

## HOW ROBUST IS YOUR STRUCTURED FINANCE TRANSACTION?

### THE AUDIT PART

#### 1.1 SARS Query

The initial letter from SARS will usually request from the taxpayer a list of documentation and/or information.

Whenever SARS requires a taxpayer to furnish documentation and/or information, SARS must state the administrative purpose for which it is sought.

All information provided must be of a factual nature and SARS is not entitled to information that extends to the realm of ideas, opinions or judgments.

An example of a query dealing with a Convertible Loan Structure would typically include the following (Please note this list is not exhaustive and only the salient items have been extracted):

*Kindly furnish by [x date] a detailed reply to the following observations or enquiries arising out of an examination of the annual financial statements of your company. Please be advised that the information is requested in terms of Section 74A of the Income Tax Act.*

- *Factual diagrammatical flowchart highlighting all transaction and cash flows and the respective dates and the names of the parties involved.*
- *Bank statements reflecting the cash flows.*
- *Loan applications and all related correspondence.*
- *Information furnished on requesting approval of the loan facility as well as information furnished on review of the facility.*

- *All agreements, addendums, amended agreements, side letters or verbal understandings and supporting documentation. Copy of the complete synopsis or presentation regarding the structure.*
- *Name of entity marketing the structure as well as marketing person.*
- *The accounting and tax treatments including journals as well as the cash flows for all transactions already accounted for and for the transactions to be accounted for in future.*
- *Discuss the extent to which the company complied or did not comply with AC 125 Financial Instruments: Disclosure and Presentation.*
- *Reasons as to the purpose for entering into these financial agreements.*
- *All opinions obtained from lawyers, auditors or any other party relating to this transaction. If you are of the view that these opinions are subject to legal privilege, kindly support your view with detailed reasons.*
- *Copies of correspondence by the auditors with the relevant bank.*
- *Detailed opinions why you are of the view that you are entitled to the deduction.*
- *Detailed valuation report with regard to the share value of the forward purchase of shares plus working papers including a discussion of the valuation methods used.*
- *Kindly explain the consequences and remedies for all the agreements involved in the structured deal and for each of the parties involved under the following circumstances:*

- *If the taxpayer does not perform in terms of the agreements concluded.*
- *If the taxpayer is placed in liquidation.*
- *If the bank is placed in liquidation.*
- *If the taxpayer wishes to exit out of the structured deal.*

The following guidelines should be considered before furnishing SARS with any documentation and/or information:

Make sure that no generic marketing brochures, presentations or proposals are furnished. All relevant documentation should be tailor-made to the specific transaction.

Ensure that all correspondence pertains specifically to the final structure implemented.

Ensure that only final versions of the agreements, addendums and side letters are provided.

Any verbal understandings must be given by the role players and preferably recorded in affidavits.

Information provided must be of a factual nature.

## **1.2 SARS Questioned**

In certain circumstances it may become apparent that SARS' query is a 'fishing expedition'. The taxpayer has rights to ask SARS what the relevance of their questions is and to clarify ambiguous requests. The taxpayer is entitled to know precisely what the administrative purpose of the query is. In this regard the taxpayer may pose the following to SARS:

1.2.1 State the authority, giving the specific sections of the Act for the solicitation of the information that you desire.

- 1.2.2 State whether the disclosure of the requested information is mandatory or voluntary. If mandatory, why do you say so and what penalties may/will result from non-compliance in furnishing the data you have requested?
- 1.2.3 State the principle and specific purposes for which the information requested is to be used in any and all capacities.
- 1.2.4 State the routine uses which may be made of the requested information or any other use to be made of the requested information.
- 1.2.5 State the effect on the taxpayer for not providing the Commissioner or its officials with the information requested.
- 1.2.6 Explain and show that the investigation involved is of the kind authorised by statute.
- 1.2.7 Explain how and why the demand for information is not too vague and broad in scope.
- 1.2.8 Explain and show that the information sought is relevant or material as a lawful subject of this enquiry.
- 1.2.9 Explain why and how the investigation is pursuant to legitimate purposes.
- 1.2.10 Explain why and how the enquiry for information may be relevant to the purposes.
- 1.2.11 Show and prove that the information is not already in the possession of the Commissioner or its officials or cannot be obtained from other sources.
- 1.2.12 Show and prove that the Commissioner or his officials has determined that this further examination is necessary.

