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TAX AND EXCHANGE CONTROL ALERT

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SPECIAL VOLUNTARY DISCLOSURE PROGRAMME: IS THE CARROT BIG ENOUGH OR WILL TAXPAYERS RISK FACING THE STICK?

A special voluntary disclosure programme (Special VDP) was announced on 24 February 2016 by the Minister of Finance in the 2016 Budget Speech, which is intended to provide further relief to qualifying persons in addition to the relief provided by the standard voluntary disclosure programme under the Tax Administration Act, No 28 of 2011 (TAA).

WHEN ARE FUNDS USED FOR A 'QUALIFYING PURPOSE'? A RULING REGARDING S8EA IN THE CONTEXT OF A BEE TRANSACTION

On 13 April 2016, the South African Revenue Service (SARS) issued Binding Private Ruling 228 (Ruling), which dealt with s8EA of the Income Tax Act, No 58 of 1962 (Act). Section 8EA is an anti-avoidance provision, which treats the yield on third-party backed shares as income instead of dividends in the hands of the holder.

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In terms of s13(1) of the Revenue Laws Bill, only certain persons who are resident as at 29 February 2016 may apply for relief under the Special VDP.

On 12 April 2016, National Treasury (Treasury) released a media statement in which the public is requested to make formal submissions on draft legislation that sets out the legal framework of the Special VDP.

The relevant draft legislation comprises the following:

- the Rates and Monetary Amounts and Amendment of Revenue Laws Bill (Revenue Laws Bill); and
- the Rates and Monetary Amounts and Amendment of Revenue Laws (Administration) Bill (Revenue Laws Administration Bill).

Revenue Laws Bill

In terms of s13(1) of the Revenue Laws Bill, only certain persons who are resident as at 29 February 2016 may apply for relief under the Special VDP. They are as follows:

- Any natural person, a close corporation or company, holding any foreign asset on 29 February 2016, and where the value of that asset was derived from:
  - an unauthorised asset, being any foreign asset accumulated or transferred in contravention of the Exchange Control Regulations; or
  - any amount that was not declared to the South African Revenue Service (SARS), in contravention of any tax legislation;
- Any natural person, or certain related parties to an applicant holding an unauthorised asset (as mentioned above), who assisted (otherwise than solely in an advisory capacity) such applicant on or before 29 February 2016, in one of two ways:
  - by accumulating foreign assets; or
  - by transferring funds or assets from South Africa for the benefit of that applicant in a manner that contravened the Exchange Control Regulations or any tax legislation, and those foreign assets, funds or assets are no longer held by that person.

In terms of s14 of the Revenue Laws Bill, a donor or beneficiary in relation to a non-resident discretionary trust may also elect that any asset situated outside South Africa and which was held by the trust on 28 February 2015, be deemed to be held by that donor or beneficiary, provided that certain requirements are met.

Section 15 of the Revenue Laws Bill provides that 50% of the total amount used to fund the acquisition of unauthorised assets acquired before 1 March 2010, must be included in the taxable income of the person in the first tax year ending after 1 March 2010. The amount will not be subject to normal tax in an earlier tax year.

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The Special VDP does not apply where any amounts have not been declared or where there was a failure to comply with the requirements of the Income Tax Act.

In terms of s16 of the Revenue Laws Bill, in addition to the relief provided by the standard voluntary disclosure programme, the following amounts will be exempt from normal tax in respect of the Special VDP:

- 50% of the total amount used to fund the acquisition of unauthorised assets if those assets were acquired before 1 March 2015; and
- 100% of any dividends, foreign dividends, interest, rental or other investment income received or accrued before 1 March 2010 in respect of the said unauthorised assets.

The term 'unauthorised assets' is defined in s12 of the Revenue Laws Bill as any foreign asset, which was accumulated as foreign assets or transferred from the Republic in contravention of the Exchange Control Regulations. In this context, a 'foreign asset' is defined as any funds held in a foreign currency and any asset transferred from or accumulated outside South Africa, excluding any foreign bearer instrument.

Section 13(2) of the Revenue Laws Bill states that the Special VDP does not apply where any amounts have not been declared or where there was a failure to comply with the requirements of the Income Tax Act, No 58 of 1962 (Act) in respect of the following taxes:

- employees' tax, in terms of paragraph 2 of the Fourth Schedule to the Act;
- withholding tax on foreign entertainers and sportspersons, in terms of Part IIIA of Chapter II of the Act;
- withholding tax on royalties, in terms of Part IVA of Chapter II of the Act;
- withholding tax on interest, in terms of Part IVB of Chapter II of the Act; and
- dividends tax, in terms of Part VIII of Chapter II of the Act.

Revenue Laws Administration Bill

Section 2(1) of Revenue Laws Administration Bill states that a Special VDP application must be made in terms of the existing provisions in the TAA relating to the standard voluntary disclosure programme. The only additional requirement is that the application must be submitted between 1 October 2016 and 31 March 2017. In terms of s2(2), the application may not be made by or on behalf of a trust or in respect of an amount that has directly or indirectly funded an asset that has been disclosed to SARS under an international tax agreement.

In terms of s3 of the Revenue Laws Amendment Bill, any gross negligence or intentional tax evasion that is disclosed under the Special VDP before notification of an audit or investigation, will enjoy relief in the form of a 0% understatement penalty. Under the existing provisions, gross negligence or intentional tax evasion that is disclosed before notification of an audit or investigation, attracts a 5% and 10% understatement penalty respectively.

