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# TAX & EXCHANGE CONTROL ALERT

## IN THIS ISSUE

### DOMESTIC TREASURY MANAGEMENT COMPANIES

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### IGNORANCE IS NOT BLISS: A RECENT JUDGMENT ABOUT UNDERSTATEMENT PENALTIES AND A CAUTION TO TAXPAYERS

In the recent matter of *Mr A & XYZ CC v The Commissioner for the South African Revenue Service* (Case Nos IT13725 & VAT1426, IT13727 & VAT1096), which involved four combined cases, the South African Revenue Service (SARS) issued assessments to Mr A and XYZ CC (Taxpayers) relating to income tax for the 2007 to 2012 years of assessment and Value-Added Tax (VAT) for the 2006 to 2013 periods.

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# DOMESTIC TREASURY MANAGEMENT COMPANIES

*The DTMC regime allows South African companies to establish one subsidiary as a holding company to hold African and offshore operations, without being subject to the exchange control restrictions.*

*DTMCs may use their functional currency as a starting point for currency translations for tax purposes, as opposed to rands, providing relief in respect of unrealised foreign currency gains or losses.*

**In 2013, the South African government introduced the domestic treasury management company (DTMC) regime to enable South African companies, which are registered with the Financial Surveillance Department (FSD) of the South African Reserve Bank (SARB), to expand into the rest of Africa and abroad. The DTMC regime allows South African companies to establish one subsidiary as a holding company to hold African and offshore operations, without being subject to exchange control restrictions.**

In order to give effect to the DTMC regime, the following provisions were introduced into the Income Tax Act, No 58 of 1962 (Act):

1. A definition for "domestic treasury management company" was inserted in s1 which came into operation on 27 February 2013 and became applicable in respect of years of assessment commencing on or after that date. This definition provided that a DTMC refers to a company:
   - incorporated or deemed to be incorporated in South Africa;
   - that has its place of effective management in South Africa; and
   - that is not subject to exchange control restrictions by virtue of being registered with the FSD of the SARB;
2. The definition of "local currency" in s24I was broadened to provide that the local currency of any DTMC in respect of an exchange item, not attributable to a permanent establishment outside South Africa, will be the functional currency of that DTMC;
3. The definition of "local currency" in paragraph 43 of the Eighth Schedule to the Act was also broadened to provide that the local currency of any DTMC in respect of amounts which are not attributable to a permanent establishment outside South Africa, will be the functional currency of that DTMC; and
4. Section 25D was amended to provide that where any amount received by, or any amount of expenditure incurred by a DTMC, in any currency other than the functional currency of the DTMC (which is not rand) must be determined in the functional currency of the DTMC and translated to rand using the average exchange rate for that year of assessment.

### Tax implications of qualifying as a DTMC

As a result of the abovementioned additions to the Act, DTMCs enjoy the following tax benefits:

- DTMCs may use their functional currency as a starting point for currency translations for tax purposes, as opposed to rands, providing relief in respect of unrealised foreign currency gains or losses. This dispensation applies to taxable income, monetary items and capital gains items;
- the local currency of any DTMC in respect of an exchange item, not attributable to a permanent

CLIFFE DEKKER HOFMEYR

# DOMESTIC TREASURY MANAGEMENT COMPANIES

CONTINUED

*Interest income derived by the DTMCs is subject to South African income tax.*

establishment outside South Africa, will be the functional currency of that DTMC in terms of s24I. Accordingly, no gains or losses should arise in respect of, *inter alia*, any unit of currency, any amount owing by or to that company in respect of a debt or owing by or to that company in respect of a forward exchange contract denominated in the functional currency of such company; and

- any amount received by or accrued to, or any amount of expenditure incurred by a DTMC in any currency other than the functional currency of that company which is not rand, must be determined in the functional currency of that company and must be translated to rand using the average exchange rate for the year of assessment.

It should be noted that interest income derived by the DTMCs is subject to South African income tax. However, DTMCs would be able to rely on the provisions of double tax agreements to reduce any foreign withholding tax on such interest income.

