

Synopsis


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Drama of high stakes
played out in tax case

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In this issue

High stakes tax case in
Wynberg magistrates' court . . . 2

Dividends withholding tax -
what the future holds 4

New passive holding company
regime introduced 6

The tax-deductibility of legal
expenses. 8

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Drama of high stakes played out in tax case

The Wynberg magistrates' court in Cape Town is an unlikely venue for a momentous tax case. Yet, over the past months, in those austere surroundings, has been played out a drama of high stakes for SARS and the taxpayers concerned.

The case has serious implications for many taxpayers around the country and raises a multitude of questions, not just about the intricacies of tax law, but also about the enforcement policies of SARS.

Unusually for criminal cases, there was no dispute as to the facts. The only issue was their legal implications.

At the core was a technical issue of tax law regarding the meaning of the "accrual" of income for purposes of the Income Tax Act 58 of 1962, and the right of a taxpayer to arrange that incipient income will not accrue to him.

The larger issue is the boundary to be drawn between legitimate tax avoidance and unlawful tax evasion, and the consequences of crossing that threshold as a result of incorrect professional advice.

Of major concern is the potential criminal liability (if any) of a taxpayer whose returns were prepared by a professional tax consultant who made up those returns on the basis of a particular interpretation of tax law, if that interpretation turns out to be wrong.

It hardly needs to be said that many taxpayers will be astonished to learn that, on the strength of the judgment given in the magistrates' court in this case, they could in such circumstances be sent to prison.

The accounting profession should be equally alarmed at this proposition, not least for the substantial damages for which they could be liable if a client, who had acted on their advice, were to suffer such a fate.

In this case, Le Roux (accused number two) asserted – and it was not disputed by the prosecution – that the financial statements of his close corporation and his companies had been audited, and that such audit included the tax treatment of the sacrificed commissions that were at the heart of this case. He said that he had signed the tax returns in the knowledge of this audit.

According to press reports, the prosecution – presumably acting on SARS's instructions – has said that it will argue for a prison sentence, without suspension, and without the option of a fine.

A criminal prosecution is a grave matter

A conviction, and the criminal record that goes with it, is a serious matter. It is an indelible stain on the individual's good name, and can have lifelong career and personal consequences.

Taxpayers will be astonished to learn that, on the strength of the judgment given in the magistrates' court in this case, they could in such circumstances be sent to prison.

Many taxpayers who might grudgingly decide not to incur the expense of disputing an assessment and simply pay the tax, would be willing to fight an expensive legal battle to avoid being branded a criminal.

It is reported that le Roux has spent over R4 million on legal fees in this matter.

The decision to embark on the criminal prosecution of a taxpayer (as distinct from simply enforcing payment of a tax debt) is also a serious decision for SARS, which has given a commitment to treat taxpayers fairly. As an organ of state, SARS has a legal duty to exercise its powers in accordance with constitutional values.

Was this an appropriate case for SARS to instigate criminal proceedings at all, let alone to argue for a prison sentence?

These large questions will hopefully be addressed in the judgment that will be given by the High Court in the pending appeal.

The case raises a number of interesting tax issues as well as issues of criminal law and procedure. We focus on the income tax issues.

The facts

The events central to the case concerned the sale of lodges at the well-known luxury golfing estate on the outskirts of George, known as Fancourt.

A company called Plattner Golf (Pty) Ltd operated a business in George, consisting of a hotel, a golfing business (including four golf courses), and a

development division that sold houses and lodges at Fancourt.

Accused number four, Garth le Roux Marketing CC, had an agreement with Plattner Golf (Pty) Ltd to sell lodges at Fancourt on commission.

A contract was signed in terms of which Lodge 816 would be sold by Garth le Roux Marketime CC. The commission on the sale, which would become due, was conditional on transfer being passed. Before transfer was passed – and thus before the right to commission became unconditional – the cc, represented by le Roux, agreed to waive its commission on the sale if the seller would reduce the price by an equivalent amount.

From the point of view of the seller, it would net the same amount from the sale. It therefore consented to the new arrangement.

From le Roux's point of view, this arrangement (and the reduced price) meant that his company would be able purchase a lodge that it would otherwise be unable to afford.

