 31(3).[157]

Of greater interest to the facts of this case study are the proposed amendments to section 31(3)(a) regarding the determination of 'excessive' financial assistance. The incumbent references to fixed capital have been replaced by wording that gives the Commissioner the discretion to determine the excessive component of the financial

[157] Previously, foreign investors could circumvent the provisions of section 31(3) by capitalising South African branches (as opposed to subsidiary or associate companies) with excessive debt.

assistance with reference to what might have been provided on an arm's length basis. This amendment may have profound effects on the circumstances of this case study, as it would likely become very difficult to argue that an arm's length lender would provide financial assistance to the same extent where the intention was to invest those funds in the volatile South African equity market.

The proposed proviso to section 31(3)(a) has the effect of preventing the application of section 31(3) where a non-resident provides financial assistance to a resident headquarter company who then loans such funds on to a foreign company in which the headquarter company has a defined interest.

Proposed changes to paragraph (b) of section 31(3) give the paragraph a more imperative quality.

Finally, a specific definition of 'connected person' is proposed in a new paragraph (c) to section 31(3).

It is submitted that Practice Note 2 will have to be revised too in order to reflect the proposed amendments to section 31(3).

Fundamental rationale

Removing the section 10(1)(h) exemption whilst retaining section 31(3) seems to fly in the face of the original rationale for the introduction of the thin capitalisation rules. In its first report, the Katz Commission 'concluded that it would be unwise at this stage to reimpose tax on interest in the hands of non-residents. The only remedy therefore lies in control over the proportion of shareholder debt to equity'.[158] Since thin capitalisation rules were seen as the 'only remedy' to abusive practices, it might be concluded logically that, circumstances permitting, such rules would not have been introduced were interest paid to non-residents to have been taxed in the first place.

The Explanatory Memorandum on the Taxation Laws Amendment Bill 2010[159] seeks to justify the proposed limitation of the interest exemption by characterising the thin capitalisation rules as 'only a partial remedy'.

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[158] Katz Commission (note 30) at 229.

[159] At 94.

The repercussions given the circumstances of the case study are clear. But for the thin capitalisation rules, the South African fiscus would be unable to tax the interest paid to the investor whilst also allowing a deduction for interest paid to the investor (via the trusts) by the companies. The effect of the thin capitalisation rules is to prevent such prejudice to the fiscus by making adjustments so as to provide for a suitable, reasonable increase in the tax base. However, after the proposed amendments, the fiscus will not only retain the tax base arising from the implementation of the thin capitalisation rules, but it will increase that tax base by limiting the exemption on interest paid to non-residents.

One might infer that the view of the National Treasury is that the interest exemption incentive for foreign investment is only required for portfolio flows (which are notoriously volatile). In any event, the available options for the capitalisation of South African businesses by foreigners will narrow considerably as a result of the proposed amendments.

Concluding remarks

The proposed deletion of section 10(1)(h) and its replacement by section 10B effectively negates the exemption on interest paid by the trusts to the investor entirely. Furthermore, the determination of the excessive component of financial assistance with reference to a similar arm's length transaction would almost certainly make it very difficult for the trusts and the companies to justify the structure of their balance sheets. Further still, the revised basis for the determination of excessive financial assistance makes the trusts vulnerable to attack under section 31(3) too.

In short, whilst the structure given in the case study continues to have merit in terms of remitting the maximum interest to the investor in terms of exchange control, it is clear that the apparently benign tax consequences that might have been contemplated originally shall not persist.

The investor's affairs would have to be restructured fundamentally, or the transactions would have to be recharacterised entirely, or the financial instruments in which the companies invest would have to change[160], or the investor would have to pay the 10% exchange control levy to remit his blocked Rands offshore.

Notwithstanding these changes, the question remains as to whether section 31(3) has application when an investor's resident status changes after granting of financial assistance.

[160] For example, he might invest in a listed debenture whose underlying assets were South African equities.

Chapter 6: Conclusions, recommendations and areas for future research

Conclusions and recommendations

This dissertation sought to examine the application of section 31(3) of the Income Tax Act, 1962 where the investor is an emigrant.

An analysis of SARS's application of section 31(3) to the facts of the case, whilst justifying SARS's approach, revealed three possible weaknesses:

1. That whilst SARS had interpreted the words 'is not a resident' and 'has granted' in the context of the time that or in the years of assessment in which the thin capitalisation rules were applied, a more thorough examination of the wording might have a different outcome.
2. That the independence of a board of trustees of a trust might impede the apparently indirect link between the investor and the recipient.
3. That the Commissioner may have abdicated his responsibility to properly exercise his discretion in respect of section 31(3), owing to the practice that is set out in Practice Note 2 and given the unique circumstances of the case.

A critical review of these three questions concluded as follows:

1. A proper literal and purposive interpretation of the words 'is not a resident' and 'has granted' (given the change in the resident status of the investor) indicates that section 31(3) should only apply where the investor was not resident at the time that the financial assistance was granted. The evident ambiguity associated with the use of 'is not a resident' with 'has granted financial assistance' should result in the interpretation of the section *contra fiscum*. It is recommended that SARS reviews the wording of this section to clarify its application.
2. Case law and the circumstances of the case give little merit to the interposition of an independent board of trustees between the investor and the recipient.
3. On a thorough consideration of the facts of the case and the manner in which the Commissioner could have been expected to exercise his discretion, it would be very unlikely that a satisfactory objection could be raised. Even if such an objection were to reach the courts, the matter would simply be referred to the

Commissioner for proper consideration and it is unlikely that he would have concluded differently.

Finally, the prospective application of the amendments proposed in the draft Taxation Laws Amendment Bill 2010 will largely negate the tax benefits of the structures used in this case study, necessitating a revision of the structures and the investment strategy and instruments, or the payment of the 10% exchange control exit levy. However, it was noted that the limitation of the exemption on interest paid to non-residents and the simultaneous retention of the thin capitalisation rules seems contrary to the original rationale for the introduction of section 31(3). It is recommended that SARS should consider the potentially punitive effects of the limitation of the interest exemption per the proposed section 10B when considered with the simultaneous application of section 31(3).

