16 February 2023

Tax & Exchange Control ALERT

CLIFFE DEKKER HOFMEYR

INCORPORATING
KIETI LAW LLP, KENYA

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KENYA

The paradox of public participation in tax legislation

On 31 January 2023, the High Courts in Nairobi and Kitale rendered judgments on petitions challenging the constitutionality of the Finance Act 2021 and the Finance Act 2022 (the Acts) respectively.

In both petitions, among other pertinent issues raised was the issue of whether public participation was conducted before the passing of the Acts considering that amendments were made to the bills when they were tabled in Parliament. Accordingly, the amendments were not the subject of discussion during the initial public consultations. The courts took divergent views on the place of public participation in amendments introduced on the floor of the house.

When a proposed bill is first introduced in Parliament, it is assigned to a committee that is tasked with facilitating public participation. Appropriate consultation involves discussions with relevant experts in the field of the proposed bill and ensures that people likely to be affected by the proposed statutory instrument have enough opportunity to comment on its content. In cases where consultations are not undertaken, the committee is required to give reasons.

Thereafter, the proposed bill, together with the comments, is presented before Parliament. New amendments can be introduced if the amendments are in line with the original intent of the bill. However, amendments dealing with a different subject or that unreasonably or unduly expand the subject of the bill or are inconsistent are excluded.

Opposition petition

With respect to the Finance Act 2021, the petitioners opposed the introduction of new amendments in the Finance Bill for being unconstitutional. The petitioners stated that while public participation was held regarding the Finance Bill 2021, there was no information given as to the basis for introducing other tax amendments while in Parliament. The contested amendments were not subjected to consultation and thus did not emanate from the public.

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Mark Linington ranked by **CHAMBERS GLOBAL 2017 - 2022** in Band 1: Tax: Consultants.

Ludwig Smith ranked by **CHAMBERS GLOBAL 2017 - 2022** in Band 3: Tax.

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KENYA

The paradox of public participation in tax legislation

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The court held that the contested amendments were constitutionally frail because they offended the principles of public participation and consequently violated the right to fair administrative action and the principles of public finance.

Further, the court noted that public participation in policy formation dictates that those most likely to be affected by a policy must have a bigger say in that policy and their views must be deliberately sought and considered. Moreover, given the robust representations that the various stakeholders had made on the proposed taxes in the Finance Bill 2021, the subsequent amendments were not minor but were substantive amendments that required public engagement.

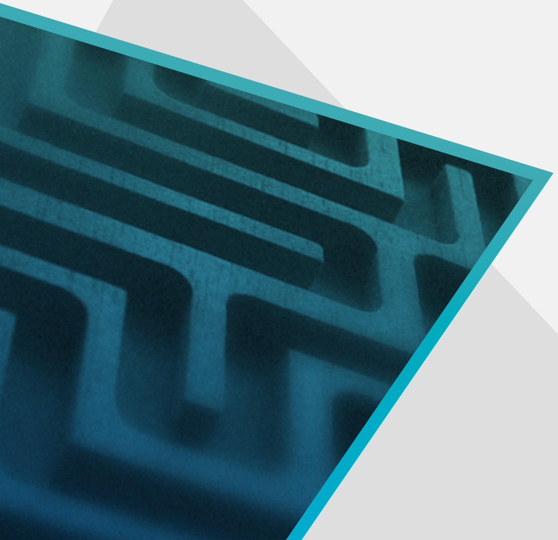
In the same breath, in the High Court in Nairobi, one of the petitioners contested the constitutionality of the Finance Act of 2022 as it contained amendments on new issues that were not part of the Finance Bill 2022 and hence not subjected to public participation.

The petitioners argued that given the consequences of the new amendments on stakeholders, the respondents had a constitutional obligation to procure the views of the public on the amendments before passing the Finance Act 2022.

In this case, while propounding the perimeters of public participation concerning amendments made by parliamentarians, the court took a broad view, holding that the amendments were in line with the original intent of the purpose and object of the bill, which was to amend tax laws. The purpose and objects of a bill are usually set out in the memorandum of the bill.

The court was guided by the parliamentary standing orders, which empower members of the assembly to make additional amendments to bills without consulting the public, through the proper procedure, which entails a reading of the amendment three times.

Furthermore, the court held that it would derail the legislative process and undermine Parliament's ability to discharge its mandate if it was required to adjourn proceedings every time a member proposed an amendment to a bill so that further public participation can be carried out.