From a business point of view, all of this was unremarkable. For an estate agent to agree to reduce his commission in order to secure a sale is a routine occurrence. There is nothing unlawful or improper about such an arrangement. Of course, the situation in le Roux's case was somewhat different. An estate agent who reduces his commission does not usually get an off-setting benefit, whereas le Roux's company got the benefit of being able to purchase the property at a reduced price.

The impact of the Brummeria Renaissance judgment

As was noted above, Garth le Roux Marketime CC had waived its commission on the sale in return for an equivalent reduction in the purchase price of the lodge purchased by the le Roux company.

The latter company therefore received, not money, but a benefit that had a money value, namely a discount on the price of property to be purchased.

When these transactions took place, namely in early 2000, many (perhaps most) tax consultants would have said that such a non-monetary benefit does not form part of a taxpayer's gross income.

Then, in 2007, the Supreme Court of Appeal judgment in the case of *Brummeria Renaissance* brought about a stunning reversal of the previous conventional wisdom, by holding that any benefit of a non-capital nature that was capable of being valued in money was "income", and that previous High Court decisions that had held the contrary were wrongly decided.

The *Brummeria* principle was crucial in the le Roux case, in regard to whether the benefit of a reduced purchase price was an "amount" that had to be included in gross income.

This, coupled with provisions in the law which can deem an amount received by one person to have been received for the benefit of another, ultimately proved fatal.

Dividend withholding tax – what the future holds

The Revenue Laws Amendment Bill currently passing through the stages from Bill to Act gives a foretaste of the dividend withholding tax regime that will replace STC.

The changes will come into effect after the giving of three months' notice of their intended introduction by the Minister by notice in the *Gazette*.

Definition of “dividend”

The first issue as to what constitutes a dividend will depend upon whether the company from which the dividend is derived is tax resident in the Republic. If it is not, the current definition of dividend will continue to apply. If it is SA tax resident, then a new regime will apply. This will be based upon the “contributed tax capital” of the company.

A dividend will be any amount that is distributed by a resident company to its shareholders to the extent that it is not paid out of contributed tax capital.

Contributed tax capital is effectively that portion of the capital that has been contributed by the shareholders out of after tax income. In the case of shares issued on or after 1 January 2009 in exchange for assets, where the shareholder holds more than 20% of the shares, the value of the contributed tax capital will be equivalent to the value of the assets so contributed as is taxed in the shareholder's hands. There will therefore be a difference between the contributed capital recorded for accounting purposes and the contributed tax capital if a capital gain on contribution of an asset is exempt or entitled to rollover relief. Further, the contributed tax capital will have to be

identified in relation to each class of shareholder and will be deemed to have been contributed pro-rata based on the proportion of shares held in relation to the total number of shares in the class.

That the legislator has seen fit not to alter the definition of dividend insofar as it relates to dividends declared by companies that are not SA tax resident introduces an interesting contradiction. On the one hand (distributions by SA resident companies) the legislature ignores company law principles in defining what constitutes a dividend, asserting that these have become increasingly less relevant for tax purposes. On the other (distributions by non-resident companies), it continues to adhere slavishly to the very company law principles that it contends are irrelevant.

Dividends tax

A dividends tax will come into operation, and STC will be terminated simultaneously with its introduction. The rate of tax will be 10%.

The intent is that companies should withhold tax at 10% on any dividend paid unless the recipient is exempt from the tax. Exempt persons include SA resident companies, the State, provincial and local authorities, parastatal organisations exempt from tax, retirement and benefit funds, public benefit organisations and mining rehabilitation funds.



Certificated and uncertificated shares

The legislation requires that companies that issue certificated shares should withhold dividends tax on any dividend declared and paid in respect of such shares.

Companies are not required to withhold tax on dividend payments where the shares are uncertificated. It is understood that the rationale for this is that the shares are all registered initially in an intermediary, which then administers a sub-register for the dematerialised shares. The company therefore typically deposits the dividend into an account administered by the intermediary, which administers the distribution to shareholders.

Exemption and treaty reduction on declaration

In the event that the beneficial owner shall have issued a written declaration that it is exempt and that it will inform the company should it cease to be the beneficial owner, or if the beneficial owner forms part of the same group of companies as the company paying the dividend, it shall not be liable to withhold and pay the tax.

