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TAX & EXCHANGE CONTROL **ALERT**

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No longer most favoured?

The South African Revenue Service (SARS), together with Government, have taken steps to close this loophole and prevent taxpayers from exploiting the MFN clause.

The international tax community was abuzz on 18 January 2019, when the Dutch Supreme Court passed down the much anticipated Hoge Raad Judgment (17/04584) in favour of the taxpayer.

The Judgment considered the interpretation of the "*most favoured nation*" (MFN) clause in the double taxation agreement between South Africa and the Netherlands, dated 10 October 2005, as amended by the protocol dated 8 July 2008 (Dutch DTA). In finding in favour of the taxpayer, the judgment concluded that to the extent that any other double tax agreement (DTA) entered into by South Africa with any other country provided a more favourable dividends withholding tax rate than the Dutch DTA, that more favourable rate must automatically apply. The judgment in the Cape Town Tax Court case of ITC1925 82 SATC 144 also supported this interpretation from a South African perspective.

Interestingly, the South African Revenue Service (SARS) never appealed the Tax Court judgment, however, SARS together with Government, have taken steps to close this loophole and prevent taxpayers from exploiting the MFN clause. In order to understand the significance of the Judgment and the proposals made by SARS, it is necessary to understand the mechanics of the MFN clause and how SARS has sought to negate this tax optimisation tool.

The MFN clause contained in the Dutch DTA contemplated that the automatic application of a more favourable rate should apply in respect of DTAs concluded *after* the Dutch DTA came into effect. However, the DTA concluded with Sweden on 25 December 1995 (as amended by the protocol on 18 March 2012) (Sweden DTA) contained wording which extended its own MFN clause to *retrospectively* concluded DTAs.

The result was that taxpayers could apply the dividends withholding tax rate of 0% which was available in the DTA concluded between South African and Kuwait on 25 April 2006 (Kuwait DTA). Broadly speaking, if either the Dutch DTA or the Sweden DTA were utilised by a South African resident, then the most favourable dividends withholding tax rate contained in the Kuwait DTA could be applied.

SARS however, took a significant step to effectively close this loophole by entering into a protocol to the Kuwait DTA on 21 April 2021 (Kuwait Protocol). The Kuwait Protocol now imposes a dividend withholding tax of 5% if a shareholder owns at least 10% of the shares in the South African company. It is worth noting that the Kuwait Protocol has still not been ratified and is therefore not yet in effect. However, some of the proposed wording in the Kuwait Protocol has raised concerns.

Article 2(2) of the protocol (which is not accessible via SARS but rather through the Parliamentary Monitoring Group) provides that "*the provisions of the Protocol shall thereupon have effect beginning on the date on which a system of taxation at shareholder level of dividends declared enters into force in South Africa*". This seems to imply that SARS intends for the Kuwait Protocol to apply retrospectively from the introduction of dividends withholding tax in South Africa in 2012. If this is the case, there could be a sharp increase in tax litigation on this issue once the Kuwait Protocol is ratified. Interestingly, the ratification of the Kuwait Protocol by South Africa was due to take place on 1 September 2021, however, there have been additional delays and it remains to be seen when formal ratification in both countries will take place.

Keshen Govindsamy

Binding General Ruling 57: SARS clarifies whether transfer duty is included in the calculation of notional input tax credits claimed on second hand fixed property

It has been the South African Revenue Service's (SARS) practice to exclude the transfer duty incurred by a purchasing vendor from the amount of "*consideration*" when calculating the notional input tax credit.

Where fixed property is purchased by a value-added tax (VAT) vendor from a non-vendor, transfer duty is payable by the purchaser. The purchaser is entitled to a notional input tax deduction if the property is to be applied in the taxable enterprise of the purchaser. The question regarding a vendor's entitlement to an input tax deduction of the costs incurred to acquire the property in these circumstances has resulted in varying levels of uncertainty in recent years.

Prior to 10 January 2012, where a vendor acquired fixed property from a non-vendor (which is regarded as second-hand goods in terms of the Value-Added Tax Act 89 of 1991 (VAT Act)) for the purpose of making taxable supplies, its entitlement to a notional input tax deduction was limited to the transfer duty actually paid in the acquisition of this fixed property. With effect from 10 January 2012, the VAT Act was amended, and this limitation was removed. Since that date, the notional input tax deduction has been treated largely the same as the notional input tax deduction available for second-hand goods. Vendors are therefore now entitled to a notional input tax deduction equal to the tax fraction (15/115) of the lesser of the consideration in money paid by the vendor for the supply of the fixed property purchased, or its open market value.

Although the position regarding a vendor's entitlement to a notional input tax deduction in respect of fixed property acquired from a non-vendor seemed to have been clarified by the amendment to the VAT Act, a second question then arose regarding whether the transfer duty costs associated with the purchase of fixed property from a non-vendor, forms part of the "*consideration*" paid by the vendor for the fixed property for purposes of calculating the notional input tax deduction. To the extent that a vendor is able to include the transfer duty costs, this would result in a higher notional input tax deduction.

It has been the South African Revenue Service's (SARS) practice to exclude the transfer duty incurred by a purchasing vendor from the amount of "*consideration*" when calculating the notional input tax credit. SARS' view was generally widely accepted and applied until it was challenged by a taxpayer in the Cape Town Tax Court. In Case No. VAT 1857, the Tax Court was tasked with determining whether the amount of consideration for purposes of calculating the notional input tax deduction should include the amount of transfer duty paid in respect of the fixed property purchased. The judgment was handed down on 25 February 2020.