- 1.2.13 Show and prove that all other administrative steps as required by your practice code have been followed to the letter of the law.
- 1.2.14 Show and prove that after initial investigation, the Commissioner or his officials has determined that a further examination is necessary and warranted.
- 1.2.15 Show and prove that the taxpayer has been properly notified that further examination is necessary.
- 1.2.16 State exact reasons in detail for the examination of the specific year/s for which information is requested.
- 1.2.17 State whether there is any misconception and/or a mistake in the tax return for the specific year/s in which the information is requested.
- 1.2.18 State exactly where the mistake lies, or if in fact, that one exists.
- 1.2.19 Specify exactly which items of income or expenses are in question on the tax return, if any.
- 1.2.20 State why the specific income and/or expense item is in question, or needs to be examined, if any.
- 1.2.21 Explain why and what issue in law or fact is being questioned.
- 1.2.22 State the name, address and telephone number of any person or persons informing you of any questions or concerns involved in any item or tax return or any activity of the taxpayer.
- 1.2.23 State exactly what was said, either verbally and/or written concerning any item, tax return or activity of the taxpayer by any person(s) informing or directing you to conduct an examination directly or indirectly.

- 1.2.24 State and prove that the taxpayer is not being subjected to an examination based on/or for any political, ideological, harassment, pressure, tactic or bad faith purpose, and is not being singled out for prosecution as an example to other taxpayers for any reason.
- 1.2.25 State and explain why the examination cannot and will not amount to an inquisition or arbitrary enquiry on the part of the Commissioner or its officials.
- 1.2.26 State and explain why you feel that the taxpayer is not being subjected to unnecessary examination or investigation.
- 1.2.27 State the exact methods used, either past or present, to gather information concerning this taxpayer, and whether information was gathered through the use of unusual means.
- 1.2.28 State whether the verification of specific deductions would be the limited scope of the examination.
- 1.2.29 State whether the Commissioner or his officials would be prejudiced against the taxpayer who arranges his affairs to minimize tax as the law permits.
- 1.2.30 Show and prove to the taxpayer how the Commissioner or his officials have jurisdiction over any subject matter concerning the taxpayer, or the parties that the taxpayer conducted business with.
- 1.2.31 Show and prove that the Commissioner or his officials have established sufficient jurisdictional facts to bring the taxpayer within the ambit of the Act so as to shift the onus in terms of Section 82 of the Act to the taxpayer.

Please note that not all of the abovementioned may be applicable and the relevant questions must be tailored to the set of facts at hand.

### **1.3 Obtaining Facts**

As soon as the SARS query is received a full factual enquiry should be performed by the taxpayer.

Ideally a taxpayer should pre-empt any SARS investigation when it comes to structured finance deals previously concluded and start compiling and saving records as soon as possible.

Apart from the written documentation, it is important to identify the key role players involved at the time the transaction was discussed and entered into. Such role players should be interviewed. This may be necessary down the line as these role players could be called to testify as witnesses.

Interviews should preferably be conducted by your advisors as they will be proficient with the type of questions that should be posed.

The other purpose for conducting interviews is that people's recollection of certain matters tends to diminish over time, so the sooner you can get a recordal the better and more accurate it will be. The role players inevitably resign, retire, change employment or die. Accordingly, it is best to obtain the information whilst they are still employed at the relevant entity and can easily cooperate.