Provision is also made for a non-resident beneficial owner that will enjoy reduced withholding by reason of a double taxation agreement to file a declaration to this effect and undertaking that it will inform the company should it cease to be a beneficial owner.

It would appear that SARS has pushed a great deal of the administration of the intended new tax onto the companies and intermediaries. The risk associated with tax administration in these entities may be expected to increase as a result.

Declarations of exemption or entitlement to reduced withholding will terminate on the earlier of the beneficial owner's ceasing to be the beneficial owner, or a period of three years.

Intermediaries

Where dividends are paid to an intermediary, such as a stockbroker, nominee company, fund manager, or any other person who manages portfolios on behalf of investors, the intermediary will be obliged to account for the dividends tax on dividends that are paid to a beneficial owner. The intermediary is relieved from liability to withhold on dividends in respect of certificated shares, if the dividends tax has been paid by another person, or if the beneficial owner has confirmed its exempt status by written declaration and undertaking to notify the intermediary should it cease to be the beneficial owner. In relation to dividends on uncertificated shares, the intermediary need not withhold dividends tax if the register it retains indicates that the person to whom the dividend is paid is exempt, unless that person has in writing directed that dividends tax be withheld, or if the dividend is paid to a regulated intermediary. Similar provisions are in place for notification to be given to an intermediary concerning exempt status or entitlement to reduced withholding.

Liability ultimately with the beneficial owner

If the dividend tax has not been withheld and the beneficial owner is not an exempt person, the beneficial owner is liable for the dividends tax.

STC credits

Companies that have unutilised STC credits will be able to utilise these credits for a period of up to five years, after which entitlement to credit will lapse. However, credits will be allocated automatically and pro-rata to the total dividend and not, as previously, only to the portion of the dividend that is not exempt from the tax. It will be the responsibility of the company to notify the recipient in writing of the extent to which the dividend is offset by STC credits.

Companies will be deemed to have declared a dividend on the day prior to which the dividend withholding tax comes into effect. This will be the last dividend cycle under STC and will fix the balance of STC credits that a company may apply in favour of its shareholders. Thereafter, the STC credit pool will increase by the amount of notified STC offsets in its dividend accruals, and decrease by the allocation of STC credits to its dividend distributions. On the fifth anniversary of the introduction of the dividend tax the STC pool will be deemed to be zero.

The notification and management of the STC pool will place an added administration burden on companies and intermediaries.

Date for payment


The dividends tax must be paid not later than the last day of the month following the month in which the dividend has been paid, unless some other person has paid the dividends tax.

Refund of overpayments

If dividends tax has been overpaid, the beneficial owner may notify the person that has overpaid and claim recovery of the tax overpaid, which may be adjusted out of the next subsequent dividend withholding tax obligation of that person. Should recovery not have been effected within one year, application for refund may be made to SARS, provided that SARS will not refund any amount where application is made more than three years after payment.

Some of the implications

It would appear that SARS has pushed a great deal of the administration of the intended new tax onto the companies and intermediaries. The risk associated with tax administration in these entities may be expected to increase as a result. A secondary effect will be to benefit State revenue collection, in that it will gather approximately 0,9% of distributable reserves as additional tax after introduction of the new regime.



New passive holding company regime introduced

As an anti-avoidance measure, the taxation of passive holding companies (“PHC”) will come into being at the time that dividends tax is introduced. The driving force behind the introduction of this legislation is a perception that high net worth individuals can avoid dividends tax by housing their portfolio investments in a company and reinvesting the dividends.

Further, it appears to be a concern that income tax at individual rates can be deferred or reduced by investment of surplus cash by individuals via investment companies. It is contended by the legislature that the interest, having been taxed at 28% can be reinvested, and the after-tax residue will only incur additional withholding tax when and if it is eventually distributed.

The Revenue Laws Amendment Bill, 2007 introduces the new passive holding company regime.

Passive holding company definition

The definition imposes three basic tests:

Not an “excluded company”

The list of excluded companies covers listed companies, banks, insurers,

approved public benefit organisations, foreign companies and the new venture capital companies

Income test

The passive income of the company is greater than 80% of the gross income from other sources of the company and all other companies that form part of the same group of companies (as defined in section 41 of the Income Tax Act).

