

# *Synopsis*

## Tax today

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*A monthly journal published by PwC South Africa providing informed commentary on current developments in the tax arena, both locally and internationally. Through analysis and comment on new law and judicial decisions of interest, it assists business executives to identify developments and trends in tax law and revenue practice that might impact their business.*



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## Contents

- 2 *Is the age of robust judicial debate a thing of the past?*
- 3 *Tax benefit – a view from Down Under*
- 5 *When are services of a non resident “imported services” subject to VAT*
- 7 *Intra-group transactions – latest developments*

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# Is the age of robust judicial debate a thing of the past?

*For taxpayers, the interpretations of our Courts are a vital aid to the application of the law. These interpretations give precision to the words used in the statutes, which, in the absence of refinement in the crucible of legal debate and argument, may be seen as blunt and potentially ambiguous.*

*It was not unusual twenty years ago for tax judgments in the SCA to be determined by a majority decision. The honourable Justices of Appeal expressed independent views on the merits of the issues before them and were not always in agreement. This was good for the development of the law.*



Within the Courts themselves, there are rules for the application of the principles that are distilled in these interpretations – the doctrine of stare decisis – designed to provide an element of certainty in the legal framework. The basis of the doctrine is that the interpretation of the law arrived at by a court should be observed if similar issues subsequently come before the court. This provides an element of certainty for the public: that the law is what the courts determine it to be.

There is a hierarchy of “authoritativeness” in relation to the decisions of the courts – a ranking system. The decisions of the highest court should be applied consistently in that court, unless it may subsequently be determined that such decision was wrong. A lower court is compelled to apply the principles decided in a higher court.

Decisions may also be weighted according to the degree of acceptance within the court in which they were made. Thus if a court comprises of more than one judge, a decision taken unanimously would be considered more weighty and reliable than a split decision carried by a majority.

That is not to say that a majority decision is to be ignored. The words used in legislation are not without potential ambiguity, and it is important to strive for an interpretation that is likely to be most appropriate. Furthermore, it is not to be expected that the best legal minds should always be unanimous in their

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# Tax benefit – a view from Down Under

*The entire thrust of the anti-avoidance provisions in section 80A to L of the Income Tax Act is based upon eliminating the unwarranted achievement of a tax benefit.*

An arrangement may be regarded as an avoidance arrangement if it results in a tax benefit. The term “tax benefit” is defined as including “any avoidance, postponement or reduction of any liability for tax.”

These are broad concepts, which will require careful judicial consideration lest they are cast so wide that every transaction by every taxpayer potentially gives rise to a tax benefit for one of the parties to the transaction.

The definition in the Income Tax Act section 1 states that “tax benefit” includes any avoidance, postponement or reduction of any liability for tax.”

The concept of tax benefit has not yet been considered by a South African court and there is therefore considerable uncertainty as to its meaning.

A recent decision of the Federal Court of Australia (RCI Pty Ltd v Commissioner of Taxation NSD 1225 of 2010, judgment given on 22 August 2011) may prove useful for the courts in South Africa.

## The facts

The salient facts were straightforward. A group of companies was undergoing a reorganisation. One of the companies, RCI, had a subsidiary - JHH(O) - which, in turn owned shares in a lower tier subsidiary, which had appreciated considerably since their acquisition. JHH(O) revalued the shares and then declared a dividend equal to the

amount of the surplus, which it satisfied partially by way of a payment in cash and partially by crediting the shareholder loan account. The shares in JHH(O) were then sold to another group company (RCI Malta) at their market value.

The Australian Tax Office cried foul. They asserted that the declaration of the dividend had depressed the value of the shares that were to be disposed

of to the group company with the result that RCI had benefited to the extent of \$172 million in capital gains tax which would have been payable. In other words, they sought merely to re-characterise the dividend as consideration for the shares on the basis that the shares would, but for the dividend, have had to be transferred for a considerably higher consideration.

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interpretation. The majority view is therefore a consensus decision that has weight, and should be applied in similar circumstances, but which may also indicate that the issue might yet require further consideration.

The principle of *stare decisis* is a cornerstone of the judicial system and the rule of law, and courts should be astute to avoid overriding or amending principles that have been distilled in a series of judicial decisions unless there are substantial and justifiable grounds to do so.

