


# Synopsis

April 2009

Tax today\*

Communicating tax information in  
today's business environment

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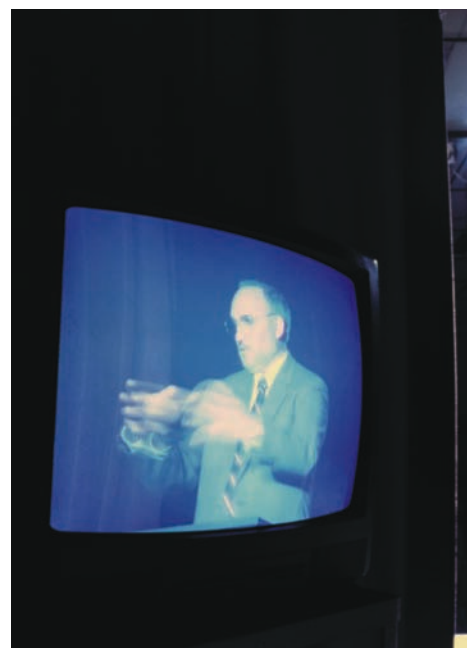
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# Communicating tax information in today's business environment

Over the last few years there has been significant change in the global tax environment, calling for more effective communication between the tax function and stakeholders. Few can overlook the scandal at the turn of the century, where the lack of disclosure of exposures to tax-driven off-balance sheet structures contributed to the demise of Enron. Tax authorities and the investment public have become more sensitive to the tax strategies and tax profile of large business entities. The enforcement environment is becoming more effective, and the investment community is becoming more aware of the effect that



*There is a clear desire for increased transparency and stakeholders want to understand a company's tax strategy and how that strategy is being implemented and sustained.*

disputes between companies and tax authorities may have on market sentiment towards an investment.

There is a clear desire for increased transparency in relation to tax matters and stakeholders want to understand a company's tax strategy and how that strategy is being implemented and sustained by the board and management.

Companies, in their turn, need to be in a position to respond to this heightened interest. This involves consideration of the objectives that they wish to achieve through tax communication, identification of the stakeholders to whom the communication should be directed, prioritisation of audiences and the nature and frequency of communication. Stakeholders will be internal as well as external, and the nature of the communication will differ significantly from group to group.

Internally, communication will tend to emphasise recording and reporting, whereas external communication will focus more on the identification and management of tax risk.

The board of directors is a critical element of the communication process. While the board is not likely to formulate the company's tax strategy, it plays an important oversight role and would be expected on a regular basis to review and evaluate the strategy and its effectiveness. It would need to consider, amongst other things, risk and reward, reputational risks, effectiveness of controls and risk management.

In the control environment, the board will need to be satisfied not only that there are appropriate controls in place, but that they have been implemented and are effectively maintained.

# Farewell to stamp duty

A recent media release from the South African Revenue Service announced the abolition of stamp duty with effect from midnight on 31 March 2009.

The payment of stamp duty (which had been a feature on the fiscal landscape for some 40 years) had been progressively eliminated over the past few years, partially by the introduction of alternative tax proposals for the taxation of transactions in marketable securities and by the removal of stamp duties on a variety of other transactions. Duties on leases, the final dutiable transaction, were abolished with effect from 1 April 2009.

It should be noted, however, that obligations to pay stamp duty that arose on or before 31 March 2009 have not been abolished, and taxpayers remain liable in respect of any such obligations.



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## Communicating tax information in today's business environment (continued)

When it comes to external communication, there is a growing demand for greater transparency. Traditionally, tax functions have been cautious about disclosing detailed information concerning their tax strategy or tax charges or liabilities in financial statements for fear that this might invite increased scrutiny, particularly from revenue authorities. This view is being increasingly challenged by stakeholders

who question whether the risk of increased disclosure outweighs the benefit of increased transparency.