In deciding the matter, the Tax Court considered the definition of "*input tax*" and the definition of "consideration" as contained in section 1 of the VAT Act. In applying the principles of interpretation, the Tax Court applied the plain meaning of the words and held that the broad definition of "*consideration*" in section 1 of the VAT Act, which includes **any payment made** in respect of the properties, is unambiguous and held that the clear language used includes transfer duty paid.

Binding General Ruling 57: SARS clarifies whether transfer duty is included in the calculation of notional input tax credits claimed on second hand fixed property...*continued*

Although the Tax Court judgment was seemingly a win for taxpayers, the effect of the taxpayer's withdrawal of opposition of the appeal and abandonment of the judgment, is that the judgment is no longer binding against SARS as it relates to that particular taxpayer.

The Tax Court accordingly found in favour of the taxpayer and concluded that transfer duty must be included in the "*consideration*" paid for fixed property and stated that its conclusion was based on the clear language of the legislation, and that the conclusion was sensible and not unbusiness-like. Furthermore, it held that this conclusion was supported by the purpose of the notional input tax deduction allowed in respect of second-hand goods; the purpose being that it was introduced to eliminate double VAT charges on the same value-added by allowing notional input relief in the absence of actual inputs.

The Tax Court judgment was contrary to SARS' practice and due to this significance, it came as no surprise when SARS filed for leave to appeal, which was granted. Notwithstanding the significance of the Tax Court judgment on the principles of VAT, the taxpayer withdrew from the appeal. A notice of withdrawal of opposition and abandonment of judgment in favour of SARS was therefore issued by the High Court under section 141 of the Tax Administration Act 28 of 2011 (TAA).

It follows that although the Tax Court judgment was seemingly a win for taxpayers, the effect of the taxpayer's withdrawal of opposition of the appeal and abandonment of the judgment, is that the judgment is no longer binding against SARS as it relates to that particular taxpayer. Furthermore, it should be noted that while the judgment itself does not fall away, SARS recently issued Binding General Ruling (VAT) 57 (BGR 57) in which it restates and affirms its view, which is contrary to the judgment handed down by the Tax Court, making it clear that there is no doubt that SARS will challenge any reliance on the Tax Court judgment by other taxpayers going forward.

Binding General Ruling 57

On 20 October 2021, SARS issued BGR 57 in which it clarifies whether the term "*consideration*" includes an amount of transfer duty paid or payable on the acquisition of second-hand fixed property for the purposes of calculating a notional input tax deduction available to vendors who acquire fixed property from non-vendors for taxable purposes.

Notwithstanding the findings of the Tax Court in VAT1857, and in line with its past practice, SARS has ruled that the term "*consideration*" does not include any transfer duty imposed under the Transfer Duty Act. As a result, the amount of transfer duty paid by a vendor to acquire second-hand fixed property for taxable purposes cannot be included in the calculation of any notional input tax deduction which may be available to that vendor under the VAT Act.

SARS' ruling is issued on the basis that the transfer duty paid is not an amount in respect of any "*consideration*" in money paid for the supply of the property. SARS refers to its Interpretation Note 70 which states that "*consideration*" refers to the purchase price that must be paid to the supplier of goods or services by the recipient.

SARS stated that under the provisions of the VAT Act, the payment in money is recognised to the extent that it has the effect of reducing or discharging any obligation relating to the purchase price for the supply during the tax period concerned. It states that transfer duty is a tax levied under the Transfer Duty Act on the "*value*" of the fixed property and is payable by the purchaser to SARS. It is not an amount paid to the seller. Transfer

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A BGR is generally binding on SARS, but not on taxpayers, however, in terms of section 82(3) of the TAA, it may be cited in proceedings before SARS or the courts by either SARS or a taxpayer.

duty therefore does not form part of the purchase price of the property and the payment thereof cannot be regarded as an amount paid which reduces or discharges any obligation of the recipient relating to the purchase price of the property.

Comments

The position taken by SARS in BGR 57 is in line with its previous practice and its arguments put forth in the Tax Court case, in terms of which it viewed the purchase price paid in respect of the sale of immovable property, to be the only "*consideration*" that may be used for the purpose of calculating the notional tax credit, and that the transfer duty paid must not be included for such purposes. On the basis that SARS has now confirmed its view as to whether the term "*consideration*" includes an amount of transfer duty for purposes of calculating the notional input tax deduction, vendors who applied the Tax Court judgment and calculated the notional input tax deduction based on the inclusion of the amount of transfer duty paid, should be aware of the potential risk that SARS may now seek to deny part of the deduction already claimed, as well as to raise penalties and interest in respect of any undeclaration flowing from it.

A binding general ruling such as BGR 57 is issued under section 89 of the TAA. It is initiated by SARS and represents the general view of SARS on matters of general interest or importance and clarifies the SARS' application or interpretation of the tax law relating to these matters. A BGR is generally binding on SARS, but not on taxpayers, however, in terms of section 82(3) of the TAA, it may be cited in proceedings before SARS or the courts by either SARS or a taxpayer.

Notwithstanding that BGR 57 is not binding on taxpayers, it seems that vendors will be required to apply this position until, and if, SARS' view as set out in BGR 57 is ever challenged, and then only if it is found to be incorrect by our courts.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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