### **1.4 Interaction with Financial Institutions**

Involve the relevant financial institution right from the start. They must be made aware up front that they are to advise the client of any SARS queries they receive and that any documentation and/or information they intend to furnish in response thereto, must be reviewed and approved by the taxpayer before it is submitted.

Before the financial institution answers any queries, it is essential that the taxpayer receive all the records in the financial institutions possession pertaining to the transaction.

The financial institution may not see the relevance in providing the taxpayer with everything but your advisor will know what is crucial to the case and what is detrimental and it may be that certain documentation which is damaging is in fact completely irrelevant to the ultimate transaction and so should not be furnished to SARS.

You may have a transaction wherein records are stored offshore. In these circumstances it is important to insist that you receive copies of everything so that you are not put in the predicament when SARS raises a query that the records are not available.

### **1.5 Re-pricing Agreements**

A re-pricing agreement can be in the form of a separate agreement, a clause or an addendum but it essentially provides for circumstances which occur or manifest later into the transaction and which impacts on the financial model of the structure, which may not have been contemplated.

Circumstances may include the introduction of and changes to any law, rule, regulation, directive or banking practice applicable to the transaction, the rate and practice of levying tax, damages and other costs which may become payable due to a breach. Of course there are innumerable scenarios which are not necessarily envisaged by the financial institution from the outset.

The effect of this is that such circumstance will be incorporated in the financial model which will then affect the payments made by the taxpayer under the agreements (e.g. rentals, interest, loan repayments or any other form of payment).

Taxpayers must be vigilant when they enter into settlements with SARS because they will invariably result in an adjustment to the model in accordance with the re-pricing agreement.

### **1.6 Aiming towards a Letter of Findings**

Ideally the taxpayer's representatives should attempt to establish a high-level relationship with representatives from SARS. In so doing, an introductory meeting should be

convened wherein the representatives discuss the way forward and the amicable approach they intend to adopt.

This is also an important forum for the taxpayer to emphasize that a letter of findings must be issued by SARS prior to any assessments and that the taxpayer be given reasonable opportunity to respond to the letter of findings.

The basis of the relationship is one of constant interaction so that should SARS require additional information and/or documentation, SARS should request same from the taxpayer instead of arriving at inferences without first obtaining concrete evidence.

## **1.7 Answering Letter of Findings**

SARS may attack structured finance deals in terms of the anti-avoidance provisions (s 103/s80A), substance over form or maybe a more specific argument (e.g. disallow a deduction under s11(a)).

### The General Anti-Avoidance Rule (GAAR)

GAAR was previously governed by s103. It has now been replaced by s80A which came into force on 2 November 2006. Accordingly, any transactions entered into prior to 2 November 2006 will still be governed by s103.

The new section 80A sees a shift in onus to the taxpayer compared to the old section 103 where the onus was initially on SARS.

Under section 103, SARS had to satisfy three requirements, namely

- transaction, operation or scheme;
- the effect of avoiding or postponing a tax liability; and
- abnormality.

If all three were met, the onus shifted to the taxpayer to prove that a tax benefit was not its sole or main purpose.

In terms of section 80A, the onus is on the taxpayer from the outset to prove that the tax benefit was not its sole or main purpose.

In the letter of findings, the taxpayer must ensure that the onus requirement is being applied by SARS correctly in accordance with the relevant GAAR section.

#### Substance over Form/Simulated transactions/Sham

SARS, in their letter of findings, must not simply arrive at broad based observations. Their conclusions must be supported by concrete evidence otherwise they are nothing more than unfounded inferences.

The following seven principles set the parameters for establishing whether a transaction is a sham and must be considered by SARS and the taxpayer when attempting to challenge the legal substance of a transaction:

- disregard the accounting treatment;
- disregard the economic substance;
- a taxpayer is entitled to arrange his affairs so as to minimize his tax liability;
- the court must give effect to the true nature of the transaction;
- what is the true intention of the parties, definitely ascertainable, which differs from the simulated transaction;
- look at the surrounding circumstances, facts, evidence and supporting documentation etc.