Companies should not underestimate their overall contribution to state revenue coffers. They are not only taxpayers in their own right. They are an important element in the collection and recovery mechanism for employees' tax, employment related levies and indirect

taxes and levies. As such their total tax contribution is significantly greater than reflected in their published financial statements. Communication of total tax contribution provides an opportunity to engage effectively with tax authorities on policy and procedure to create a system that streamlines the processes and reduces the compliance burden.

# The new 100% deduction for investment in approved venture capital companies

Section 12J of the Income Tax Act, which provides for a deduction in respect of expenditure incurred in exchange for the issue of venture capital company shares comes into effect on 1 July 2009.

## Background

In terms of general principles, an investment that takes the form of the acquisition of shares in a company is not tax-deductible expenditure for the investor; that is to say, the person who purchases or subscribes for the shares, unless that person is a share-dealer, in which event the shares are trading stock and the cost of acquiring them is deductible in terms of section 11(a) of the Income Tax Act (which deduction is deferred until realisation by virtue of the trading stock provisions).

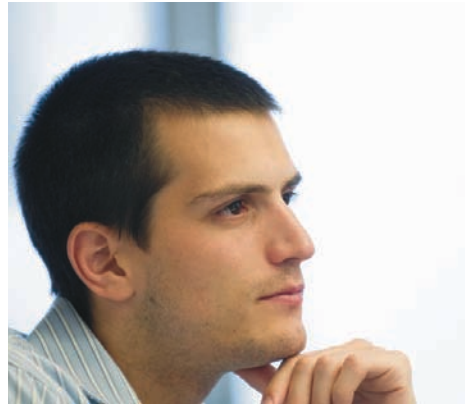
Nor is a company that issues shares taxable on receipt of the moneys it receives as a contribution to its share capital in consideration for the shares.

## Lack of access to equity finance by South African small businesses

Historically, small and medium-sized businesses in South Africa have had difficulty accessing equity finance, partly because of a lack of expertise on their part in locating potential investors, and partly because the business risks in this sector of the economy have tended to discourage investors.

These factors have impeded growth in the important small business sector of the national economy.

In order to assist small and medium-sized businesses to gain access to capital needed for their formation and growth, section 12J (inserted by the Revenue Laws Amendment Act 60 of 2008) provides a generous tax incentive for individuals and certain kinds of



companies to invest in venture capital companies that will in turn provide finance to the small business sector of the economy and to junior mining companies.

## The new deduction for investment in SARS-approved VCCs

The tax incentive takes the form of a 100% deduction of the amounts invested, in other words, amounts contributed to the VCC in consideration for subscribing for shares in the VCC.

For individual investors, the deduction is subject to a ceiling of R750 000 per tax year and a life-time deduction limit of R2.25 million, but refreshed by the amount of any recouped expenditure.

Listed companies and their 70%-held controlled group companies can qualify for the section 12J deduction, but other unlisted companies and trusts do not qualify; the latter disqualification prevents individuals from overcoming the R750 000 ceiling by making investments through companies and close corporations controlled by them.

There is no tax deduction for shares acquired in a VCC otherwise than by way of a subscription for shares, for example, by purchasing the shares from an existing shareholder.

For the purposes of section 12J, a "venture capital company" means a company that has been approved as such by the Commissioner, who issues a certificate to this effect.

A VCC is intended to be a marketing vehicle to attract retail investors. Such a company has the benefit of bringing together small investors, as well as concentrating investment expertise for the benefit of the small business sector. The controlled VCC environment also offers protection to investors by providing for liquidity and a balancing of risks in small business portfolios.

## The essential nature of a venture capital company

The essence of a venture capital company is that it does not itself carry on an active business, but instead opens a fund (that is to say a pool of money provided by the persons who take up shares in the VCC) that the VCC then invests in other businesses.

Typically, a VCC will choose a particular investment profile so that persons who subscribe for shares in the VCC know what kind of businesses their money will be invested in. Usually, the VCC invests its entire fund in a spread of companies within the chosen profile in the expectation that the VCC will liquidate all of its investments in about three to seven years, in other words, within the usual

time frame in which a successful business will experience substantial growth.