KENYA

The paradox of public participation in tax legislation

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Principles of public participation

There is no substantive law that provides for how public participation should be carried out. The question of how and when public participation should be carried out has been left open to the interpretation of the court. The proposed Public Participation Bill 2019 attempted to provide a framework for effective public participation. The bill was, however, not passed into law.

The Supreme Court has also previously emphasised the principle of public participation, noting that it is through public participation that Kenyans find their sovereign place in the governance they have delegated to both the National and County Governments. In *British American Tobacco Kenya, PLC v Cabinet Secretary for the Ministry of Health and Five Others* [2019] eKLR, the Supreme Court laid down the guiding principles of public participation.

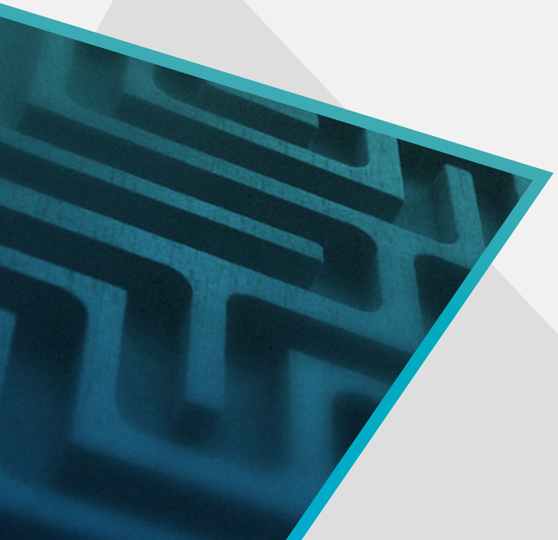
Public participation should be real not illusory, it must be purposeful and meaningful, it must be accompanied by reasonable notice and opportunity, it must be inclusive and transparent and the public must first be sensitized on the subject matter.

Conclusion

Balancing rights is a nuanced process, and Kenyan judges have a significant role in interpreting and applying the law in a way that strikes a balance between fundamental rights and the greater good. On one hand, the public must be involved in the law-making process, especially when the greater burden is to be borne by them. On the other hand, parliamentarians as representatives of the people can propose changes in bills on the behalf of people.

Although there is no prescribed legal framework for public participation in amendments, public participation must be real and not an act of public relations. Amendments that have a potentially long-lasting impact on the public must be subjected to consultations in order to achieve the qualitative component of public participation. Otherwise, disclaiming the need for public involvement under the pretext that the amendments are envisioned under the scope of the bill may open the legislative process to mischief which will lead lack of public trust and involvement in law-making.

Alex Kanyi and Ndinda Munyaka



SOUTH AFRICA

Are you *"affected"* by the release of SARS' Interpretation Note 127?

How a taxpayer is financed is an important consideration when calculating their taxable income.

A taxpayer that is financed through debt may, subject to certain conditions, exceptions and restrictions, become entitled to deduct interest payments that are incurred in the production of income. In contrast, a taxpayer that is financed through equity will not become entitled to deduct any dividends or returns on capital.

The South African Revenue Service (SARS), therefore, has a vested interest in ensuring that the South African tax base is not depleted by taxpayers with excessive intra-group, back-to-back or intra-group guaranteed debt which may result in excessive interest deductions. This is in line with the various ongoing Base Erosion Profit Shifting initiatives being implemented at a global level.

In this context, South Africa introduced thin capitalisation rules in 1995. Thin capitalisation refers to a taxpayer that has too much debt when considered against the amount of its equity. SARS' guidance on what constituted excessive international financial assistance was first documented in Practice Note 2, dated 14 May 1996 (PN 2). PN 2 was withdrawn on 5 August 2019 with effect from years of assessment commencing on or after 1 April 2012. This coincided with the substitution of the transfer pricing provisions in section 31 of the Income Tax Act 58 of 1962 (Act) resulting in thin capitalisation no longer being governed by a separate subsection of 31, but instead the general transfer pricing provisions.

Another interpretive tool that provides guidance insofar as section 31 of the Act is concerned is SARS' Practice Note 7, dated 6 August 1999 (PN 7). PN 7 sets out the guidelines and procedures to be followed in the determination of arm's length prices in respect of various cross-border transactions (as opposed to only loan funding), taking into account the South African business environment.