Areas for future research

The facts of the case study are comprehensive, and the scope of this dissertation was limited to an analysis of section 31(3) only. However, several areas of future research interest arise in respect of the thin capitalisation rules.

Firstly, it would be worthwhile examining the effects of the remittance of interest to a jurisdiction with which South Africa has concluded a double taxation agreement. The application of the terms of the double tax agreement might have offered some respite to the taxpayers. This may be of even more pertinence given the proposed amendments to the Income Tax Act.

Secondly, an exploration of whether or not the simultaneous application of section 31(3) and the exchange control regulations are discriminatory, and hence whether such simultaneous application would be unconstitutional or prohibited in terms of the OECD's Model Convention on Income and on Capital, could be considered too.

Thirdly, given the apparent weaknesses of the structures used in the case study, as well as their susceptibility to attack under the proposed amendments to the Income Tax Act, an exposition of any alternative means would be valuable.

There are also other matters that arise from the facts of the case study that are not directly related to section 31(3), but which may warrant further investigation.

Firstly, the effects of section 9C of the Income Tax Act on the characterisation of trading profits in the case study could be considered, particularly if such characterisation would compromise or limit the deductibility of interest before any consideration of section 31(3).

Secondly, although section 31(3) is an anti-avoidance section, it would be illuminating to discuss whether or not the general anti-avoidance rules in the Act would have application in this instance, how they might be applied and what the effects thereof might be.

Appendix 1: Financial information pertaining to the case study facts

COMPANY BALANCE SHEETS as at end February	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Cash	100.0	-	-	-	-	-	-	-	-	-
Trading portfolio	-	102.9	82.3	100.0	100.0	115.1	146.1	162.4	84.4	111.9
TOTAL ASSETS	100.0	102.9	82.3	100.0	100.0	115.1	146.1	162.4	84.4	111.9
Share capital	-	-	-	-	-	-	-	-	-	-
Retained income/accumulated losses	-	2.9	-36.0	-26.8	-16.0	15.1	46.0	62.5	-15.7	13.9
TOTAL EQUITY	-	2.9	-36.0	-26.8	-16.0	15.1	46.0	62.5	-15.7	13.9
Loan from Trust	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Accrued interest	-	-	18.3	26.7	16.0	-0.0	0.0	-0.0	0.0	-2.0
TOTAL LIABILITIES	100.0	100.0	118.3	126.7	116.0	100.0	100.0	100.0	100.0	98.0
TOTAL EQUITY and LIABILITIES	100.0	102.9	82.3	100.0	100.0	115.1	146.1	162.4	84.4	111.9

INCOME STATEMENTS for the years ended February	2002	2003	2004	2005	2006	2007	2008	2009	2010
Trading profits	17.1	-23.7	25.7	24.5	42.6	41.0	27.6	-66.0	38.2
Dividends	1.5	3.1	2.5	3.0	3.0	3.5	4.4	4.9	2.5
Interest	-15.7	-18.3	-18.9	-16.7	-14.5	-13.5	-15.5	-17.1	-11.2
Net income before tax	2.9	-38.9	9.2	10.8	31.1	30.9	16.5	-78.2	29.5
Tax	-	-	-	-	-	-	-	-	-
Retained income	2.9	-38.9	9.2	10.8	31.1	30.9	16.5	-78.2	29.5

TAX CALCULATIONS for the years ended February	2002	2003	2004	2005	2006	2007	2008	2009	2010
Dividends	1.5	3.1	2.5	3.0	3.0	3.5	4.4	4.9	2.5
Sales of shares	14.2	-	8.0	24.5	27.5	10.0	11.2	12.1	10.7
Cost of sales of shares	-12.1	-	-7.2	-16.6	-13.1	-3.5	-3.3	-6.0	-3.7
Opening stock	-	87.9	91.0	83.7	67.1	54.0	50.5	47.2	41.2
Purchases	100.0	3.1							
Closing stock	-87.9	-91.0	-83.7	-67.1	-54.0	-50.5	-47.2	-41.2	-37.5
GROSS INCOME	3.6	3.1	3.3	10.9	17.4	9.9	12.3	11.0	9.6
Less EXEMPT dividends	-1.5	-3.1	-2.5	-3.0	-3.0	-3.5	-4.4	-4.9	-2.5
INCOME	2.1	-	0.8	7.9	14.4	6.5	7.9	6.1	7.0
Less interest DEDUCTION	-15.7	-18.3	-18.9	-16.7	-14.5	-13.5	-15.5	-17.1	-13.2
TAXABLE INCOME	-13.6	-18.3	-18.1	-8.9	-0.1	-7.0	-7.6	-11.0	-6.2
ASSESSED LOSS b/f	-	-13.6	-31.9	-50.1	-58.9	-59.0	-66.0	-73.6	-84.6
NET TAXABLE INCOME/(ASSESSED LOSS)	-13.6	-31.9	-50.1	-58.9	-59.0	-66.0	-73.6	-84.6	-90.8
Tax rate	30%	30%	30%	30%	29%	29%	29%	28%	28%
TAX	-	-	-	-	-	-	-	-	-

SARS application of s31(3)	2002	2003	2004	2005	2006	2007	2008	2009	2010
Restated retained income per SARS	2.9	2.9	12.1	22.9	15.1	46.0	62.5	62.5	92.0
Loan:fixed capital ratio	34.5	40.8	10.5	5.1	6.6	2.2	1.6	1.6	1.1
STC rate	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	10.0%	10.0%
Disallowed interest in terms of s31(3)(a)	-14.3	-17.0	-13.5	-6.8	-7.9	-	-	-	-
Tax thereon	4.3	5.1	4.0	2.0	2.3	-	-	-	-
STC thereon	1.8	2.1	1.7	0.9	1.0	-	-	-	-
Total	6.1	7.2	5.7	2.9	3.3	-	-	-	-
Average SARS interest rate	13.0%	14.2%	14.1%	11.2%	10.5%	10.7%	12.3%	14.3%	9.2%
Interest on tax and STC owing	6.9	8.2	6.5	3.2	3.6	-	-	-	-
Penalties	12.2	14.4	11.5	5.8	6.6	-	-	-	-
TOTAL AMOUNT	25.2	29.8	23.8	11.9	13.5	-	-	-	-