It was not unusual twenty years ago for tax judgments in the Supreme Court of Appeal to be determined by a majority decision. The honourable Justices of Appeal expressed

independent views on the merits of the issues before them and were not always in agreement. This was good for the development of the law. It demonstrated that eminent legal minds were not entirely *ad idem* on the matters at issue, and that there may yet be room for further refinement.

### **Only two decisions in which more than one judgment delivered**

In the past five years the reported cases on tax disputes heard in the Supreme Court of Appeal and reported in the South African Tax Cases reports appear to reflect only two decisions in which more than one judgment has been delivered, and in one of those the second

(minority) judgment dealt a different view on a technical issue, while the Justice of Appeal nevertheless supported the majority decision. At least four of the unanimous decisions have been the subject of considerable criticism, not least for the absence of dissenting views (*Defy Ltd v C:SARS 72 SATC 99*, *C:SARS v Foskor (Pty) Ltd 72 SATC 174*, *C:SARS v NWK Ltd 73 SATC 55*, *C:SARS v Founders Hill (Pty) Ltd 73 SATC 183*).

The absence of apparent judicial disagreement on the application of principles that have an important and sometimes radical effect on the law raises the question whether the age of robust judicial debate has passed and why this should be.

The Court had to consider the application of section 177C (1)(a) of the Australian Income Tax Assessment Act, which gives the Commissioner power to intervene if an amount might reasonably be expected to be included in the income of the taxpayer had the scheme not been entered into.

Thus the postulation of the ATO was that, if the dividend had not been declared, the shares in JHH(O) would have been disposed of for a consideration that was \$478 million greater than the actual consideration payable in the transaction.

RCI, on the other hand, argued that the tax on a gain of an additional \$478 million was so great that it would have abandoned or deferred the transaction to a later time (if it would ever have undertaken it), and the tax contended by the ATO would not have become payable. On this basis the dividend did not give rise to a tax benefit.

The Court relied on *Commissioner of Taxation v Peabody* (1994) 181 CLR 359, in which it had been held (at 382) that:

*“the existence of a tax benefit is to be established as an objective fact and is not a matter of the Commissioner’s opinion or satisfaction that there is a tax benefit”*

Applying this construction, the Court rejected the assertion of the ATO that the benefits that were intended to flow from the reorganisation were so great that RCI would have disposed of the shares in JHHO in any event despite the potential tax cost, and that the dividend was a scheme to reduce the tax cost of an inevitable transaction. Instead it held:

*“...[If] the scheme ... had not been entered into or carried out, the reasonable expectation is that the relevant parties would have either abandoned the proposal, indefinitely deferred it, altered it so that it did not involve the transfer by RCI of its shares in JHH(O) to RCI Malta or pursued one or more of the other alternatives referred to in the Information Memorandum; but they would not have proceeded to have RCI transfer its shares in*

*JHH(O) to RCI Malta at a tax cost of \$172 million. On this view, RCI did not obtain the tax benefit it was alleged by the Commissioner to have obtained in connection with the scheme.”*



***This approach has much to commend it. It is not sufficient for the taxing authority to merely postulate that a transaction delivers a tax benefit by assuming that a course of conduct would necessarily have been followed as an alternative to the actual transaction. It must be able to identify the course of conduct that reasonably would have ensued in its absence. In short, a tax benefit must be established by reference to what would have happened not what might have happened.***

How this approach will sit with our courts remains to be seen. However, it is clear that the introduction of a new concept does not necessarily result in greater precision or clarity in the law, as it opens up new avenues of interpretation and may render previous well-established concepts obsolete.

# When are services of a non resident “imported services” subject to VAT

*The VAT Act requires that VAT be paid by the recipient of “imported services”. In short, imported services are services performed by a non-resident supplier to a resident recipient that are used for a purpose other than making taxable supplies in the course or furtherance of an enterprise.*

When imported services are supplied to a person, that person is required to calculate the VAT element that applies to the charge for the services and make payment of that amount to SARS.

The Tax Court in the Western Cape was recently called upon to decide whether certain services were imported services or not (*Case No. VAT 382*, judgment given on 13 June 2011).

## Background

The facts, in their simplest form, were as follows:

The recipient was a mining company and a registered vendor.

The recipient’s shares were listed on a number of stock exchanges, including the JSE, in the form of so-called linked units, which linked its shares to interests that it held in another listed entity.

Related party shareholders of the recipient proposed a transaction in terms of which the interests of the recipient and its linked investment would be de-linked and the linked units replaced with shares in a new holding company with the recipient and its formerly linked investment as its subsidiaries.