SOUTH AFRICA

Are you *"affected"* by the release of SARS' Interpretation Note 127?

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More recently, and in response to the updated transfer pricing guidelines issued by the Organisation for Economic Co-operation and Development (OECD), SARS issued a draft interpretation note that provides guidance on the application of the arm's length principle when pricing intra-group loans as contemplated in section 31 of the Act. After a round of public consultations, the draft interpretation note was finalised and published on 17 January 2023 as Interpretation Note 127 (IN 127).

In addition to providing guidance on the application of the arm's length principle within an intra-group context, IN 127 also sets out the consequences for taxpayers if an intra-group loan is incorrectly priced after applying the arm's length principle. Given the importance of this complex area of tax law, this article highlights and discusses some of the key guidelines and outcomes of IN 127.

The arm's length principle

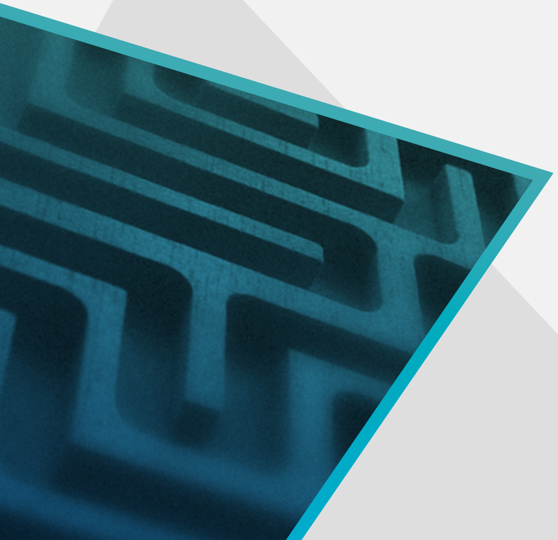
Section 31 of the Act targets *"affected transactions"*. An *"affected transaction"* is defined as, amongst other things, a transaction entered into between connected or associated persons where at least one party is either a South African tax resident or a non-resident with a permanent establishment in South Africa (whereas the other party is a non-resident), and the terms and conditions of the transaction are different from those that would have been agreed upon between persons acting at arm's length (i.e independent parties).

In terms of the OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations, dated 20 January 2022 (OECD Guidelines) (which SARS partially relies on as guidance on the application of and adherence to the arm's length principle), the application of the arm's length principle is based on a comparison of the conditions of the tested transaction with the conditions that would have existed had the parties been independent and undertaking a comparable transaction under comparable circumstances.

In the context of a loan, IN 127 establishes that SARS will consider a transaction to be non-arm's length if, amongst other factors, some or all of the following circumstances exist:

- the taxpayer is thinly capitalised;
- the duration of the lending is greater than would be the case at arm's length; or
- the repayment terms, interest rate or other terms are not what would have been entered into or agreed to between independent parties.

Therefore, when applying the arm's length principle, IN 127 states that the conditions and economically relevant circumstances of a transaction must be compared with the conditions and economically relevant circumstances of a comparable transaction between independent parties. In order to do this, one needs to conduct functional and comparative analyses.



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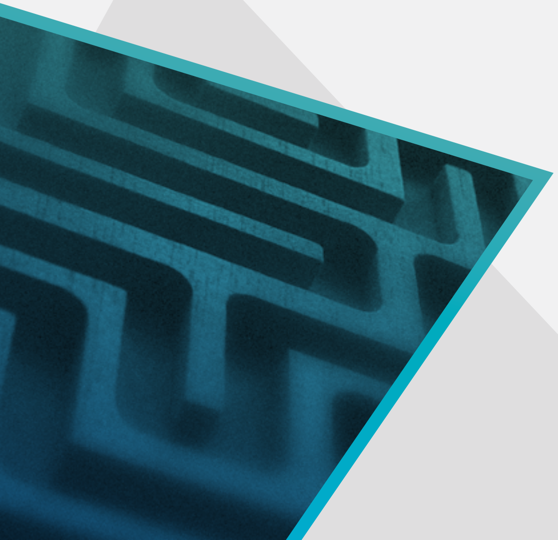

Functional analysis

IN 127 refers to various conditions and economic factors as being relevant for consideration when identifying the commercial and financial relations of the parties. We outline these below.