Appendix 2: Section 31(3) of the Income Tax Act

(a) Where any person who is not a resident (hereinafter referred to as the investor) has granted financial assistance contemplated in paragraph (c) of the definition of "services" in subsection (1), whether directly or indirectly, to –

(i) any connected person in relation to the investor who is a resident; or

(ii) any other person (in whom he has a direct or indirect interest) other than a natural person, which is a resident (hereinafter referred to as the recipient) and, by virtue of such interest, is entitled to participate in not less than 25 per cent of the dividends, profits or capital of the recipient, or is entitled, directly or indirectly, to exercise not less than 25 per cent of the votes of the recipient,

and the Commissioner is, having regard to the circumstances of the case, of the opinion that the value of the aggregate of all such financial assistance is excessive in relation to the fixed capital (being share capital, share premium, accumulated profits, whether of a capital nature or not, or any other permanent owners' capital, other than permanent capital in the form of financial assistance so contemplated) of such connected person or recipient, any interest, finance charges or other consideration payable for or in relation to or in respect of the financial assistance shall, to the extent which it relates to the amount which is excessive as contemplated in this paragraph, be disallowed as a deduction for the purposes of this Act.

(b) For the purposes of paragraph (a), financial assistance granted indirectly shall be deemed to include any financial assistance granted by any third person who is not a connected person in relation to the investor, a connected person contemplated in paragraph (a) or the recipient, where such financial assistance has been granted by arrangement, directly or indirectly, with the investor and on the strength of any financial assistance granted, directly or indirectly, by the investor or any connected person in relation to the investor, to such third person.

Appendix 3: Relevant excerpts from terms defined in section 1 of the Income Tax Act which are used in section 31(3)

"**connected person**" means –

(a) in relation to a natural person –

(i) any relative; and

(ii) any trust (other than a portfolio of a collective scheme in securities) of which such natural person or such relative is a beneficiary;

(b) in relation to a trust (other than a portfolio of a collective scheme in securities) –

(i) any beneficiary of such trust; and

(ii) any connected person in relation to such beneficiary;

(bA) in relation to a connected person in relation to a trust (other than a collective investment scheme in property shares managed or carried on by any company registered as a manager under section 42 of the Collective Investment Schemes Control Act, 2002, for purposes of Part V of that Act and other than a portfolio of a collective investment scheme in securities), includes any other person who is a connected person in relation to such trust; …

(d) in relation to a company – …

(iv) any person, other than a company as defined in section 1 of the Companies Act, 1973 (Act No. 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the company's equity share capital or voting rights;

"**person**" includes an insolvent estate, the estate of a deceased person, any trust and any portfolio of a collective investment scheme in securities;

"**resident**" means any - …

(a) natural person who is –

(i) ordinarily resident in the Republic; or

(ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic –

(aa) or a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and

(bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment,

in which case that person will be a resident with effect from the first day of that relevant year of assessment …

(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic,

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation;

Appendix 4: Definition of 'financial assistance' per section 31(1) of the Income Tax Act

"services" includes anything done or to be done, including, without limiting the generality of the foregoing—

(a) the granting, assignment, cession or surrender of any right, benefit or privilege;

(b) the making available of any facility or advantage;

(c) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;

(d) the performance of any work;

(e) an agreement of insurance; or

(f) the conferring of rights to or the use of incorporeal property.

Appendix 5: Excerpts from section 64C of the Income Tax Act which are relevant to section 31(3)

(2) For the purposes of section 64B, an amount shall, subject to the provisions of subsection (4), be deemed to be a dividend distributed by a company to a shareholder, where - …

(e) that amount represents additional taxable income or reduced assessed loss of that company by virtue of any transaction with the shareholder or a connected person in relation to such shareholder, the consideration of which is adjusted or any amount of interest, finance charge or other consideration is disallowed as a deduction in accordance with the provisions of section 31;

(4) The provisions of subsection (2) shall not apply - …

(c) to so much of any amount (other than an amount contemplated in subsection (2)(e)) as exceeds the company's profits and reserves which are available for distribution, including any amount deemed in terms of the definition of "dividend" in section 1 to be a profit available for distribution: Provided that any prohibition or limitation on any such distribution contained in the company's memorandum and articles of association or founding statement or any agreement shall be disregarded in the application of this paragraph.

Appendix 6: SARS Practice Note 2

Practice Note: No. 2 – 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

1. Introduction

1.1 In anticipation of a possible relaxation in exchange controls, the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (under the chairmanship of Prof M.M. Katz) recommended in its first and second interim reports that transfer pricing provisions be introduced into the Income Tax Act, 1962 (the Act), inter alia to counter thin capitalization practices which may have adverse tax implications for the South African fiscus.

Transfer pricing provisions are normally applied to adjust the prices of goods and services in terms of certain transactions concluded between related parties to reflect an arm's length price which would have applied had the transaction been concluded on normal commercial grounds between unrelated parties. The effect of the application of transfer pricing provisions is to neutralise the tax benefit arising from such transactions. On the other hand, thin capitalization provisions are applied to limit the deductibility of interest where there is a disproportionate ratio between the loan capital and equity employed in, for example, a company.

In order to counter such practices, section 23 of the Income Tax Act, 1995 (Act No. 21 of 1995), substituted section 31 of the Act. Such section consists of a combination of transfer pricing and thin capitalization provisions which may, for instance, be applied where financial assistance is granted in respect of international transactions.