- onus on the taxpayer to prove that the agreements are genuine and were implemented in accordance with their legal tenor.

## **1.8 Essence of Structure**

The entire structure and its individual parts must be carefully scrutinized to ensure that each component is legally and properly implemented. It may be that one of the legs was not implemented properly by the financial institution and is therefore invalid. This flaw in a fundamental pillar of the transaction could shift the liability to the financial institution.

In summary, the taxpayer must investigate the transaction from all angles.

## **1.9 Attorney/Client Privilege**

Any opinions obtained from the outset, before and pursuant to SARS' query, must be protected by attorney-client privilege. This will ensure they do not have to be disclosed to SARS at all, even if the matter eventually goes to court.

Opinions may contain qualifications or provisos. For example, counsel may arrive at a finding on the assumption of something. If this gets into SARS' hands, they could focus on that qualification and misinterpret it entirely.

Taxpayers must make sure to furnish counsel with every last detail in order to avoid such assumptions.

## **1.10 Settlements**

Oftentimes SARS will offer a standard settlement when it comes to structures that were commonplace in the market. In these circumstances, such settlements should be available to all taxpayers in similar circumstances and on the same basis. Failure to offer these settlements consistently would result in a breach to the taxpayer's legitimate expectations as well as biased and impartial conduct on SARS' behalf.

If it is common knowledge that settlements have been offered, a taxpayer is entitled to insist that they receive the same offer or consideration whether they elect to conclude same or proceed to court.

Taxpayers must be aware that outcomes arrived at via settlements will most likely be factored into the re-pricing agreement. Therefore taxpayers should examine the implications of a settlement from all angles.

Settlements will impact on the taxpayer and the financial institution. Accordingly, representatives from both parties should be involved throughout the settlement negotiations.

## **THE ASSESSMENT**

### **1.11 Reasons for the Assessment**

Whenever a taxpayer receives an assessment they are entitled to request adequate reasons therefore. The right to request adequate reasons is in terms of Rule 3 of the Rules promulgated under section 107A of the Act as well as the Promotion of Administrative Justice Act read together with the Constitution.

It is imperative that the taxpayer be in a position to say '*although I do not agree with the assessment, I understand how SARS arrived thereat*'; this can only be achieved if the taxpayer receives adequate reasons. Accordingly, if the initial assessment does not explain properly how SARS came to their decision, the taxpayer can call for reasons.

A taxpayer has 30 days from the due date of the assessment to request adequate reasons. It is imperative that if the taxpayer requires additional explanations and clarification, that he does so at this stage. Once he receives the adequate reasons from SARS he will be better equipped to apply his mind and challenge SARS.

### **1.12 Preparing the Objection**

The objection must contain the grounds on which the taxpayer disputes SARS' argument. This is the opportunity to put forward as much evidence as possible to discharge the onus that rests on the taxpayer. Accordingly, the objection should be as comprehensive as possible.

It is important to note that the grounds can pertain both to the substantive merits of the case as well as any procedural irregularities. The taxpayer must raise any procedural issues in the objection and oftentimes they should be considered and resolved before the substantive merits are examined. If the procedural aspects are not advanced at this juncture the taxpayer will most likely lose the opportunity to raise same at a future date.

### **1.13 Suspending the pay-now–argue-later Principle**

The general principle that SARS enforces is commonly referred to as the 'pay-now-argue-later' (PNAL) rule. The PNAL rule can be suspended in certain instances.

It has been held that a liability is only contingently payable pending the outcome of an objection and therefore until such time as the objection has been finalized, all the taxpayer's payment obligations should be suspended. This decision was advanced as a dictum in *Singh's* case but SARS are disinclined to apply it. However, the Commissioner may exercise his discretion to suspend the PNAL rule where the taxpayer advances mitigating circumstances. These may include the following:-

- the circumstances of the case give rise to reasonable doubt and there is a strong possibility of the taxpayer's success;
- paying the amount will cause grave financial hardship which could not be reversed if the taxpayer were to ultimately succeed with his objection; and
- the taxpayer puts up security for the outstanding amount should his objection fail.

