

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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Sale of goods - when does income accrue?

It has been a long established principle of income tax law that income accrues to a seller of goods when he becomes entitled to payment in respect of such goods. Typically, the customer becomes liable to make payment once the goods have been delivered, and the income accrues upon delivery.

This was the position urged by SARS in a recent matter decided in the Tax Court, Johannesburg in Case Number 12262.

The dispute involved two principal issues.

The main issue: accrual

The main dispute involved the export of fluorspar by the taxpayer. It was established in evidence that the usual requirement is that the concentration of the calcium fluoride in fluorspar should be not less than 97%. The concentration may be affected by moisture. Management of the moisture content during transportation is critical, as there are risks of loss if the moisture is too low and risks of reduction in purity if it is too high. Fluorspar is prone to significant fluctuation in moisture content in the course of shipment and payment is made only for the quantity of dry fluorspar delivered in the country of destination. For this reason, it is sold subject to inspection and assay by the purchaser on delivery. In the event that the fluorspar delivered does not meet the technical specification in the agreement, the shipment may be rejected. However, in practice the parties negotiate a price reduction to take account of the technical deficiencies.

SARS' position was simply that the purchase price accrued on the date that the fluorspar was delivered on board ship at the port of export under an FOB sale.

The taxpayer argued to the contrary, on the basis that the contract was not

complete until there had been agreement on the price, and that the price could not be agreed until the shipment had been inspected and analysed by an assayist in the country of destination.

The Court noted that the sale of a mass of identical items (fungibles) typically involves weighing, counting or measuring and cited the case of *Page N.O. v Blieden & Kaplan* 1916 TPD 606; where a consignment of maize was sold, and delivered into bags supplied by the purchaser. Notwithstanding that a bag typically had a particular mass when filled, it had been held that it could not be said that the price for the consignment became due and payable when the bags were filled, as the amount payable was not determinable until the bags had been accurately weighed.

The Court therefore found that the shipments of fluorspar were not complete sales until the delivery had been accepted and the price finally determined and agreed upon. In essence the sales were subject to suspensive conditions and only became effective once the conditions were fulfilled.

Although the sales were FOB, in which ownership typically passes when the consignor delivers the bill of lading to the consignee, this general rule does not apply if the parties have agreed that ownership shall pass at some other time. The Court considered it vital to identify the event that caused ownership to pass:

“Thus, as between the appellant and the purchasers of fluorspar, this mutual

“It does not necessarily follow from the fact that a contract is FOB that, once the cargo is ‘on board’, the seller has acquired the right to claim payment from the purchaser...”



intention between the seller and the purchaser as to the event which triggers the passing of rights and obligations when goods are to be in transit is of critical importance.”

Furthermore, the Court continued:

“It does not necessarily follow from the fact that a contract is FOB that, once the cargo is ‘on board’, the seller has acquired the right to claim payment for [sic. - from] the purchaser. When the purchaser [sic. - seller] acquires this right depends on the intention of the parties. That intention need not be express but may also be inferred.”

The taxpayer therefore succeeded and the income in respect of the shipments was held not to have accrued in the year of assessment but only when the price was finally agreed in the subsequent year.

The secondary issue: deferred deduction of the cost of sale

The taxpayer’s position, however, was negatively affected by the provisions of section 23F(2) of the Income Tax Act, which is designed to deal with situations where

expenditure has been incurred in respect of trading stock disposed of during a year of assessment where the consideration in respect of such trading stock will not accrue until after the end of the year of assessment. A taxpayer is required to include an amount in income in the year that the trading stock was disposed of equal to the expenditure that has been incurred and allowed as a deduction in respect of the acquisition of the trading stock.

In effect, until the consideration accrues, the amounts expended in respect of acquisition of the trading stock that have been allowed as a deduction are added to income as if the items were still part of the closing stock of the taxpayer.

The taxpayer contended that only the direct mining costs incurred in acquiring the fluorspar were to be included in income. SARS contended that the costs of acquisition included processing costs that were incurred to convert the fluorspar from its raw state to the state in which it was exported.

The Court here found in favour of the SARS argument, effectively deferring taxation not on the gross consideration for the shipments but only on the gross margin.

Useful addition

The judgment is a useful addition to the body of law on the timing of the accrual of income, particularly because it focused on the legal relationships between the parties, finding that the law of contract determines the events from which the tax consequences flow.