A committee of directors of the two companies was set up to evaluate the proposed transaction and empowered to consult independent advisors to determine the implications for independent shareholders.

After consultation with various consultants, which resulted in a revised proposal being put forward, the boards of directors were able to



satisfy themselves that the proposal was fair and reasonable and to recommend it to their shareholders.

The transaction was effected through a scheme of arrangement sanctioned by the High Court and duly implemented.

The non-resident consultant invoiced the recipient for its share of the cost of services.

SARS determined that the services provided by the non-resident consultant were imported services and assessed the recipient to VAT in respect of those services. The recipient objected against the assessment and, after disallowance of the objection, the matter came before the Court on appeal.

## The arguments

SARS contended that the business of the recipient was the sale of minerals. These sales were the taxable supplies that it made. The services were not supplied to the recipient in relation to

the sale of minerals, but so they might report to shareholders. Sales of minerals were not in the least affected by the advice obtained from the consultant; hence the consultant’s services were imported services.

The recipient argued otherwise. It carried on an enterprise in the course of which minerals were continuously and regularly supplied for a consideration. Its supplies were therefore taxable supplies. It carried on business as a listed company, and was accordingly required to operate within a regulated framework. Stock exchange requirements necessitated that its Board of Directors take appropriate external advice to enable it to report to its shareholders on the reasonableness of the proposed transaction. The services were, in effect, overhead costs of the business of making taxable supplies, and therefore they were not imported services.

## When are services of a non resident “imported services” subject to VAT

### Comparable authority

The recipient referred to a Canadian income tax decision (*BG Service Co Canada v R* [2002] GSTC 124 (TCC)) where the obtaining of advice to counter a hostile takeover bid was held to be:

*“a result of the necessary response to developments arising in the operation of the business to produce income ... Such costs are commercial in nature and as part of the business activities ... are therefore incurred for the purpose of gaining or producing income”.*

SARS relied on an Australian income tax decision (*FCT v The Swann Brewery Co Ltd* (1991) 22 ATR 295 (FCA) at 303), in which it had been stated:

*“It could not be said that the expenditure was relevant or incidental to the gaining or producing of assessable income on the facts of this case. It was directed to duly informing*

*the shareholders of the corporation of the true worth of their shares and the adequacy of the offer the offer to acquire their capital interest in the corporation... To qualify ... it must be shown that the expenditure is characterised by the business ends to which it is directed, those ends forming part of or being truly incidental to the business... The expenditure upon aids to the consideration of the adequacy of the evaluation of the capital interest of the shareholders contained in the takeover offer and of the nature of the response to that offer recommended to shareholders owed nothing to the conduct of the business of the taxpayer.”*

The Court referred to the GST ruling in respect of the *Swann Brewery* transactions, from which it was clear that the indirect tax issues are substantially different than the income tax issues. Paragraph 70 of the ruling listed circumstances in

which the acquisition of goods or services would be in the course or furtherance of the enterprise including where:

*“the acquisition is made by the enterprise in accordance with, or to satisfy, a statutory requirement imposed on the enterprise.”*

The ruling concluded at paragraph 74:

*“For GST purposes, however, the commissioner would, on balance, accept that acquisitions made by a company in these circumstances would be made in carrying on of its enterprise, having regard to all the factors mentioned at paragraph 70 of this Ruling”.*

# Intra-group transactions – latest developments

*There has been a great deal of media attention on the proposed amendments to the Income Tax Act in respect of the group reorganisation provisions, and, more particularly, the taxation of intra-group transactions in terms of section 45.*

