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TAX & EXCHANGE CONTROL **ALERT**

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Pandora Papers: Nowhere to hide? Some considerations for SA residents

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Piercing the corporate veil in tax fraud cases

"Piercing the corporate veil" is a common law remedy used by courts to address the abuse of the separate personality of juristic entities by directors and shareholders, and has become a codified concept under the Companies Act 71 of 2008. In practice, this remedy enables the courts to ignore the separate personality of the company and hold its incorporators, shareholders or directors (collectively referred to as *"Controllers"*) accountable, in their personal capacities, for the manner in which the business is conducted.

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Pandora Papers: Nowhere to hide? Some considerations for SA residents

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Recently, 11,9 million financial records known as the Pandora Papers were leaked, revealing the offshore financial assets of many internationally well-known persons. One of the questions raised pursuant to the leak is whether the investments made by these persons are legal from a tax perspective.

From a South African tax perspective, it provides an opportunity for South African residents who have investments offshore, or who intend to invest offshore in future, to ensure that such investments are made in compliance with all relevant South African tax laws. In this article, we discuss some of the considerations and developments that South Africans must bear in mind.

Common Reporting Standard and exchange of information

One of the most significant changes that has taken place in international tax law in the last few years, is the introduction of the Common Reporting Standard (CRS). In terms of the CRS, the tax authorities of countries that have opted into and implement the CRS, must exchange certain information held by reporting financial institutions operating in their jurisdiction, with the tax authorities of other countries implementing the CRS. Therefore, the South African Revenue Service (SARS) will first collect information from South African institutions that must report information to it under the CRS, and once collected, exchange the information with the relevant foreign tax authorities. As a result, if a South African resident holds an account with a foreign financial institution that is obliged to report information under the CRS to its local tax authority, the information pertaining to that account is likely to come to SARS' attention pursuant to the exchange of information between SARS and the foreign tax authority.

The bottom line is this – South Africans cannot make use of offshore structures to hide the existence of assets. South African residents must also keep in mind that even though South Africa does not have double taxation agreements with certain so-called low tax jurisdictions, it still has agreements providing for the exchange of tax information with many of these jurisdictions. This means that SARS can rely on these agreements, if necessary, to obtain information regarding a South African resident from a specific foreign tax authority.

Developments regarding enforcement of tax laws by SARS

In 2021, the following notable developments occurred:

- In the 2021 Budget, the Minister of Finance announced that SARS would receive additional financial resources to increase its capacity to enforce tax laws and investigate the affairs of so-called high net worth individuals (HNWIs).
- Pursuant to this announcement, SARS' HNWI unit was created and started sending letters to taxpayers who will be classified as HNWIs.
- More recently, SARS and the US Internal Revenue Service (IRS) announced that the IRS' criminal investigation division and SARS' enforcement division would be joining forces to fight tax and economic crimes affecting both countries.

In the 2017/2018 period, the Inter-Agency Working Group on Illicit Financial Flows was created, which comprises SARS and the following agencies:

- South African Reserve Bank;
- Financial Intelligence Centre;
- Hawks Directorate for Priority Crime Investigation;

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What South African residents should therefore bear in mind is that it might be easier for SARS to obtain information regarding their financial affairs than they think.

- National Prosecuting Authority;
- Special Investigating Unit;
- South African Police Force; and
- Financial Sector Conduct Authority.

While the Tax Administration Act 28 of 2011 (TAA) generally prohibits SARS from disclosing certain confidential information regarding a taxpayer with third parties, it does provide for exceptions and specific instances where information can be shared. On the other hand, SARS would be able to obtain information regarding a specific taxpayer from one of the aforementioned agencies, to the extent that these agencies are allowed to share information regarding a specific taxpayer.

What South African residents should therefore bear in mind is that it might be easier for SARS to obtain information regarding their financial affairs than they think.

From information sharing to paying additional tax

While it appears that SARS can obtain information regarding a South African taxpayer's financial affairs or financial status lawfully through different avenues, it is still required to comply with the provisions of the TAA regarding audits before it can assess a taxpayer for additional tax. In other words, the mere sharing of information does not automatically equate to a taxpayer with foreign assets being liable for more tax. In this regard, one should especially note sections 40 and 42 of the TAA.

In terms of section 40 of the TAA, SARS is entitled to audit a taxpayer. It has also been confirmed in *Carte Blanche Marketing CC and Others v Commissioner for the South African Revenue Service* [2020] 4 All SA 434 (GJ), that the decision to audit is not subject to review (see our Tax & Exchange Control Alert of 8 October 2020). In other words, a taxpayer faced with an audit cannot prevent SARS from undertaking that audit. However, if SARS does not conduct the audit in accordance with section 42 of the TAA, this could constitute an infringement of a taxpayer's constitutional right to fair administrative action. If so, it could result in the additional assessment issued pursuant to such a flawed audit process being set aside (see our Tax & Exchange Control Alert of 4 May 2018).

Conclusion: Principles for prevention of tax pain

The saying goes that "*prevention is better than cure*". In the context of investing offshore and preventing non-compliance with South African tax laws, the same principle applies. Some of the important aspects to consider when investing offshore or into an offshore structure, are the following:

- **Setting up or investing into the offshore structure:** Where a South African resident intends to set up an offshore structure, all relevant tax considerations should be considered. Where one is investing into an offshore trust structure, one would initially need to advance a loan to the trust or make a donation. Where a donation is used to fund the trust, donations tax will be payable. Where a loan is advanced to the trust, one must ensure that the terms of the loan are compliant with sections 31 and 7C of the Income Tax Act 58 of 1962 (ITA). SARS Interpretation Note 114 (IN114), which provides examples of how these sections can interact, should also be considered. Although IN114 is not binding, it provides some insight as to how SARS might apply sections 7C and 31 in a certain set of circumstances.