Incentive shares

Capital or revenue?

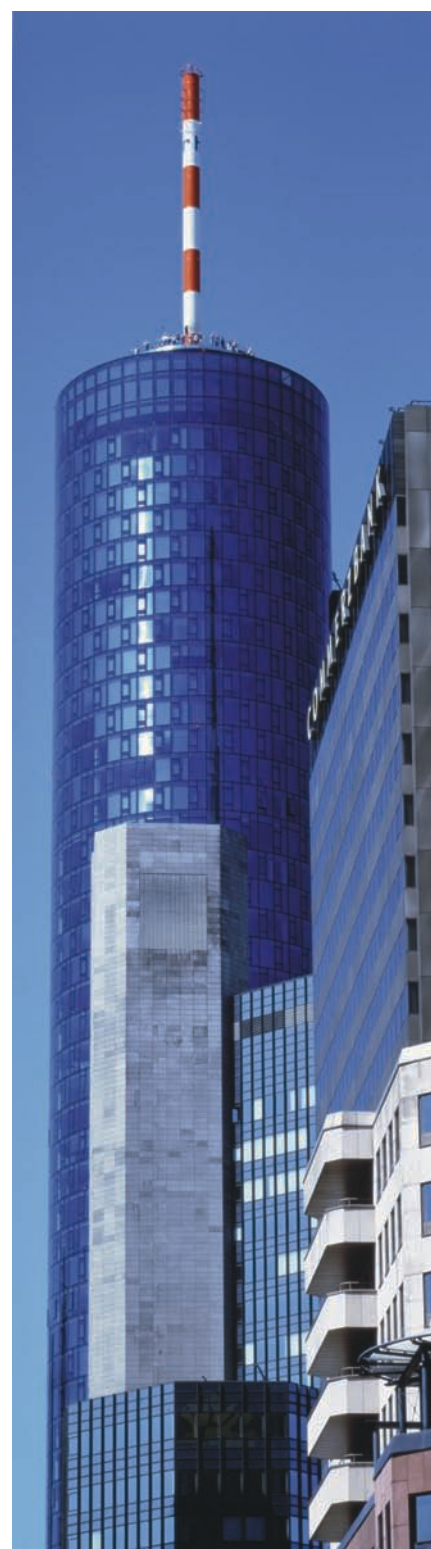
There has long been debate over whether shares acquired by executives in terms of executive share incentive schemes are capital assets or trading stock. Typically, when markets are buoyant and the shares appreciate, capital asset stances are commonplace, whereas, when markets decline, assertions that the shares are trading stock are more likely to emerge.

Occasionally disputes on this issue come before the courts, as was the case in Case Number 12886, which was heard in the Tax Court in Pretoria (judgment delivered 21 October 2010).

Briefly, Mr S was granted options to acquire shares in 2003 and again in 2004. In May 2007 he exercised some of the options, acquiring 115 000 shares, and in June 2007 he acquired a further 15 000 shares. It appears that the cost of the shares (including the cost of the options) was R2,67 per share for the first 100 000 shares and R4,36 per share for the remaining shares. At the time of acquisition of the shares by Mr S, the market values were R14,68 and R15,58 per share.

It was the evidence of Mr S that he had determined to exercise the options because commentary on the share's performance in the financial press indicated "that a further growth in price of up to 30% was expected". In support of this, a newspaper article published in 2007 was presented in evidence: it indicated that a price of R18 per share might be expected to be reached over a 12 month period. He had exercised his rights in order to speculate and "make a quick buck" from the expected escalation in market price.

As it transpired, the market turned down late in 2007 and the market price of the shares at 28 February 2008 stood at R9,57 per share. Mr S, having sold no shares, valued the shares as closing stock for tax purposes at R9,57 per share. He claimed that the cost of the shares for tax purposes was equivalent to the market value at the date upon which he exercised his rights to acquire the shares. By deducting this cost, and including the market value of the shares at year end as closing stock, he contended that he was entitled to claim a net deduction equal to the decline in the value of the shares.