1.2 Measures to counter transfer pricing schemes are in essence contained in section 31(1) and (2). Although these provisions may also, in certain circumstances, be applied to combat thin capitalisation, the provisions of subsection (3) are more specifically aimed at countering thin capitalisation schemes. Once the excessive portion of financial assistance has been determined in accordance with the guidelines as set out in paragraph 4 of this Practice Note, the provisions of section 31(2) must be applied to determine whether the interest calculated on that portion of the financial assistance falling within the 3:1 guideline provided in the aforementioned paragraph, is based on an arm's length price (interest rate). In this regard consideration should be given to the guidelines provided in paragraph

2.2. On a literal interpretation of section 31 the concept of financial assistance would include not only interest-bearing financial assistance, but also interest-free financial assistance. As the purpose of subsection (3) is in essence to enable the Commissioner for Inland Revenue to determine an acceptable debt/equity ratio in order to disallow a deduction in respect of interest relating to the excessive portion of loan capital, the application of subsection (3) will be limited to interest-bearing financial assistance. This will, however, not have the effect that financial assistance which is not interest-bearing, will be regarded as permanent owners' capital. On the same basis only, interest-bearing financial assistance will be taken into account in the application of the transfer pricing provisions of subsection (2) in cases where it is applied in conjunction with the provisions of subsection (3) in order to determine whether the interest calculated on that portion of the financial assistance falling within the 3:1 guideline, is based on an arm's length price (interest rate). However, where the application of the thin capitalization provisions are not necessary because the financial assistance granted falls within the prescribed guidelines, financial assistance may include financial assistance which is not interest-bearing in the application of the provisions of subsection (2).

1.3 Example

A profitable South African company, TPS (Pty) Ltd, was capitalised in rand by its shareholder who is a non-resident. The company's financial year ends on 31 August. The RSA prime rate was 18,5% throughout the 1995/6 year of assessment. The following further information is relevant for the application of section 31:

Fixed capital

Shareholder		R1 000 000
Loans		R4 000 000
Shareholder granted loan #1 on 1/9/95 @ 24% p.a.	R2 000 000	
Shareholder granted loan # 2 on 26/1/95 @	R2 000 000	

0% p.a.

Interest

Loan #1: R2 000 000 at 24%	R480 000

Section 31(3) is not applicable as the interest-bearing financial assistance granted falls within the 3:1 guideline.

Calculation of excessive interest in terms of section 31(2)

Interest falling within the 3:1 guideline	=	R480 000
Weighted average of financial assistance:		
R2 000 000 for 147 days		294 000 000
R4 000 000 for 219 days		<u>876 000 000</u>
		1 170 000 000 ÷ 366
	=	R3 196 721
Effective interest rate of acceptable		
financial assistance	=	R480 000 ÷ R3 196 721
	=	15%

Excessive interest relating to the 1995/6 year of assessment is Rnil as the 20.5% [18.5% + 2% (see 2.2 below)] limit has not been exceeded.

2. Section 31(1) and (2)

2.1 The scope of subsections (1) and (2) is limited to an "international agreement" as defined. A transaction, operation or scheme qualifies as an international agreement where such agreement has been entered into between–

• a natural person ordinarily resident in the Republic or a person other than a natural person managed or controlled in the Republic (hereinafter referred to as a resident); and

• a natural person not ordinarily resident in the Republic or a person other than a natural person managed or controlled outside the Republic (hereinafter referred to as a non-resident).

Furthermore, paragraph (c) of the definition of "services" in section 31(1) encompasses the granting of financial assistance, including a loan, advance or debt and the provision of any security or guarantee.

2.2 Where in terms of section 31(2) a service, specifically the granting of financial assistance, is provided by a non-resident to a resident who is a connected person in relation to the non-resident and the consideration relating to the financial assistance is excessive in the sense that the consideration does not reflect an arm's length price, the Commissioner may, in the determination of the taxable income of the resident, adjust the consideration in the hands of the resident to reflect an arm's length consideration in relation to the financial assistance granted. Consideration, in the context of financial assistance, will be interpreted to include not only interest or related finance charges, but also a discount or premium. Where the loan, advance or debt is denominated in rand, a rate not exceeding the weighted average of the South African prime rate plus 2 percentage points will be an acceptable nominal annual interest rate. Where the loan, advance or debt is denominated in a foreign currency, a rate not exceeding the weighted average of the relevant interbank rate plus 4 percentage points will be an acceptable nominal annual interest rate. Any interest exceeding the above-mentioned prescribed rates will be regarded as excessive interest and will consequently not be allowed as a deduction for income tax purposes.

3. Section 31(3)

Section 31(3) was introduced specifically to address thin capitalisation transactions between certain related parties. The provisions of this section will apply where financial assistance is granted directly or indirectly by a non-resident of the Republic (the investor) to–

(a) a resident (the resident) of the Republic who is a connected person in relation to the investor; or

(b) a person other than a natural person who is managed or controlled in the Republic (the recipient) in whom the investor has a direct or indirect interest by virtue of which the investor is entitled to participate in 25% or more of the dividends, profits or capital of the recipient or is entitled to exercise, directly or indirectly, 25% or more of the voting rights of the recipient.

Where in terms of such an arrangement the Commissioner is satisfied that the financial assistance granted by the investor to the resident or the recipient is excessive in relation to the fixed capital of the resident or recipient, any interest relating to the excessive portion of the financial assistance shall be disallowed as a deduction in the hands of the resident or recipient.