### Exchange control implications of qualifying as DTMC

DTMCs also enjoy the following exchange control benefits:

- Authorised Dealers (ie certain banks which have been appointed to assist the FSD in administering certain aspects relating to the exchange control policy) may authorise transfers from a listed company to the DTMC up to R3 billion per calendar year (as opposed to R2 billion for unlisted companies). Up to this amount, there will be no restriction on transfers in and out of the DTMC, provided that such transfers are not undertaken to avoid tax;
- the DTMC will be allowed to freely raise and deploy capital offshore, provided that these funds are without recourse to South Africa. Additional domestic capital and guarantees will be allowed to fund bona fide foreign direct investments in the same manner as the current foreign direct investment allowance;

# DOMESTIC TREASURY MANAGEMENT COMPANIES

CONTINUED

*Companies will henceforth find it less cumbersome to manage their African and offshore operations from South Africa.*

- the DTMC will be allowed to operate as a cash management centre for South African entities. Cash pooling will be allowed without any restrictions and local income generated from cash management will be freely transferable; and
- the DTMC may choose its functional currency and operate a foreign currency account and a rand denominated account for operational expenses.

Furthermore, DTMCs are required to adhere to certain reporting requirements.

In order to make the DTMC regime more effective, the Taxation Laws Amendment Act, No 17 of 2017 removed the requirement that a DTMC must be incorporated or deemed to be incorporated in South Africa, with effect from 1 January 2018.

It is evident that companies will henceforth find it less cumbersome to manage their African and offshore operations from South Africa, which will support the growth of South Africa's economy and promote integration across the continent and abroad.

*Gigi Nyanin*

## Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

Mark Linington has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory for 2017.

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# IGNORANCE IS NOT BLISS: A RECENT JUDGMENT ABOUT UNDERSTATEMENT PENALTIES AND A CAUTION TO TAXPAYERS

*SARS abandoned its contention that the matter involved repeat cases and all penalties imposed amounted to 100%.*

*The Taxpayers argued that they were unable to submit their tax returns due to their administrative capacity not being up to standard.*

**In the recent matter of *Mr A & XYZ CC v The Commissioner for the South African Revenue Service* (Case Nos IT13725 & VAT1426, IT13727 & VAT1096), which involved four combined cases, the South African Revenue Service (SARS) issued assessments to Mr A and XYZ CC (Taxpayers) relating to income tax for the 2007 to 2012 years of assessment and Value-Added Tax (VAT) for the 2006 to 2013 periods. The Taxpayers had failed to submit any tax returns for either tax type during these years, which resulted in an audit by SARS into the Taxpayers' affairs.**

Originally, SARS imposed an understatement penalty of 150% on the basis that the Taxpayers' behaviour amounted to 'intentional tax evasion,' but did not constitute a 'repeat case' (in terms of which a penalty of 200% would be imposed). Pursuant to the Taxpayers' appeal and the referral of the income tax dispute for alternative dispute resolution, SARS reclassified the Taxpayers' behaviour as 'gross negligence,' and deemed the failure to submit returns in those years of assessment occurring after 2007 for income tax, to be repeat cases. As such, penalties of 100% were imposed for the 2007 year of assessment and 125% in the case of all subsequent years (the repeat cases). With respect to the VAT aspects of the dispute, a separate objection and appeal process was followed and in SARS's statement of grounds of assessment, it had still argued that penalties of 150% should be imposed in respect of VAT from the 2006 year of assessment, for intentional tax evasion. The Taxpayers appealed against the understatement penalties imposed in respect of VAT and income tax and argued that the worst categorisation of their conduct or behaviour is that they failed to take reasonable care, which in terms of s223 of the Tax Administration Act, No 28 of 2011 (TAA) results in a penalty of 25%.

## Judgment

Ultimately, SARS abandoned its contention that the matter involved repeat cases and accepted that the penalties in each case should be 100%. The court concurred with SARS's decision to abandon its 'repeat case' contention and reasoned that an attempt to secure higher penalties in this manner contravened Rule 31(3) of the Tax Court Rules. This rule provides that "SARS may not include in the statement [of grounds of assessment] a ground that constitutes a novation of the whole of the factual or legal basis of the disputed assessment or which requires the issue of a revised assessment".