- The contractual terms of the loan. This requires a consideration of the terms of the written agreement between the parties. In some instances, it may require that one also look at other documents (i.e. term sheets or other negotiation documents) as well as the conduct of the parties to ensure that the contractual form and actual conduct are aligned.
- The functions performed, assets used and risks assumed by the parties. For example, a lender's decision as to the terms of the loan would be informed by an analysis and evaluation of the risks inherent in the loan, the capability to commit capital of the business to the investment, determining the terms of the loan, and organising and documenting the loan.
- Features and attributes of the transaction. For example, in the case of a loan, those characteristics may include, but are not limited to, the amount of the loan, its maturity date, the schedule of repayment and the nature or purpose of the loan (for example, trade credit, merger, acquisition, mortgage).
- Economic circumstances, which will include a consideration of the currency, geographic locations of the parties, local regulations, the business sector of the borrower and the timing of the transaction.
- Business strategies of the parties. For example, independent lenders may be prepared to lend on terms and conditions to an enterprise undertaking a merger or acquisition that might otherwise not be acceptable to the lender for the same business if it were in a steady state.

The conditions and economically relevant characteristics mentioned above must be applied against the backdrop of both the lender's and borrower's perspectives when comparing transactions.

From the borrower's perspective this will include a consideration of the borrower's ability to service the debt, and the risks related to the borrower's acceptance and use of the funds.

From the lender's perspective, this will include a consideration of, amongst other things, the risks that the debt arrangement carries for the lender. In this context, IN 127 highlights the use of credit ratings as the creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge and the amount of the debt. Credit ratings can serve as a useful measure of creditworthiness and therefore help to identify potential comparables or to apply economic models in the context of relevant party transactions.

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Are you *"affected"* by the release of SARS' Interpretation Note 127?

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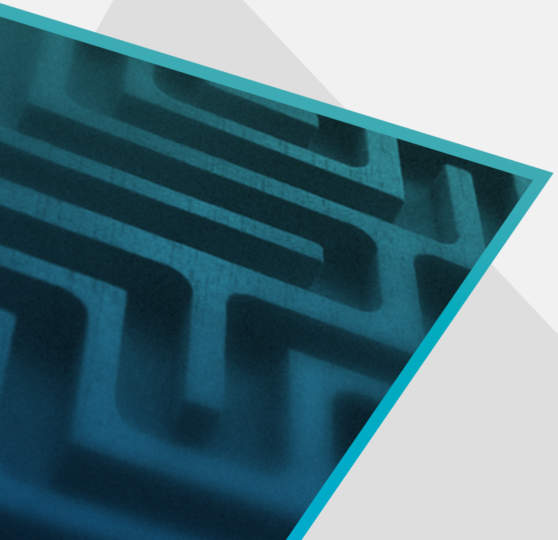

Comparative analysis: Intra-group loan pricing

IN 127 also sets out the approaches that can be followed in conducting the comparative analysis (i.e. benchmarking/pricing an intra-group loan) which we discuss below.

- The comparable uncontrolled price (CUP) method. This involves benchmarking the tested loan against publicly available information that reflects independent parties acting in a similar manner and under similar conditions as the tested loan. IN 127 also mentions the possibility of testing the loan against internal CUPs.
- Loan fees and charges approach. Where loan fees and charges are imposed in terms of a loan (such as arrangement fees), they should be evaluated in the same way as any other intra-group transaction.
- The cost of funds approach. In the absence of comparable uncontrolled transactions, IN 127 suggests that this could be used as an alternative to price loans in some circumstances. The cost of funds will reflect the borrowing costs incurred by the lender in raising the funds to lend.
- The credit default swaps approach. Credit default swaps reflect the credit risk linked to an underlying financial asset. This approach can, therefore, be used where there is a lack of availability of information regarding the underlying asset, that could be used as a comparable transaction. In terms of this approach, taxpayers and tax administrations are allowed to use the spreads of credit default swaps to calculate the risk premium associated with intra-group loans.
- Economic modelling approach. Certain industries rely on economic models to price intra-group loans by constructing an interest rate as a proxy to an arm's length interest rate.
- Bank opinions approach. In some circumstances taxpayers may seek to evidence the arm's length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a 'bankability' opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise.

Timing the arm's length test

Another important aspect that is considered in IN 127 is timing – i.e. when should the arm's length principle be applied to an affected transaction.

SOUTH AFRICA

Are you *"affected"* by the release of SARS' Interpretation Note 127?