## 1.14 When should penalties not apply

### Section 103 / Section 80A

The event which creates the tax consequences of a transaction of the type contemplated in section 103(1) or section 80A is the exercise by the Commissioner of his discretion under the section.

It is an enabling provision in the sense that no liability arises thereunder **unless and until** the Commissioner actually exercises his discretion to increase the taxable income of the taxpayer in respect of a particular year of assessment.

Section 103(1) and section 80A are a tax avoidance measure and not a charging section. Tax avoidance presupposes a legal arrangement or transaction which, but for some special provision in the Act, would not render the taxpayer liable for tax.

The effect of section 103(1) and section 80A is that although a taxpayer has, by legal means, no income subject to tax or is entitled to a permissible deduction, in the circumstances stated in the section he may be taxed in a way that would nullify the tax benefit. The transaction therefore remains valid and enforceable between the parties, but for tax purposes the Commissioner may ignore it.

Section 103(1) and section 80A are therefore in themselves penal provisions.

The question therefore arises whether additional tax could be imposed where a section 103(1) or section 80A adjustment has been made by the Commissioner.

Additional tax can only be imposed when the jurisdictional facts in section 76(1)(a), (b) or (c) are present.

Paragraph (a) deals with the situation where a taxpayer makes default in rendering his return. Paragraph (b) deals with the situation where the taxpayer omits something from his return which ought to have been included and properly charged. Paragraph (c) deals with the situation where the taxpayer makes an incorrect statement in a return which

results in the assessment of income which is less than the tax properly chargeable. Only when any one of the circumstances as set out in paragraph (a), (b) or (c) has occurred can additional tax be imposed.

Additional tax is calculated on the difference between the tax as calculated in respect of the taxable income returned by a taxpayer and the tax properly chargeable after taking into account the taxpayer's omission or act.

A taxpayer cannot make adjustments in terms of section 103 or section 80A; the section requires the Commissioner to do so and places the responsibility on him to be satisfied that the jurisdictional facts in the sections are met.

Upon rendering a return a taxpayer will account for his affairs and make statements which will conform to the legal nature of his transactions and consequently pay the tax properly chargeable before any application of section 103 or section 80A.

The taxpayer can therefore not calculate tax payable by taking into account a section 103 or section 80A adjustment; it can merely disclose all its transactions in line with what is required in the return.

Section 103 or section 80A will therefore be invoked when the Commissioner subsequent to rendering a return is satisfied that properly deductible expenditure is incurred in 'abnormal circumstances' and solely or mainly for the purpose of avoiding tax.

The section would then operate to deny the taxpayer the deduction of expenditure that would otherwise be properly deductible or attribute income in circumstances where no income accrued or was received in terms of a legal arrangement.

As a result, the jurisdictional facts in paragraph (a) (b) and (c) of section 76(1) can never be present in these circumstances as they relate to acts or omissions by the taxpayer which resulted in tax properly chargeable not being charged. The tax payable in terms of section 103 or section 80A is not payable as a result of the acts or omissions of the taxpayer; it is SARS' discretion to invoke the section which results in the tax being payable.

Section 89*quat* imposes interest on the underpayment of provisional tax. Section 103(6) and section 80K specifically provide that the Commissioner may not exercise its discretion in terms of section 89*quat*(3) to remit interest where an adjustment is made in terms of the sections.

#### Substance over form

It is unlikely that penalties will be waived if the doctrine of substance over form is successfully applied. This is because it will be held that the taxpayer willfully and knowingly entered into a transaction with the intention of deliberately disguising it in order to avoid tax.

For the same reason it would be unlikely that they would waive s 89 *quat* interest.