The Taxpayers argued that they were unable to submit their tax returns due to their administrative capacity not being up to standard. However, no witnesses were called and no evidence was presented to prove that the Taxpayers lacked the administrative capacity to submit the relevant returns. In this regard, the Tax Court considered s102(2) of the TAA, which states that the burden of proving the facts on which SARS has based an understatement penalty rests on SARS. Despite this provision, the court held that there are some facts (for example, the administrative capacity of a taxpayer) that fall purely within the knowledge of



CLIFFE DEKKER HOFMEYR

# IGNORANCE IS NOT BLISS: A RECENT JUDGMENT ABOUT UNDERSTATEMENT PENALTIES AND A CAUTION TO TAXPAYERS

CONTINUED

*The court held that to default in rendering a return is to omit something, make a false statement or fail to submit the return in its entirety.*

the Taxpayer. Furthermore, it held that SARS had, to the satisfaction of the court, established a *prima* facie case from which the only inference to be drawn was that the tax returns were intentionally withheld. The lack of evidence presented by the Taxpayer contributed to the validity of the argument put forward by SARS, leading the court to conclude that SARS had discharged the burden of proof.

The court went on to say that it in no way accepts that a lack of administrative capacity warrants a failure on the part of the Taxpayers to submit their tax returns.

When SARS classifies a taxpayer's behaviour in terms of the understatement penalty table in s223 of the TAA, the court has a duty to determine whether a taxpayer's conduct was properly classified. In this case, the Taxpayers' behaviour was classified by SARS as grossly negligent. The court referred to the judgment in *MV Stella Tingas: Transnet Limited t/a Portnet v Owners of the MV Stella Tingas and Another* 2003 (2) SA 473 (SCA), where it was held that in order for there to be gross negligence, the conduct in question "must involve a departure from the standard of the reasonable person to such an extent that it may be properly categorised as extreme; it must demonstrate, where there is found to be risk-taking, a complete obtuseness of mind, or where there is no conscious risk-taking, a total failure to take care".

A further consideration in this classification was the successful application by Mr A for tax amnesty in 2006. SARS contended that the amnesty previously granted to Mr. A prohibited the Taxpayers from claiming an "imperfect understanding of their obligations with regard to the rendition of returns," and the court concurred. Based on this, the court concluded that the Taxpayers' behaviour was characterised by a "complete obtuseness of mind" and had therefore been properly classified by SARS as grossly negligent.

In arguing that no understatement penalties should be imposed, the Taxpayers relied heavily on their interpretation of the phrase "default in rendering a return" as found in the definition of the term "understatement" in s221 of the TAA. An "understatement" means any prejudice to SARS or the *fiscus* as a result of, among other things, a default in rendering a return. The Taxpayer contended that the failure to render a return does not equate to a default in rendering a return and as such, there had been no understatement to warrant a penalty.

The court examined the language of, and the intention behind, the definition of understatement and unequivocally stated that there is no merit behind the argument put forward by the Taxpayers. The court held that to default in rendering a return is to omit something, make a false statement or fail to submit the return in its entirety. The court further relied on s95 of the TAA, which empowers SARS to issue assessments based on estimates when (among others) a taxpayer "fails to submit a return as required".

The Taxpayers further relied on the anomalies in the wording of the TAA, specifically the phrase "default in rendering a return" in the definition of "understatement" and the word 'accepted' in s222(3)(a). The court conceded that there are anomalies in the wording of the TAA but applied the approach



CLIFFE DEKKER HOFMEYR

# IGNORANCE IS NOT BLISS: A RECENT JUDGMENT ABOUT UNDERSTATEMENT PENALTIES AND A CAUTION TO TAXPAYERS

CONTINUED

*The court found that the failure to submit a tax return and the consequent failure to pay the tax due implicitly prejudices SARS and the fiscus.*

to interpretation adopted in *Panamo Properties (Pty) Limited and Another v Nel and Others* NNO 2015 (5) SA 63 (SCA). In that case, it was held that a court must consider whether there is a sensible interpretation to the provision that would avoid the application of such anomaly. There are two principles that must be followed in this regard:

- The court must endeavour to give meaning to every word and every section in the statute and not lightly construe any provision as having no practical effect; and
- If the provisions of the statute that appear to conflict with one another are capable of being reconciled then they should be reconciled.

The court held that the conclusion drawn by the Taxpayers that a penalty can only be imposed when there is an understatement in a return, and not when there is no return at all, suggests that the term "default in rendering a return" is without purpose. This is contrary to the principles set out in *Panamo Properties*. The court considered the entirety of Chapter 16 of the TAA and concluded that the phrase "in a return" should be read as "in or in connection with a return," thereby eliminating the anomaly.