4. Determination of “disallowable interest” relating to excessive financial assistance

4.1 As a general guideline, the Commissioner will not apply the thin capitalisation provisions contained in section 31(3) where the financial assistance/fixed capital ratio does not exceed 3.1. The excessive portion of financial assistance granted by an investor will, therefore, be that portion of the financial assistance which exceeds an amount equal to three times the fixed capital of the resident or recipient of the financial assistance. This approach will ensure a degree of continuity as it will, to some extent, correspond with the current practice of the Exchange Control Authorities. The interest (interest, finance charge or other consideration including inter alia a discount or premium) in relation to or in respect of financial assistance shall be apportioned between the amount of financial assistance which is considered to be acceptable and the amount of financial assistance which is regarded as excessive. In order to determine which portion of interest relates to excessive financial assistance in relation to an investor in respect of a year of assessment, the following formula will be applied.

$A = B \times ((C - D) / C)$

in which formula–

“A” represents the disallowable interest, limited to interest incurred during such year in respect of financial assistance granted on or after 19 July 1995;

“B” represents the total interest incurred during such year in respect of all financial assistance, contemplated in subsection (3), in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995);

"C" represents the weighted average of all interest-bearing financial assistance which was in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995); and

"D" represents the greater of–

• three times the fixed capital of the resident or recipient as at the end of the relevant year of assessment; and

• the weighted average of all interest-bearing financial assistance granted prior to 19 July 1995, which existed during such year.

4.2 The financial assistance contemplated in section 31 to be used in symbol C is an amount equal to the weighted average of the financial assistance in existence during the relevant year of assessment and includes interest-bearing financial assistance only. Where no significant variation occurred in the level of financial assistance during the year of assessment, the amount of financial assistance as it exists at the end of the relevant year of assessment may be used. Trade credit which is interest-bearing must be included in the amount of financial assistance granted as contemplated in section 31(1). Furthermore, where a South African company is partially owned by an investor (e.g. 50%) and such investor is jointly and severally, together with all other shareholders, liable in terms of a security provided in respect of–

•a foreign bank overdraft of the South African company; or

•any other independent third party foreign loan to the South African company,

a portion of the overdraft or loan, pro rata to the investor's interest in the company, will be regarded as financial assistance granted by such investor.

4.3 In determining the amount of fixed capital of the resident or recipient in the Republic, the following items are to be taken into account on a pro rata basis in accordance with the investor's interest in the South African entity:

•share capital;

•share premium;

•accumulated profits of a capital and revenue nature; and

•permanent owner's capital (excluding any financial assistance) in circumstances where there is no share capital.

Fixed capital will be reduced by any reserves and increased by any losses, resulting from the revaluation of assets. The amount of fixed capital to be used when calculating symbol "D" of the formula is an amount equal to the fixed capital at the end of the relevant year of assessment. However, the annual net trading losses sustained during the current and immediately preceding two years of assessment, limited to losses sustained for years of assessment during which the investor has granted financial assistance to the resident or recipient, may be added back to fixed capital to be used in symbol "D" of the formula.

4.4 In determining the fixed capital relating to investors the calculation should not be done on the basis of what the investors invested, but rather on such investor's pro rata share of the total fixed capital. Furthermore, fixed capital will exclude deferred tax as determined for accounting purposes.

4.5 Where financial assistance is granted to a resident of the Republic by more than one investor as contemplated in subsection (3), the rules of section 31 will be applied to such investors, without reference to any person other than an investor having an interest in the fixed capital of the resident or recipient.

5. Example

A profitable South African company, TCS (Pty) Ltd, was capitalised in rand by its shareholders, all of them being non-residents. Only X is an investor. The company's financial year ends on 31 August. The RSA prime rate was 18,5% throughout the 1995/6 year of assessment. The following further information is relevant for the application of section 31:

Fixed capital		R15 000 000
Shareholder X – (2/3)	R10 000 000	
Various other shareholders – (1/3)	R5 000 000	
Loans		R40 000 000
Shareholder X granted loan #1 on 1/9/95 @ 24% p.a.	R30 000 000	

Shareholder X granted loan # 2 on 26/1/96 @ 18% p.a.	R10 000 000	
Interest		R8 277 049
Loan # 1: R30 000 000 at 24% for 366 days	R7 200 000	
Loan # 2: R10 000 000 at 18% for 219 days	R1 077 049	

Calculation of disallowable interest in respect of shareholder X in terms of section 31(3)

B = R8 277 049

C	=	R30 000 000 for 147 days	4 410 000 000
		R40 000 000 for 219 days	8 760 000 000
			13 170 000 000 ÷ 366
	=	R35 983 606	
D	=	The greater of (R10 000 000 × 3) or Rnil	
	=	R30 000 000	

$$A = \frac{8\ 277\ 049}{1} \times \frac{(35\ 983\ 606 - 30\ 000\ 000)}{35\ 983\ 606}$$

= R1 376 365 (disallowable interest for the 1995/6 year of assessment)

Calculation of excessive interest in respect of shareholder X in terms of section 31(2)

Interest falling within the 3:1 guideline	=	R8 277 049 – R1 376 365
	=	R6 900 684
Effective interest rate of acceptable financial assistance	=	R6 900 684 ÷ R30 000 000
	=	23%
Excessive interest relating to the 1995/6 year of assessment	=	R6 900 684 × (23 – 20,5) ÷ 23
	=	R750 074

6. Commissioner's discretion

6.1 Notwithstanding the guideline of the 3:1 ratio and the interest rates referred to in paragraph 2.2, with regard to the application of section 31, it is acknowledged that a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate may be applicable as a result of transactions and agreements entered into for commercial and economic reasons rather than to obtain tax advantages.

6.2 Where a taxpayer, therefore, can justify a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate under particular or special circumstances, he may approach the Commissioner, to exercise his discretion in terms of section 31. This will, generally be of a temporary nature and a period may be specified within which the 3:1 ratio should be restored or the interest rate be reduced.

6.3 Taxpayers falling within the 3:1 ratio will not be required to justify their ratio. They must, however, submit the information requested in the annual income tax return.