#### **1.15 Bringing the Financial Institution to the Party**

The financial institution played the main role in selling the product to the taxpayer and most times assured the taxpayer that the structure was not untoward in light of expert opinions obtained. Accordingly, the financial institution should be held partially responsible for their role in devising and offering the product.

Similarly the opinions the financial institution obtained could assist the taxpayer's case and should be disclosed to the taxpayer who in turn may elect to provide the contents to SARS.

Just because the financial institution sold the product to the taxpayer, it does not mean that they are no longer involved. Representatives thereof will have intimate knowledge of the structure and why it does not fall foul of GAAR and/or the doctrine of substance over form. Accordingly, they should assist the taxpayer in formulating counter arguments to any queries raised by SARS.

In many cases there is a sound business rationale for including a particular step in the transaction which should be considered from the financial institution's perspective and not necessarily from the taxpayer's perspective. In these circumstances the taxpayer may

not have knowledge of it and it is therefore crucial to involve the financial institution in explaining the purpose in terms thereof.

#### **1.16 Prescription**

SARS will purport to raise additional assessments under section 79(1) of the Act.

If this emanates from the Commissioner exercising its discretion under s103(1)/s80A, there is an argument to suggest that if full and proper disclosure was made in the tax returns of a taxpayer, which SARS considered, and in response to which SARS issued original assessments, having determined the taxpayer's taxable income, SARS may be prevented from altering their decision once 3 years has lapsed.

There may be a scenario that prescription is imminent within a few months and SARS becomes eager to issue assessments so as to avoid the year of assessment prescribing. Taxpayers must caution SARS that assessments raised hastily are premature and unfair.

Inevitably SARS will enter into some sort of agreement whereby the taxpayer agrees to extend the prescription date so as to enable the parties to interact properly. Obviously each matter is unique and taxpayer's should be slow to agree to an extension in circumstances where they are confident there had been full disclosure and no fraud or misrepresentation. This will then prohibit SARS from opening the assessment.

In addition, any agreed extension should pertain specifically to the item under consideration and should not apply to the entire year of assessment. Taxpayers should ensure that their advisors guide them when it comes to examining terms and conditions of any agreement entered into with SARS. Furthermore, any agreement should be reduced to writing.

#### **1.17 Reporting to the Audit Committee and Provision Recommendation**

A tax exposure is typically a combination of capital, penalties and/or *s89quat* interest. A determination must be made, based on the information available, as to whether there is a tax exposure or whether circumstances exist to mitigate or eliminate the exposure. Based

on this determination the amount is either provided for, raised as a contingent liability or excluded as an exposure.

In reporting to the Audit Committee, the tax exposure is dependent on the facts of the matter which in turn will dictate the risk. The risk could be classified into three categories, namely, probable, possible and remote. Each category should have a corresponding percentage, e.g. 100%, 50% and 20% respectively. This will quantify the provision to be made for each item and will give the committee a better understanding of the exposure.

## **THE APPEAL PROCESS**

### **1.18 Referring the matter to Alternative Dispute Resolution (“ADR”)**

ADR is generally the last opportunity for attempting to resolve the matter amicably. Both SARS and the taxpayer discuss the merits and resources that would be involved in arguing the matter before a court and weigh up whether it would be in everyone’s best interest to settle. Notwithstanding the fact that a taxpayer may have a fairly strong case, a settlement is generally the more attractive option in light of the time, money and effort that is required to prepare for court. In addition it is always unpredictable how a judge will view the merits of the case and this may be a risk that the taxpayer does not wish to take.

### **1.19 Mandate to Settle**

Before the ADR hearing, the taxpayer should confirm that the appropriate SARS representatives will be present and will have the relevant authority to settle, if necessary.

Make sure that any legitimate expectations created by SARS are adhered to and that their treatment of the matter is in accordance with consistent practice and precedent. Any arbitrary or irrational decision must be challenged and if necessary taken on review.