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Section 31 of the Act requires a taxpayer to consider whether, at the time of concluding the relevant affected transaction, the amount of the loan or the rate of interest charged are arm's length. However, this section also requires taxpayers to continuously reassess whether a loan amount or rate of interest charged continues to be arm's length throughout that loan's subsistence.

This is confirmed in IN 127, which notes that the frequency and timing of reassessment will depend on the nature of the particular taxpayer's business and the amount of change and variability it experiences. Practically, IN 127 suggests that annual testing is sufficient. It also sets out the documentary requirements which are not insignificant.

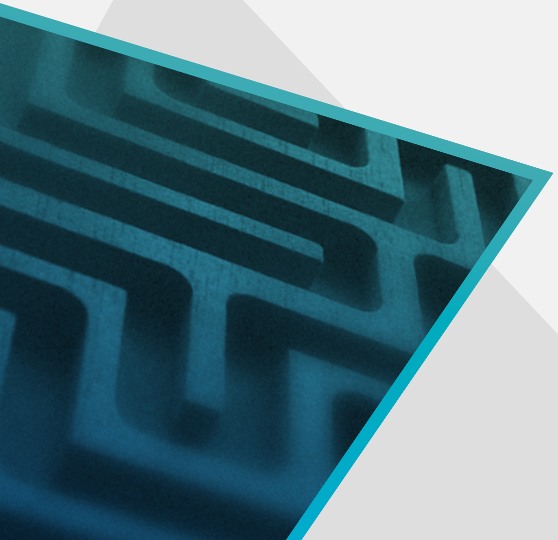
Effect of being *"affected"*

Section 31(2) of the Act provides that where an affected transaction results in a tax benefit, the taxable income of the person who derives the tax benefit must be determined as if that transaction had been entered into on the terms and conditions that would have existed between independent persons dealing at arm's length. For example, in the context of a loan where SARS deems the interest rate charged between connected persons to be higher than would be agreed between person's acting at arm's length, a portion of the interest paid will be disallowed as a deduction by the debtor taxpayer. This is known as the primary adjustment.

In addition, section 31(3) of the Act provides that to the extent that section 31(2) of the Act causes a difference in any amount applied in the calculation of a taxpayer's taxable income, that difference is subject to a secondary adjustment. This secondary adjustment takes the form of either a deemed donation, where the taxpayer is a person other than a company, or a dividend *in specie*, where the taxpayer is a company.

Section 31 of the Act finds application where, for example, a foreign company lends money to its wholly owned subsidiary in South African pursuant to a loan agreement, and the terms of the loan are such that independent parties, operating at arm's length, would not have agreed to such terms and conditions. These could be anything from the amount of the loan, the duration of the loan, the rate of interest charged, the lack of security and/or covenants, subordination, etc.

In terms of section 31(2), the subsidiary will be required to calculate its taxable income as if the loan agreement was entered into between independent parties dealing at arm's length (primary adjustment). Further, any difference calculated from the application of section 31(2) which results in a tax benefit for the subsidiary (such as incurring a greater amount of tax deductible interest) will be deemed to be a dividend *in specie* in that resident company's hands.



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Are you *"affected"* by the release of SARS' Interpretation Note 127?

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In IN 127, SARS clarifies that, in its view, the deemed dividend *in specie* in this instance does not confer an actual benefit on the South African resident company. Rather it is an amount calculated purely for tax purposes. As such, SARS argues that no "*beneficial owner*", which is defined as the person entitled to the benefit of a divided in section 64D of the Act, exists. Therefore, SARS concludes that any South African resident company that receives a deemed dividend *in specie* under section 31(3) of the Act will not be entitled to the dividends tax exemption under section 64FA of the Act.

It is interesting to note that IN 127 does not deal with the position prior to the enactment of the Taxation Laws Amendment Act 33 of 2019 (2019 TLA). The 2019 TLA introduced specific amendments to address certain deficiencies in the law relating to the imposition of dividends tax on section 31(3) deemed dividends *in specie*. It is also interesting to note that IN 127 does not address the application of double tax treaties to secondary transfer pricing adjustments. Some double tax treaties, such as South Africa's treaty with the US, specifically mention that double tax treaty relief should be afforded to secondary transfer pricing adjustments such as section 31(3) deemed dividends *in specie*.