7. Financial assistance in currency other than rand

Where financial assistance is denominated in a currency other than the currency of the Republic, the equivalent currency value of the Republic must be determined by applying the spot or relevant forward rate, as the case may be, on the date the amount of financial assistance is to be determined. However, where there is an increase in the rand value of the financial assistance as a result of a weakening of the rand against the relevant foreign currency, the rand value of the financial assistance may be determined with reference to the spot or relevant forward rate, as the case may be, on the following dates: In the case of a loan owing by a person, the date on which the amount payable in respect of the loan was received by such person and in the case of a debt owing by a person, the date on which the debt was actually incurred.

8. Back-to-back arrangements

In the application of section 31(3), the term "financial assistance granted indirectly" includes back-to-back arrangements through independent parties or co-investors. Where a foreign parent company, therefore, makes a loan to a South African bank, a foreign bank or any other person on condition that the bank or other person on-lends the funds to the South African subsidiary of the parent company, the loan will be treated as financial assistance. Where the foreign parent company provides a guarantee to a foreign bank or any other non-resident as security for a loan to the local subsidiary, the bank debt will be treated as financial assistance. Where, however, the foreign parent company provides a guarantee to a South African bank as security for a loan to the local subsidiary, the bank loan will not be treated as financial assistance as the foreign company will not receive any interest and the recipient of the interest will be taxed thereon.

9. Excessive (see par. 2.2) and disallowable (see par. 4) interest subject to secondary tax on companies (STC)

In the case of companies the total amount of the excessive and disallowable interest will be deemed to be a dividend declared in terms of section 64C (3)(e) of the Act and STC will be payable on the excessive and disallowable interest. As the determination of the excessive and disallowable portions of interest and the exercising of the Commissioner's discretion are to be made at the time the relevant assessment is raised, the dividend cycle in respect of such deemed dividend will, for purposes of the definition of "dividend cycle" in section 64B(1), be regarded to end on the date of assessment in respect of the year of assessment to which the excessive and disallowable interest relates. Where, however, the taxpayer has been notified in writing by the Commissioner of the amount of the excessive and disallowable interest prior to such date of assessment, the dividend cycle will be regarded to end one month after the date of such notification.

10. Application

The provisions of section 31 shall inter alia only apply to any services supplied on or after 19 July 1995. As already mentioned, the supply of services includes the granting of financial assistance. Interest incurred after that date on a loan or advance received or debt incurred before that date will, therefore, not be subject to the provisions of section 31.

Appendix 7: Addendum to SARS Practice Note 2

Addendum to SARS Practice Note No. 2 added by Notice 746 Government Gazette 23407 of 17 May 2002

1. Paragraph 2.2 of Practice Note No. 2, dated 14 May 1996 has been replaced with the following paragraph:

> "Where in terms of section 31(2) a service, specifically the granting of financial assistance, is provided by a non-resident to a resident who is a connected person in relation to the non-resident and the consideration relating to the financial assistance is excessive in the sense that the consideration does of reflect an arm's length price, the Commissioner may, in the determination of the taxable income of the resident, adjust the consideration in the hands of the resident to reflect an arm's length consideration in relation to the financial assistance granted. Consideration, in the context of financial assistance, will be interpreted to include not only interest or related finance charges, but also a discount or premium. Where the loan, advance or debt is denominated in rand, a rate not exceeding the weighted average of the South African prime rate plus 2 percentage points will be an acceptable nominal annual interest rate. Where the loan, advance or debt is denominated in a foreign currency, a rate not exceeding the weighted average of the relevant interbank rate plus 2 percentage points will be an acceptable nominal annual interest rate. Any interest exceeding the above mentioned prescribed rates will be regarded as excessive interest and will consequently not be allowed as a deduction for income tax purposes."

2. The amendment referred to in paragraph 1 above is effective from the date of publication of this notice and will apply to:

- Financial assistance granted on or after such date;
- Financial assistance granted before such date, but which does not have a fixed date of repayment.

Appendix 8: Extract from the Explanatory Memorandum on the Income Tax Bill 1995

Clause 23 Determination of taxable income of certain persons in respect of international transactions: Substitution of section 31 of the Principle Act.

The amendment proposed by this clause substitutes the provisions of section 31 of the Principal Act. These provisions will be used to address tax avoidance schemes involving the manipulation of prices for goods and services under cross-border transactions between connected persons. In accordance with international precedent in may developed countries, it is the intention that such transfer pricing rules may also be applied to counter the abusive practice of thin capitalisation.

Thin capitalisation

A company may be financed in various ways e.g. by equity capital or by debt capital or a combination of debt and equity. A company is said to be thinly capitalised when its equity capital is small in comparison to its debt capital. Because a company and its investors may be treated differently for tax purposes, depending on whether the return to the investor originates from debt or equity financing, thin capitalisation may be used as effective tax avoidance device. On the company side, payments of interest are generally deductible in the determination of its taxable income while dividends are not, giving a company provided with loan a taxation advantage over a company provided with equity capital. In the case of a foreign investor, interest would normally fall within the ambit of section 10(1)(hA) of the Principal Act and would therefore be exempt from normal tax. Several countries have introduced comprehensive provisions to counter thin capitalisation, allowing a recharacterisation of debt as equity and consequently the denial of interest expense as a deduction if the debt to equity ratio exceeded a prescribed ratio. However, such an approach requires very detailed and complex provisions. Many countries on the other hand prefer to apply the arm's length principle contained in their transfer pricing legislation to counter such abusive practices. The following is provided for in the proposed section 31 of the principal Act:

Subsection (1) introduces definitions in respect of “goods”, “international agreement” and

“services”. It is important to note that paragraph (c) of the definition of “services” includes the granting of financial assistance, including a loan, advance or debt and the provision of security or a guarantee. This ensures that a scheme involving thin capitalisation could be dealt with under the provisions of section 31.

Subsection (2) provides that the Commissioner, in the determination of a taxpayer’s taxable income, may adjust the consideration in respect of a transaction to reflect an arm’s length price for the goods or services. These provisions may in a broad sense be regarded as transfer pricing rules.