Not a share dealer

SARS countered that he was not entitled to any relief owing to the reduction in the value of the shares. SARS' argument was simply that the shares were not trading stock as Mr S was not a share dealer. He had acquired the shares as a perquisite of his salaried employment. He apparently had no history of having dealt in shares and he had not sold any of the shares that he had acquired in May and June 2007 during the relevant year of assessment. In short, he was not a dealer in shares. In any event, it was urged, he had paid R2,67 and R4,36 per share, and this was the cost that he was permitted to deduct. Thus, the amount to be included in trading stock was equal to the cost actually incurred, being lower than the market value. Therefore no net deduction arose.

The Court would have had to deal with a number of issues if it were to determine the matter fully. In the event, it considered only one issue and referred the matter back to the Commissioner "to make a revised assessment in light of this judgment".

The judgment of the Court was based on the issue whether the expenditure incurred by Mr S in acquiring the shares was of a capital or revenue

nature. If the expenditure was of a revenue nature, the shares were trading stock. In this regard it relied on the *dictum* from *BP Southern Africa v C:SARS 69 SATC 79 (SCA)* from paragraph 7 of the judgment:

"The purpose of the expenditure is important and often decisive in assessing whether it is of a capital or revenue nature – often decisive."

It was common cause between the parties that a single venture could constitute a trade and that shares could qualify as stock in trade. It therefore fell to the Court to determine whether there was a trade having regard to the evidence and the inferences to be drawn from the circumstances.

The evidence showing that Mr S that he had acquired the shares with speculative intention had not been contradicted. He had not invested in shares as capital assets to any relevant measure. An extremely short period of time had passed between the acquisition of the shares and the end of the year of assessment and no adverse inference arose from his failure to have made a sale within that period.

The root cause is the lack of consistency in the legislation ... the Income Tax Act should be amended to harmonise the trading stock rules with the capital asset rules.

The Court concluded:

"Thus, in view of the Appellant's uncontested evidence, together with the common cause facts, and the fact that a "trade" can consist of a single "venture", it is the finding of this Court that the Appellant's appeal must be allowed and it is found that the acquisition of the shares became stock in trade.

The Court sidestepped the issue whether a loss was allowable and referred the matter back to SARS to make an assessment.

Was there a loss?

The critical (and still undecided) issue is the determination of the cost of the shares when Mr S acquired them.

SARS argued that he had paid R2,67 and R4.36 per share in order to acquire the shares, and that these were the amounts to be taken into account as representing the cost of trading stock held and not disposed of at the end of the year of assessment. Thus the amounts of the deduction and the inclusion in income as closing stock were the same, and no net loss resulted.

It is apparent (although not explicitly so stated in the judgment) that Mr S argued that the cost price of the shares should be deemed to be the market value on the

date of acquisition. In terms of section 8A of the Income Tax Act, he would have been taxed on an amount equivalent to the difference between the market value and the amount paid for the shares. In effect, the award of the shares at a bargain price was economically the same as if he had been paid an amount in cash and used that amount to acquire the shares. If Mr S was correct then he would claim a deduction for the cost of the shares in an amount equal to the market value on the date that he acquired the shares. He then would have been entitled in that year of assessment (in terms of the law as it then stood) to account for the trading stock at year end at the lower of cost or market value and the net effect would be a deduction, equivalent to the decline in market value, to which he contended he was entitled.

There is no clarity on this issue and one commentator on South African Income Tax cautiously inclines to the view that SARS would probably include the amount that has been included in the taxpayer's income in terms of section 8A as part of the cost of the shares for purposes of determining the value of stock in trade.

Tax Freedom Day

Tax Freedom Day is the day of the year when a taxpayer has earned what is needed to pay his taxes for that year, and hence the date from which the taxpayer begins working for himself, rather than for the revenue authorities.

The London Daily Telegraph says that the Adam Smith Institute has reported that, where Britain is concerned, this auspicious date will fall on 30 May 2011, compared to 27 May in 2010. The main reason for the three extra days is the rise in Value Added Tax, which increased from 17.5 per cent to 20 per cent on 4 January 2011.

In the USA, Tax Freedom Day for 2010 fell on 9 April.

The last published data reveals that Tax Freedom Day in South Africa for 2009 fell on 10 May of that year.

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The possibilities are intriguing:

If Mr S had sold the shares on the date upon which he acquired them at the same market value, he would have made a handsome accounting gain. For tax purposes he would have been entitled to claim that the gain was not taxable because the difference between the acquisition price paid by him and the market value had been taxed as remuneration and he could not be taxed twice on the same amount. He could, on the other hand, have argued that the shares were acquired for a cost equal to the market value and sold for the same value and therefore there was no profit.