Regarding the word "accepted", the Taxpayer averred that the failure to submit a return is the only type of understatement not accepted by SARS. This implies that SARS will accept other forms of understatements, which is not the case. The court held that the word "accepted" in s222(3)(a) means that "[SARS] 'accepts' as correct the apparent position, whether that involves a mis-stated return or the absence of one altogether. Once the understatement is discovered and acted upon, the resultant tax position must be compared to the one which would have [been] obtained if the understatement had not been acted upon".

Regarding the meaning of "prejudice to SARS or the *fiscus*" as found in the definition of "understatement", the Taxpayers firstly contended that the imposition of penalties and the levying of interest extinguishes any prejudice caused by the failure to submit a return. Secondly, the Taxpayers argued that SARS had failed to prove that any prejudice had occurred as a result of the Taxpayers' failure to submit their returns.

The court rejected the first argument as it found it had no merit. A penalty is a punishment, the quantum of which is to be determined by the nature of the wrongful conduct of a taxpayer. The extent of the penalty depends not on the prejudice suffered by SARS or the *fiscus*, but on the level of blameworthiness of a taxpayer's conduct. Therefore, any compensation, even if sufficient to eradicate any prejudice, does not render the wrongful conduct of the Taxpayers lawful. Regarding the second argument, the court found that the failure to submit a tax return and the consequent failure to pay the tax due implicitly prejudices SARS and the *fiscus*. There is prejudice because the failure to pay taxes when they are due prevents the state from having access to money that is necessary to fund state expenditure.



CLIFFE DEKKER HOFMEYR

# IGNORANCE IS NOT BLISS: A RECENT JUDGMENT ABOUT UNDERSTATEMENT PENALTIES AND A CAUTION TO TAXPAYERS

CONTINUED

*A taxpayer who fails to declare their foreign income correctly in their future income tax returns will likely be unable to claim ignorance of his tax disclosure obligations.*

Even in those circumstances where SARS has in its possession funds to be refunded to a taxpayer, there will still be prejudice because SARS is not entitled to the use of such funds. The court went on to say that SARS is prejudiced by the mere application of its resources to audit the affairs of taxpayers and pursue the collection of taxes due to it.

The court ordered that for each year of assessment and each VAT period, an understatement penalty of 100% would be imposed, as opposed to the higher penalties that SARS sought to impose originally. This did not apply to the 2012 income tax year of assessment, in respect of which no understatement penalty would be imposed as the return was not due when the audit was initiated and the late submission of this return, arose as a result of the expanded scope of the audit.

### Comment

Although it appears that the overall outcome of the case was negative for the Taxpayers, one should keep in mind that at the very least, the initial penalties of 150% were reduced to 100% although the Taxpayers' argument that 25% penalties be imposed at worst, was rejected. The understatement penalty for the 2012 income tax year of assessment was also entirely set aside. Furthermore, it could be argued the threshold for gross negligence is very high pursuant to this judgment as it was the failure to submit returns where the Taxpayers knew that they should have submitted returns pursuant to the successful tax amnesty application, that led the court to its conclusion. In other words, one could argue that the mere failure to submit a return does not in and of itself constitute gross negligence in terms of s223 of the TAA. In addition, the Taxpayers did not lead any oral evidence while SARS did lead evidence, which is quite unusual. This is certainly a factor that would have counted against the Taxpayers in this matter.

From a jurisprudential perspective, this case provides helpful guidance regarding the correct interpretation of tax legislation and in particular, the interpretation of the understatement penalties provisions of the TAA, which are relatively new and have not been considered by our courts yet on many occasions.

From a practical perspective, the case also serves as a caution to taxpayers who recently declared their foreign income in terms of the normal voluntary disclosure programme (VDP) or special voluntary disclosure programme (SVDP) and received tax relief pursuant to such applications. Where such relief or amnesty has been granted, a taxpayer who fails to declare their foreign income correctly in their future income tax returns will likely be unable to claim ignorance of his tax disclosure obligations. This case suggests that in these circumstances, (where a taxpayer ought to be aware of all such duties and obligations and fails to comply therewith), it is likely that a penalty of at least 100% will be imposed.

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