Subsection (3): Although the aforegoing provisions may also be applied to counteract thin capitalisation schemes, the provisions of the proposed subsection (3) are more specifically aimed at counteracting such schemes and include in the net, not only connected persons but also persons in whom the investor has a 25% interest as well as schemes whereby back-to-back financial assistance is granted. It must be mentioned that the Commissioner’s discretion is subject to objection and appeal in terms of section 3 of the Principal Act.

Finally, any amount adjusted or disallowed in terms of this section will be deemed to be a dividend for STC purposes.

Appendix 9: Schedule of annual returns and projected debt to equity ratios

Tax year ending February	JSE Total Return	JSE capital return	JSE dividend yield	Prime + 2%
1962	23.0%	15.3%	7.5%	8.8%
1963	32.3%	25.3%	6.1%	8.0%
1964	26.8%	21.2%	5.4%	7.5%
1965	16.3%	11.1%	4.9%	8.0%
1966	4.3%	-0.7%	5.0%	9.0%
1967	20.5%	15.1%	4.8%	9.8%
1968	26.6%	21.9%	4.8%	10.5%
1969	43.3%	39.5%	3.3%	10.3%
1970	-23.2%	-26.1%	3.0%	10.0%
1971	-17.2%	-21.4%	4.9%	10.3%
1972	14.7%	9.5%	5.3%	10.9%
1973	52.7%	47.4%	3.8%	10.7%
1974	24.9%	20.0%	4.0%	10.0%
1975	-5.9%	-11.8%	5.3%	12.8%
1976	-10.6%	-17.4%	7.6%	13.8%
1977	1.1%	-6.7%	8.9%	14.3%
1978	16.9%	8.7%	8.1%	14.5%
1979	65.3%	55.8%	6.7%	14.0%
1980	84.3%	75.0%	6.2%	11.8%
1981	12.4%	3.4%	6.3%	11.6%
1982	4.3%	-3.8%	8.3%	17.3%
1983	41.4%	34.4%	8.0%	21.0%
1984	32.3%	25.5%	5.6%	19.2%
1985	-3.7%	-9.2%	5.5%	25.2%
1986	55.6%	48.5%	5.2%	21.9%
1987	55.9%	50.4%	4.2%	16.0%
1988	-23.7%	-27.6%	3.9%	14.6%
1989	56.5%	50.5%	4.7%	18.1%
1990	39.7%	35.0%	3.8%	22.3%
1991	-5.5%	-9.1%	3.9%	23.0%
1992	32.3%	28.3%	3.3%	22.1%
1993	-1.7%	-5.0%	3.4%	20.3%
1994	45.3%	41.8%	2.8%	17.8%
1995	8.9%	6.2%	2.3%	17.9%
1996	32.5%	29.8%	2.4%	20.3%
1997	9.3%	7.0%	2.3%	21.7%
1998	-0.3%	-2.3%	2.4%	21.8%
1999	-9.3%	-11.8%	2.6%	24.2%
2000	42.6%	39.5%	2.3%	18.8%
2001	18.5%	15.3%	2.5%	16.5%
2002	26.4%	22.0%	2.9%	15.7%
2003	-20.0%	-22.7%	3.3%	18.3%
2004	34.2%	29.7%	3.6%	16.0%
2005	27.5%	23.7%	2.8%	13.2%
2006	45.6%	41.6%	2.6%	12.5%
2007	38.6%	35.2%	2.3%	13.5%
2008	21.9%	18.9%	2.4%	15.5%

2009	-37.6%	-39.8%	3.5%	17.1%
2010	48.3%	44.9%	3.2%	13.0%
Average to 2002	21.1%	15.9%	4.7%	15.4%
Overall average	20.9%	16.0%	4.4%	15.3%
Average since 1987	20.3%	16.7%	3.0%	17.9%

Projected debt to equity ratios assuming the averages to 2002:

Year	Assets	Trading return	Dividend	Interest at prime + 2%	Residual	Equity	Debt: equity
0	100.0						
1	105.2	15.9	4.7	15.4	5.2	5.2	19.3
2	110.6	16.7	5.0	16.2	5.5	10.6	9.9
3	116.4	17.5	5.2	17.1	5.7	16.4	6.8
4	122.4	18.5	5.5	17.9	6.0	22.4	5.2
5	128.7	19.4	5.8	18.9	6.3	28.7	4.3
6	135.4	20.4	6.1	19.8	6.7	35.4	3.6
7	142.4	21.5	6.4	20.9	7.0	42.4	3.2
8	149.8	22.6	6.7	22.0	7.4	49.8	2.9

Appendix 10: Excerpts from the draft Taxation Laws Amendment Bill 2010

18. (1) The Income Tax Act, 1962, is hereby amended by the insertion of the following section:

"Exemption of interest receive by or accrued to persons that are not residents

10B. (1) For the purposes of this section –

'bank' means any –

(a) bank as defined in section 1 of the Banks Act, 1990 (Act No.94 of 1990);

(b) mutual bank as defined in section 1 of the Mutual Banks Act, 1993 (Act No. 124 of 1993; or

(c) co-operative bank as defined in section 1 of the Co-Operative Banks Act, 2007 (Act No. 40 of 2007)

'debt instrument' means any loan, advance, debt, bond, debenture, bill, promissory note, banker's acceptance, negotiable certificate of deposit or similar instrument;

'goods' means any corporeal movable thing;

'Government debt instrument' means any debt instrument issued by the government of the Republic in the national, provincial or local sphere;

'interest' means interest as defined in section 24J(1) or deemed interest as contemplated in section 8E(2);

'listed debt instrument' means any debt instrument that is listed on an exchange as defined in section 1 of the Securities Services Act, 2004 (Act No. 36 of 2004), and licensed under section 10 of that Act;

'non-resident' means any person that is not a resident;

'portfolio of a collective investment scheme' means any portfolio of a collective investment scheme as defined in section 1, other than a portfolio of a collective scheme in property;

'South African Reserve Bank' means the central bank of the Republic regulated in terms of the South African Reserve Bank Act, 1989 (Act No. 90 of 1998).