Comment

In response to a parliamentary question, the Minister of Finance recently indicated that SARS has collected R6.3 billion under the standard voluntary disclosure programme, since it was launched in 2012. He also indicated that 8,401 taxpayers had made applications under the programme between 2012 and 16 March 2016.

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The standard programme grants successful applicants relief in the form of immunity from criminal prosecution, a significantly reduced understatement penalty and 100% relief in respect of certain administrative non-compliance penalties.

However, there are concerns that in their current form, the Revenue Laws Bill and Revenue Laws Administration Bill do not go far enough to encourage taxpayers to disclose any transgressions relating to foreign assets. Currently, the standard programme grants successful applicants relief in the form of immunity from criminal prosecution, a significantly reduced understatement penalty and 100% relief in respect of certain administrative non-compliance penalties. Although the elimination of all understatement penalties and the fact that certain income received from unauthorised assets prior to 1 March 2010 will be exempt from tax should be lauded, it remains to be seen whether the proposed relief will be a sufficient incentive. For example, it remains to be seen whether taxpayers will make use of the Special VDP where 50% of the amount that was used to obtain the relevant assets will be subject to tax.

Treasury's media statement of 12 April 2016 indicates that written comments must be forwarded to Treasury by 29 April 2016. The media statement also states that the Standing Committee on Finance in Parliament will shortly be having a briefing, and begin the hearing process for both bills.

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Section 8EA is an anti-avoidance provision, which treats the yield on third-party backed shares as income instead of dividends in the hands of the holder.

On 13 April 2016, the South African Revenue Service (SARS) issued Binding Private Ruling 228 (Ruling), which dealt with s8EA of the Income Tax Act, No 58 of 1962 (Act). Section 8EA is an anti-avoidance provision, which treats the yield on third-party backed shares as income instead of dividends in the hands of the holder.

Section 8EA of the Act was introduced in order to strengthen the anti-avoidance rules where share instruments, most often preferred shares, had a number of debt-like features and the dividends in respect of the share issues were guaranteed by unrelated third parties.

The purpose of s8EA of the Act

In terms of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 (Explanatory Memorandum), s8EA of the Act was introduced in order to strengthen the anti-avoidance rules where share instruments, most often preferred shares, had a number of debt-like features and the dividends in respect of the share issues were guaranteed by unrelated third parties. The effect of these third party guarantees was that the holder of the share had no direct or indirect meaningful stake in the risks associated with the issuer. According to the Explanatory Memorandum, s8EA was further amended to provide greater relief for transactions financed in this fashion, especially in the context of black economic empowerment where the shares are issued to finance a substantial acquisition in an operating target company and to cater for a greater variety of transactions. One of the ways in which third parties may avoid the anti-avoidance rule, is if the consideration for the issue of the shares is applied directly or indirectly to acquire equity shares in an operating company.

The mechanics of s8EA

Section 8EA(2) is the charging provision and provides that "any dividend or foreign dividend received by or accrued to a person during any year of assessment in respect of a share must be deemed in relation to that person to be an amount of income received by or accrued to that person if that share constitutes a third-party backed share at any time during that year of assessment".

However, s8EA(3) effectively makes provision for certain exceptions where the funds derived from the issue of a preference share were applied for a "qualifying purpose". In terms of s8EA(1), where the funds derived from the issue of the preference shares are used to directly or indirectly acquire equity shares in an 'operating company', the use of these funds will constitute a 'qualifying purpose'. An 'operating company' is defined as any company that carries on business continuously, and in the course or furtherance of that business provides goods or services for consideration or carries on exploration for natural resources.

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SARS ruled that the use of the funds derived by the Applicant from the issue of the preference shares to subscribe for the ordinary shares in the Project Company will not be regarded as having been applied for a 'qualifying purpose' as defined in s8EA(1).

Ruling

The applicant (Applicant) was a company incorporated in and resident in South Africa, and the co-applicant (Co-Applicant) was a provider of finance.

It was proposed that the Applicant, as a BEE investor, would fund a certain newly estabslished project company (Project Company) by means of loan funding, as well as subscribing for 25% of the ordinary shares in the Project Company.

The Applicant would fund the subscription price of the ordinary shares in the Project Company out of the proceeds of issuing ordinary shares to its holding company and issuing preference shares to the Co-Applicant.

The Co-Applicant would require the Applicant's holding company to provide the Co-Applicant with a guarantee for any amount which the Applicant had contracted to pay to the Co-Applicant, but fails to pay in respect of the preference shares. The Co-Applicant would also require a cession and pledge by the Applicant's holding company of its shares in the Applicant.

However, at the time of the Applicant's investment in the Project Company, the Project Company would not be operating or providing the goods or services that it intends to provide for consideration. The Project Company is expected to be operational only within 18 months from the commencement of the construction of a certain plant.

SARS ruled that the use of the funds derived by the Applicant from the issue of the preference shares to subscribe for the ordinary shares in the Project Company will not be regarded as having been applied for a 'qualifying purpose' as defined in s8EA(1). This is so because the Project Company will not be an 'operating company' as defined at the relevant time. The Ruling seems to be based on the fact that the Project Company will not be considered to be carrying "on business *continuously*" in terms of the definition of 'operating company'.

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