A PHC is taxable on its dividend income at the rate fixed annually by Parliament.

In this context

“passive income” is the gross income derived from financial instruments. This excludes rent, royalties and capital gains other than in relation to financial instruments.

“gross income” is as generally defined for income tax purposes, excluding royalties and

dividends from companies in which the company holds more than 20% of the equity and voting rights.

Ownership test

At any time of the year 5 or fewer natural persons who are residents together with connected persons in relation to such individuals must have held more than 50% of the participation rights.

Taxation of PHC

A PHC is taxable on its dividend income at the rate fixed annually by Parliament. In addition, a rate of taxation will be fixed by Parliament in respect of its other income. It has been indicated that the rate of tax on dividend income will be 10% and 40% on other income. In this respect the taxation rates are as would apply to a trust. The disadvantage that a PHC will have compared to a trust is that it is unable to mitigate the tax on capital

gains by distributing the gains to the members in the same year of assessment.

Taxation of dividends paid by PHC

Dividends paid by a PHC to its shareholders will be exempt from the dividends tax to the extent that the sum of that dividend and all dividends paid on or after the date of implementation does not exceed the sum of:

dividend income taxed at the rate prescribed for taxing PHC dividends; and

the taxable income taxed at the rate prescribed for other PHC income.

Administrative provisions

SARS has power to estimate the amount due if it considers that PHC tax has not been paid in full. Interest and administrative penalties may be imposed in respect of late payment or underpayment.

Every person that controls or is regularly involved in the management of the overall financial affairs of PHC or an unregulated intermediary that is liable to withhold tax and that is a shareholder or director of that company is personally liable for the dividends tax, additional

tax, penalty or interest for which that company is liable.

Potential impact

Trusts will be taxed at the same rate as a PHC on their income. However, capital gains on the disposal of trust assets may be distributed to beneficiaries, reducing the potential tax exposure from 20% to a maximum of 10%. It is also considered unlikely that PHC's would be considered attractive to high net worth individuals, even in the absence of the proposed new legislation. The main reason is that investment in financial instruments is typically made to generate capital growth. The estate duty implications of this growth would generally militate against the widespread personal ownership of investment companies.

The tax-deductibility of legal expenses

South Africa's Income Tax Act is not, in general, conspicuously generous toward taxpayers where the tax-deductibility of expenditure is concerned

One exception is the statutory provision for the deductibility of legal expenses, namely section 11(c) which states that, in determining the amount of taxable income from carrying on a trade, a taxpayer is allowed to deduct –

“any legal expenses ... actually incurred by the taxpayer during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade [other than expenditure of a capital nature].”

The significance of this formula is that, unlike deductions claimed in terms of the general deduction formula in section 11(a), the taxpayer need not show that the legal expenses were incurred “in the production of income”, that is to say, were incurred with the intention of producing an inflow of funds. He need merely prove that the legal expenses were incurred in respect of a claim –

“arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade”

which is a much easier test to satisfy than the intention to produce income.



Thus, for example, legal expenses incurred in defending a legal claim (that is to say legal expenses which, in the nature of things, cannot produce income but, at best, can merely avoid having to pay money to the plaintiff) will qualify for deduction, provided the other elements of section 11(c) are satisfied, notably that they were incurred by the taxpayer “in the carrying on of his trade”.

Also significant in this regard is that the draconian section 23(m), which bars a

wage or salary-earner from claiming any but a narrow band of expenses as tax deductions specifically provides that it does not apply to expenses claimed under section 11(c), quoted above.

A wage or salary-earner is considered to be “trading”

It seems that a salary or wage-earner carries on a “trade” (see *KBI v van der Walt* 1986 (4) SA 303 (T) at 308F) and thereby fulfils this prerequisite of section 11(c).

Consequently, in South Africa, a salary or wage-earner who incurs legal expenses in defending himself in work-related disciplinary proceedings would (it is submitted) be entitled to deduct such expenses in terms of section 11(c).

By contrast, in the recent Australian decision in *Commissioner of Taxation v Day* (2008) 243 ALR 448, it took the Federal Court of Australia twenty-three pages of agonizing to decide whether such legal expenses were deductible under the general deduction formula of Australia's Income Tax Assessment Act.

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