(2) Subject to subsection (3), there must be exempt from normal tax any interest –

(a) received by or accrued to any non-resident during any year of assessment in respect of-

(i) any Government debt instrument held by that non-resident;

(ii) any listed debt instrument held by that non-resident;

(iii) any debt owed by –

(aa) any bank;

(bb) the South African Reserve Bank; or

(cc) any other non-resident,

to that non-resident;

(iv) the purchase price of any goods imported into or exported from the Republic;

(v) the financing of any transaction under which goods are imported into or exported from the Republic; or

(vi) any debt owed by a non-resident;

(b) payable as contemplated in section 27(6) of the Securities Services Act, 2004 (Act No. 36 of 2004), to any non-resident that is a client as defined in section 1 of that Act; or

(c) received by or accrued to any portfolio of a collective investment scheme that is deemed to have accrued to any non-resident in terms of section 25BA(a)

(3) Notwithstanding subsection (2), interest received by or accrued to a non-resident during any year of assessment in respect of –

(a) any amount advanced, whether directly or indirectly, by the non-resident to a bank will not be exempt from normal tax is the amount is advanced in the course of any arrangement, transaction, operation or scheme to which the non-resident and any other person are parties in terms of which the bank advances any amount to that other person on the strength directly or indirectly of the amount advanced by the non-resident to the bank; or

(b) any debt owed by any other non-resident to that non-resident will not be exempt from normal tax if that non-resident –

(i) is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during that year; or

(ii) at any time during that year carried on business through a permanent establishment in the Republic.”.

(2) Subsection (1) comes into operation on 1 March 2011 and applies in respect of any interest that accrues, is received, becomes payable or is deemed to have accrued on or after that date.

53. (1) Section 31 of the Income Tax Act, 1962 is hereby amended –

(a) by the insertion in subsection (1) of the following definition:

“ <u>**‘financial assistance’** includes –</u>

<u>(a) any loan, advance or debt; or</u>

<u>(b) the provision of any security or guarantee.</u>”.

(b) by the deletion in subsection (1) of the definitions of “goods” and “services”;

…

(e) by the substitution in subsection (3)(a) for the words preceding subparagraph (i) of the following words:

“Where any person who is not a resident (hereinafter referred to as the investor) has granted financial assistance **[contemplated in paragraph (c) of the definition of ‘services’ in subsection (1)]**, whether directly or indirectly, to – “;

(f) by the deletion in subsection (3)(a) of subparagraph (ii);

(g) by the insertion in subsection (3)(a) after subparagraph (ii) of the following subparagraph:

“<u>(iii) a permanent establishment in the Republic of any other person who is not a resident</u>,”;

(h) by the substitution in subsection 93) for the words following subparagraph (iii) of the following words:

“and the Commissioner is, having regard to the circumstances of the case, of the opinion that the value of the aggregate of all such financial assistance **[is excessive in relation to the fixed capital (being share capital, share premium, accumulated profits, whether of a capital nature or not, or any other permanent owners’ capital, other than permanent capital in the form of**

financial assistance as so contemplated) of such connected person or recipient] exceeds the financial assistance which would have been granted had the investor and the connected person or person with a permanent establishment been independent persons dealing at arm's length, any interest, finance charge or other consideration payable for or in relation to or in respect of the financial assistance **[shall]** must, to the extent to which it relates to the amount which is excessive as contemplated in this paragraph, be disallowed as a deduction for the purposes of this Act.";

(i) by the additional in subsection (3) of the following proviso to paragraph (a):

": Provided that where the investor has granted financial assistance to a resident that is a headquarter company, this paragraph will not apply to so much of the financial assistance that is directly applied for the purposes of granting any financial assistance to any foreign company in which that headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 20 per cent of the equity shares and voting rights";

(j) by the substitution in subsection (3) for paragraph (b) of the following paragraph:

"(b) For the purposes of paragraph (a), financial assistance granted indirectly **[shall]** must be deemed to include any financial assistance granted by any third person who is not a connected person in relation to the investor **[,]** or a connected person contemplated in paragraph (a) **[or the recipient]**, where **[such]** that financial assistance has been granted by arrangement, directly or indirectly,, with the investor and on the strength of any financial assistance granted, directly or indirectly, by the investor or any connected person in relation to the investor, to **[such]** that third person."; and

(k) by the insertion in subsection (3) of the following paragraph:

"(c) For the purposes of this subsection, **'connected person'** means a connected person as defined in section 1, provided that the expression 'and no shareholder holds the majority voting rights of such company' in paragraph (d)(v) if that definition must be disregarded."

(2) Paragraphs (a), (b), (c), (d), (e) and (k) of subsection (1) come into operation on the date of promulgation of this Act and apply in respect of years of assessment commencing on or after that date.

(3) Paragraph (i) of subsection (1) comes into operation on 1 January 2011 and applies in respect of years of assessment commencing on or after that date.

(4) Paragraphs (h) and (j) of subsection (1) come into operation on that date on which the Companies Act, 2008 (Act No. 71 of 2008), comes into operation.

(5) Paragraphs (f) and (g) of subsection (1) come into operation on 1 October 2010 and apply in respect of interest, finance charges or other consideration that is received or accrues on or after that date.

65. (1) Section 64C of the Income Tax Act, 1962 is hereby amended –

(c) by the substitution in subsection (2) for paragraph (e) of the following paragraph:

"(e) that amount represents –

(i) additional taxable income or reduced assessed loss of that company **[by virtue of any transaction with the shareholder or a connected person in relation to such a shareholder, the consideration of which is adjusted]** as a result of a determination made by the Commissioner in terms of section 31(2); or

(ii) any amount of interest, finance charge or other consideration that is disallowed as a deduction in accordance with **[the provisions of]** section 31(3);".

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