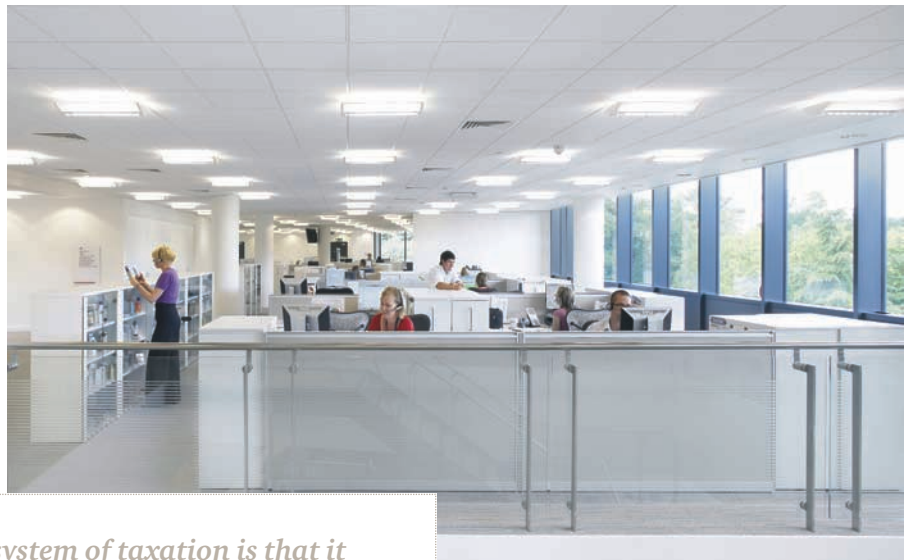
One of the problems with the South African Income Tax Act, when it comes to the taxation of groups of companies, is the absence of a system of group taxation. Group taxation recognises that the affairs of companies that are owned or controlled centrally are frequently integrated, and that the economic activity of the group should be taxed on the basis of its transactions with unrelated (non-group) parties. The group is recognised as a single taxpayer, and its operational results are aggregated, after eliminating intra-group transactions, and a single group taxable result is derived.

One of the benefits of a group system of taxation is that it facilitates the reorganisation of assets within the group envelope in a tax neutral fashion.

The legislature some years ago apparently identified that there was a need in South Africa to align the tax law on group reorganisations more closely with the developed world, so that reorganisation

acquisition by the SPV, to set the entry price at an affordable level for the BEE partners. That this was an aim of the policy was confirmed when the minimum holding threshold to establish membership of a group was reduced from 75% to 70%, so that the relief provisions could apply side by side with a minimum BEE participation requirement of more than 25%.

SARS and National Treasury are now proposing further



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transactions that did not result in the inflow of income or gain to the group should not suffer tax. Amendments, colloquially referred to as the corporate restructure provisions, were enacted to facilitate such transactions.

One of the provisions permitted a tax neutral transfer of assets between companies forming part of the same group of companies, or intra-group transactions. The provisions contained a number of anti-avoidance provisions, whose purpose was to counter possible abuse by non-resident owners, or the opportunity for resident owners to convert amounts taxable as ordinary income into capital gains.

It was clear from the outset that these provisions were a welcome relief to taxpayers and were harmonious with national policy initiatives, particularly as they facilitated carve-out of assets that were appropriate for black economic empowerment transactions into special purpose vehicles. It was also possible, through gearing the

specific tax avoidance measures and new reporting requirements aimed principally at intra-group transactions, but also extending to amalgamations, unbundlings and liquidations.

The draft legislation provides for two radical changes in the law.

The first is that there will be a denial of the deduction of interest on gearing related to the acquisition of assets in terms of an intra-group transaction, unless SARS has ruled that the interest is deductible, consequent on an application by the borrower, which must be made before the transaction is implemented. Only transactions financed from within the group envelope by companies that are not in or expected to be in an assessed loss position will not require approval for the deduction of interest funding. Approval will also be required if non-disclosable transactions are refinanced from outside the group of companies.

## ***Intra-group transactions – latest developments***

The second is that the loan funds will be deemed to have a base cost of zero. However, no capital gain will be recognised on repayment if the lender is a company in the same group as the borrower at the time of the transaction and at the time of repayment.

These draconian provisions are deemed to take effect from 3 June 2011, and are backed up by the belated decision to exercise a statutory power to compel persons to file a special return detailing their participation in corporate restructure transactions. The reporting requirement will also extend to participants in asset-for-share transactions under section 42 of the

Income Tax Act. In essence, all transactions that have not been the subject of an interest deduction application or that fall outside of *de minimis* limitations relating to the transaction size and cumulative transaction values within the fiscal year, will require the filing of a return within 30 days of becoming liable to notify the transaction, on pain of penalty.

The filing of a special return will not relieve taxpayers from obligations in respect of reportable arrangements.

The power to require a return to be submitted has existed ever since the corporate restructure provisions were introduced and it is questionable why the power was not exercised earlier,

and whether the radical amendments currently proposed would have been necessary had these powers been exercised earlier.

The amendments are stated to be “temporary” and will remain in place at least until 31 December 2013, by which time SARS and National Treasury expect to have had the opportunity “to investigate a longer term solution”.