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If one is dealing with a direct investment into an offshore company, one would need to consider whether section 31 of the ITA has been complied with in purchasing shares or subscribing for shares in that company.

If one is dealing with a direct investment into an offshore company, one would need to consider whether section 31 of the ITA has been complied with in purchasing shares or subscribing for shares in that company. Where a loan is advanced to that foreign company, that loan must also comply with the transfer pricing provisions in section 31. Aside from the tax considerations, one must also comply with any exchange control rules applicable to the investment into the offshore structure.

- **Annual payment of tax:** Depending on how the investment into the offshore structure was funded, some tax will likely be payable to SARS on an annual basis. Where a loan is advanced, the interest income will be subject to tax. Furthermore, a taxpayer must appreciate whether the attribution rules apply to the income, capital gains or dividends derived by the offshore structure. The attribution rules could apply even if the offshore trust has not vested any amounts in a South African beneficiary. Where one holds shares directly in a foreign company, one must consider whether the controlled foreign company rules apply to tax the amounts derived by the foreign company.
- **Keeping records is key:** The TAA requires that a South African resident must keep records for at least five years after the submission of a tax return. If SARS institutes an audit or verification process in respect of a specific period, the provision of documentary proof is key to avoid having to pay additional tax. If the records are relevant to an audit or investigation under Chapter 5 of the TAA that the taxpayer is aware of or a person lodges an objection or appeal under section 104(2) of the TAA, the person must retain the relevant records until the audit or investigation has been concluded, or the assessment or decision become final, despite the aforementioned 5-year requirement.

Louis Botha

Piercing the corporate veil in tax fraud cases

Given SARS' stance on holding Controllers accountable, individuals, especially entrepreneurs, must be aware of the repercussions they could face if they and their businesses become involved in schemes to defraud SARS.

"*Piercing the corporate veil*" is a common law remedy used by courts to address the abuse of the separate personality of juristic entities by directors and shareholders, and has become a codified concept under the Companies Act 71 of 2008. In practice, this remedy enables the courts to ignore the separate personality of the company and hold its incorporators, shareholders or directors (collectively referred to as "*Controllers*") accountable, in their personal capacities, for the manner in which the business is conducted.

Since entities have their own separate personality distinct from their Controllers and are obliged to pay taxes in South Africa (and outside South Africa), it is quite rare for entrepreneurs or directors to be required to personally cover the taxes due by these entities. Moreover, the Controllers are rarely subjected to criminal prosecution in respect of tax matters involving these entities. However, there have recently been various instances in which directors or entrepreneurs were held to account for taxes due by the entities in which they either serve as directors or hold an interest, with the more apparent reason for personal liability being fraud.

On 6 October 2021, the South African Revenue Service (SARS) published a statement in terms of which the Commissioner for SARS, Mr Edward Kieswetter, expressed great concern about crimes associated with tax, in particular, where juristic entities are used to defraud SARS whilst the individuals in control of these entities essentially hide behind the corporate veil.

Given SARS' stance on holding Controllers accountable, individuals, especially entrepreneurs, must be aware of the repercussions they could face if they and their businesses become involved in schemes to defraud SARS. SARS, the judiciary and the National Prosecuting Authority have not taken this lightly. A recent example is the decision of the Bloemfontein Regional Court to sentence a businessman running a close corporation, Mr MJ Ntabe, to imprisonment for providing SARS with false supporting documents to substantiate incorrect calculations for value-added tax (VAT). It is reported that the SARS audit department raised additional assessments, which resulted in a total loss of R1 million to SARS. Similarly, during August 2021, the Bloemfontein Regional Court sentenced a director of a catering and accommodation company to imprisonment for submitting nil VAT returns to SARS while the business was actively trading. The imprisonment sentence was wholly suspended on condition that the accused reimburse SARS the tax due by a certain date. In addition, the company itself was subject to a suspended fine as a result of the fraudulent activity.

Piercing the corporate veil in tax fraud cases*...continued*

Entrepreneurs, and taxpayers in general, must strive to always have their tax affairs in order and seek professional assistance when uncertain, as they will face greater hardship should they engage in fraudulent activities.

In light of the COVID-19 pandemic and challenges faced by many taxpaying entities and individuals, in a statement published on 19 August 2021, the Commissioner for SARS reiterated the efforts Government has undertaken to provide affected businesses and individuals with tax relief measures to alleviate hardship in the current economic climate. Considering these efforts, it is difficult to ascertain the reasons behind these fraudulent schemes, especially as the Commissioner for SARS had previously stated that companies and their directors would face criminal prosecution in respect of their transgression of the law and defrauding the fiscus of revenue that was due to the Government.

Comment

Entrepreneurs, and taxpayers in general, must strive to always have their tax affairs in order and seek professional assistance when uncertain, as they will face greater hardship should they engage in fraudulent activities. It is clear that although the concerned entity is in fact "*the taxpayer*" who is liable to SARS for any taxes due, the authorities are not afraid to look behind the corporate veil and hold the Controllers accountable.

Ursula Diale-Ali, overseen by Louis Botha

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