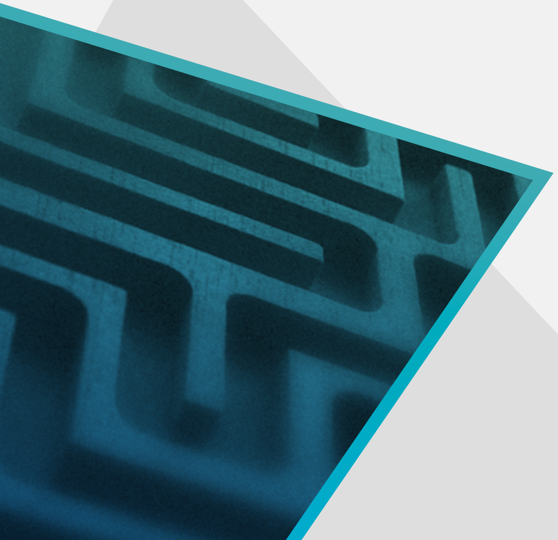
Tools of interpretation

IN 127, and interpretation notes generally, are not binding legislation. Rather, they provide insight into how SARS will interpret and apply the Act when carrying out its functions (collecting tax). Therefore, at most, they can be considered an indication of a practice generally prevailing (albeit by SARS).

Despite this, IN 127 reflects many of the principles set out by the OECD insofar as intra-group transactions are concerned. In this regard, in *ITC 1943* 83 SATC 429, the South African tax court noted that it cannot be denied that the OECD Guidelines on Transfer Pricing are a world standard in transfer pricing matters and that countries should align themselves with the OECD Guidelines where appropriate.

Therefore, taxpayers should note the importance and impact of IN 127 on their intra-group funding and the guidance provided therein, especially considering how sparse transfer pricing cases are in South Africa.

Jerome Brink, Puleng Mothabeng and Nicholas Carroll



SOUTH AFRICA

Incorrect form, irrelevant substance: A discussion on the case of *Applicant X v The Commissioner for SARS*

Policies and procedures are often put in place for a variety of reasons, but an overarching reason includes the desire to streamline even the most chaotic of events. Procedure allows for predictability, flow and, more importantly, appeasement of the courts by one's good form.

When that procedure is blatantly disregarded, one risks walking away with a bigger burden than what was originally at stake. Such was the case in the matter of *Applicant X v The Commissioner for the South African Revenue Service* 2022/12 (ADM) [2022] JHB (21 December 2022) which involved a dispute over an amount claimed by the applicant for certain home office expenses. Derogation of court procedure found the applicant walking away with a bit more than she could chew.

Facts

During the compilation of her 2021 tax return, the applicant had made a claim for home office expenditure in the sum of R137,118. The South African Revenue Service (SARS) had issued her with an original assessment on the same day of her filing her return, and later an additional assessment which reconsidered the original assessment issued. Dissatisfied with this, the applicant filed a notice of objection on 16 September 2021, insisting that she had incurred home office expenditure in the sum of R100,501 and disputing the additional assessment raised by SARS. She filed another objection on 26 October 2021 after SARS had failed to respond to her earlier objection. (Note: The judgment elsewhere makes reference to to the lodging of an appeal on 26 November 2021 and to SARS invalidating the initial objection on 18 January 2021. However, the court's finding is does not turn on these facts and whether the dates are correct.)

When she had not received a response from SARS, the applicant sought a default judgment order arguing that because SARS had failed to respond timeously to the notice delivered in terms of Rule 56 of the Tax Court Rules (Rules), the original assessment ought to be reinstated.

SOUTH AFRICA

Incorrect form, irrelevant substance: A discussion on the case of *Applicant X v The Commissioner for SARS*

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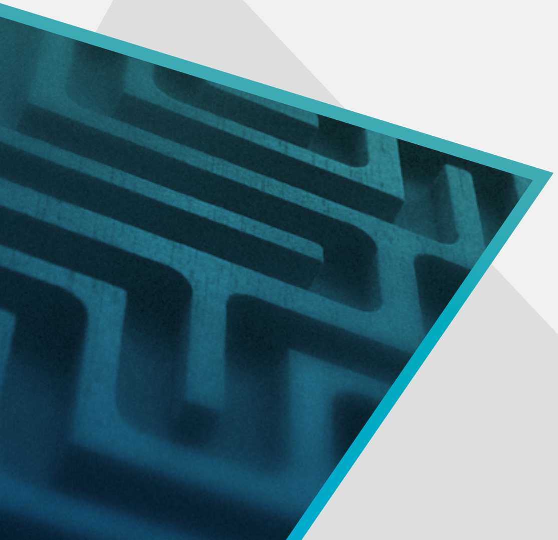