If Mr S had sold the shares on the last day of the year of assessment for proceeds that would have been less than the market value when he acquired the shares, he still would have recorded an accounting profit. The question then arises

whether the correct tax treatment should be to disregard the profit on the basis that it formed part of an amount that had been included in his income at the time the shares were acquired or to allow him to claim a loss equivalent to the decline in the value of the shares?

Although economically these alternative treatments give the same result, they rely on different principles.

If the result of the second example is that there would not be a deductible loss, this would result in an intriguing disparity between the determination of the base cost of incentive shares acquired as capital assets and the cost of the same shares acquired as trading stock. The Eighth Schedule to the Income Tax Act, paragraph 20(1)(h)(i), specifically states that the market value of the security shall be the base cost of incentive shares where market value has been taken into account to determine an amount that

has been included in income in terms of section 8A.

However, the position taken by SARS in the case of Mr S apparently rejects the proposition that the market value of the security at date of acquisition should be taken as the cost of the shares. It appears that SARS is arguing that different methods should be applied in determining the cost of incentive shares acquired by an employee depending on the employee's intention at the date of acquisition of the shares.

Lack of consistency

The root cause is the lack of consistency in the legislation, which has apparently been seized upon by SARS as a

justification for its position. It is submitted that the Income Tax Act should be amended to harmonise the trading stock rules with the capital asset rules in this regard, so that the cost incurred or deemed to be incurred in acquiring trading stock are identical to the costs incurred or deemed to be incurred in acquiring capital assets.

It is unfortunate that the Court, having clearly set out the opposing positions, did not seek to resolve this apparent contradiction, but passed the ball back to SARS. In light of the opposing positions taken by the litigants as to the determination of the cost of the shares and the lack of consistency in the law, the Courts may not have seen the last of this dispute.

Editor's note: On the question whether the taxpayer may value shares at the lower of cost or net realisable value, the door has now been shut by the enactment of amendments to section 22 of the Income Tax Act in the Taxation Laws Amendment Act No. 7 of 2010, which takes effect from the commencement of years of assessment commencing on or after 1 January 2011. However, the inconsistency between determining the cost of trading stock and capital assets remains to be resolved.

Interest on tax not paid on due date

Section 89quat(3) of the Income Tax Act has been amended to rephrase the basis on which the Commissioner can exercise the discretionary power to direct that interest on tax that was not paid on the effective date is to be wholly or partially remitted.

Hitherto, section 89quat(3) has stated that, where the Commissioner is satisfied that any amount has been included in the taxpayer's income or that any deduction, allowance, disregarding or exclusion claimed by the taxpayer has not been allowed, and that –

the taxpayer has on reasonable grounds contended that such amount should not have been so included or that such deduction allowance, disregarding or exclusion should have been so allowed

the Commissioner may direct that interest not be paid by the taxpayer on the amount of tax in question.

In *CSARS v Foskor* [2010] ZASCA 45 it was held at paras [50] – [51] of the judgment that, in the circumstances of that case, section 89quat interest ought to be remitted in terms of section 89quat(3) on the grounds that the taxpayer had taken legal advice on the point in issue, acted in accordance with that advice, and furnished the legal opinion in question to the

Commissioner who apparently accepted it as correct for some two decades before taking a different view.

However, the Voluntary Disclosure Programme and Taxation Laws Second Amendment Act 8 of 2010 has now amended section 89quat(3) to read as follows:

Where the Commissioner having regard to the circumstances of the case is satisfied that the interest payable in terms of subsection (2) is a result of circumstances beyond the control of the taxpayer, the Commissioner may direct that interest shall not be paid in whole or in part by the taxpayer.

It is by no means clear in what circumstances it could be said that the interest payable is a result of circumstances beyond the control of the taxpayer. In fact, this phrase makes little sense, given that interest on assessed tax becomes payable as a result of the passage of time, which is indeed a factor outside the taxpayer's control.

Presumably the amendment intended to convey that interest can be remitted where the late payment of tax was beyond the taxpayer's control. But even that is scarcely a sensible criterion, given that lack of money to pay the tax may be a factor outside the taxpayer's control.

This amendment comes into effect on 2 November 2010 and applies to years of assessment ending on or after that date.

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