SARS, on the other hand, believed the matter was not brought before the court in the proper manner. The applicant had brought her notice in terms of Rule 56 where SARS was of the opinion that it ought to have been brought under Rule 52(1)(b) of the Rules. SARS further argued that the applicant did not comply with Rule 56, specifically as a notice indicating the applicant's intention to apply for default judgment within 15 business days if SARS does not remedy the default within that period, was not delivered to SARS (Rule 56(1)(a)). It also alleges that Rule 56(1)(b) was not complied with.

Judgment

Notwithstanding the issues of merit, it was clear to the court that the question of procedure ought first to be resolved. The key question being: Was the application properly delivered in terms of Rule 56(1)(a) and 56(1)(b)?

The court considered Rule 50 of Part F of the Rules to understand what constitutes "*delivery*". It provides that when determining the address to which applications on notice ought to be delivered, one should refer to the address as stipulated under Rule 2. Rule 2 goes on to state that the address for delivery may include an address that:

- the taxpayer or appellant must use or has selected under these rules;
- SARS has specificied under these rules or, in any other case, the Commissioner has specified by public notice as the address at which the documents must be delivered to SARS; or
- is determined under Rule 3 as the address of the clerk or the Registrar.

Within the context of this case, the address as stipulated by the Commissioner in a public notice was key. The public notice in question would be *Government Gazette No. 38666* dated 31 March 2015 which indicates the physical and email address to which delivery of any document, notice or dispute request may be addressed.

It was quickly apparent that the applicant did not in fact deliver the notices in terms of Rule 56(1)(a) and 56(1)(b) to the SARS Tax Court Litigation Unit, as required by the Rules. The applicant, delivered the notices to an email address of the Registrar of the Tax Court only and not to the Tax Court Litigation Unit. For this reason, the court found it unnecessary to go into the merits of the case as the application for default judgment stood to fail at that point.

SOUTH AFRICA

Incorrect form, irrelevant substance: A discussion on the case of *Applicant X v The Commissioner for SARS*

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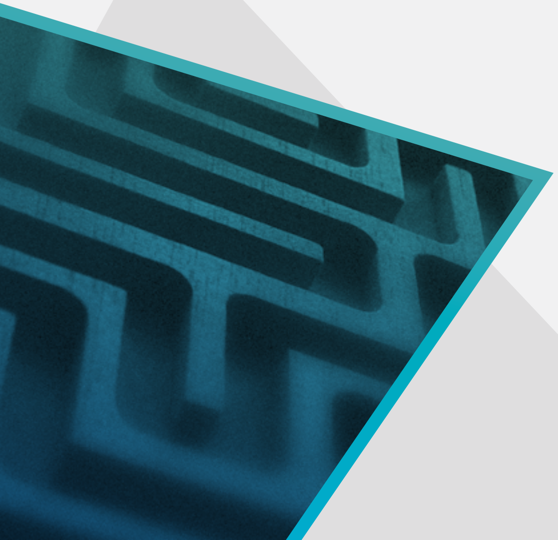

Costs

The court granted SARS' request for costs against the applicant on an attorney and client scale. While the court was aware that the imposition of costs on such a scale is limited to circumstances where the conduct of a party is quite clearly vexatious and reprehensible, the behaviour of the applicant was found to be exactly so. The court believed that the applicant's application was vexatious and imposed a financial burden on SARS to oppose it. Thus, the court awarded costs on a punitive scale.

Comment

This case is a testament that hours of preparation into a performance can easily be rendered meaningless if not presented on the correct stage. It is an age-old reminder that while the merits of the case are exceptionally important, failure to follow the correct procedure can be the difference between you walking away with a win or a loss and then some. One can appreciate that the taxpayer in this case may have been desperate to obtain a positive outcome and avoid paying additional tax, given that the dispute arose during the COVID-19 lockdown, which took a financial toll on many. However, the case is a reminder that taxpayers should obtain proper advice when pursuing tax disputes against SARS, to ensure that simple procedural errors are not a stumbling block to achieving success. This is even more important in cases such as this, where it appears that the amount in dispute was a deduction of approximately R100,000, whereas the legal costs incurred (including the cost order) would likely exceed this.

Esther Ooko (overseen by
Louis Botha)

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