Some of the businesses in which the VCC invests will inevitably fail, but others will prosper. When the VCC sells the shares in the companies whose shares it has acquired, the VCC will, if all goes according to plan, show an overall profit.

Where a VCC invests its funds, it takes shares in the company in which it is investing. Sometimes, it will also take a measure of control over the company by having seats on the board of directors, or by contractual arrangements in which large transactions will need the VCC's approval. In many instances, a VCC offers expertise by way of business advice, or business contacts, as well as just money.

In the South African context, a lack of access to equity finance by small and medium-sized businesses and by junior mining companies was perceived to be an impediment to the growth of this important sector of the economy.

One way of addressing this problem would have been for the state to provide loan finance, but that would have been an unwelcome drain on state resources.

It was, therefore, decided to attempt to harness investment capital available within the private sector by providing a tax incentive by way of a tax deduction for individuals and certain companies to invest in approved private venture capital companies.

## Section 12J

Section 12J is available only to VCCs that invest in the small business sector (other than those engaged in

“impermissible trades”) and in junior mining companies

In order to ensure that VCCs that are accorded SARS-approval provide finance only to sectors of the economy that the state wishes to encourage, section 12J provides that the tax deduction is not available if the venture capital company invests its capital in companies which carry on an “impermissible trade”.

The statutory definition of this term encompasses not only companies carrying on the kinds of business typical of the wealthier sector of the populace who need no fiscal support or encouragement, such as legal services, tax advisory services, auditing and banking, but also those types of businesses which the state does not particularly wish to foster, such as gambling and the supply of liquor.

Also included in the definition of “impermissible trade” is a trade carried on in respect of immovable property, other than as a hotel-keeper. Thus, a VCC that has been given SARS approval under section 12J cannot take up shares in property companies, save those that operate hotels, including bed and breakfast establishments.

Section 12J contains further provisions intended to ensure that, within 36 months of being approved by SARS as a venture capital company for purposes of section 12J, the VCC channels 90% of its investment capital into small and medium businesses or junior mining companies.

Thus, section 12J requires that an approved VCC must derive at least 90% of its income from financial instruments and from services rendered to a

qualifying company, for example, where the VCC provides expert advice, as well as share capital, to the companies in which it invests.

The intention is thus that an approved VCC cannot itself carry on an active business, save as an adviser to the companies in which it invests.

Section 12J requires that an approved VCC must channel its investment capital into “qualifying shares”, that is to say the shares of “qualifying companies”.

Moreover, at least 10% of the VCC's investments must be in shares of qualifying companies whose assets have a book value not exceeding R5 million, and 80% of the VCC's investments must be in shares of companies that hold assets with a book value not exceeding R10 million.

In order to prevent a proliferation of small VCCs from springing up, which would be difficult for the state and SARS to monitor, section 12J requires that, to gain the tax benefits of the section, the investment of the VCC in qualifying shares must total at least R30 million or, where the VCC invests in a junior mining company, at least R150 million.

## Reporting requirements

Section 12J foreshadows stringent reporting requirements to ensure that approved VCCs cannot abuse the tax incentives provided by section 12J, for example by using the money invested in them to make disguised loans.

Thus, a VCC will be required, not only to submit an annual return to SARS containing prescribed information, but must also submit a report to the Minister of Finance.

# ‘Clothes make the man’ but not the transaction

A body of law has developed which, correctly, states that where parties to a transaction intend a particular result, but clothe the transaction in some other form, the courts will disregard the form of the transaction and give effect to the original intent.

## Origins in SA tax law

The conflict between taxpayer and tax gatherer in this regard goes back nearly 70 years to the celebrated and oft-cited case of Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd 1941 AD 369. Here, an importer had carried on business by importing fabric which it then sent to a cut, make and trim subcontractor, who, for a fee, produced garments from the cloth which the importer then sold. The importer enjoyed a rebate of import duty. A change in regulations required that the rebate would not be given unless manufacturer was the owner of the imported goods. The importer therefore entered into a contractual arrangement in terms of which the imported fabric was sold to the erstwhile subcontractor and the finished goods were sold back at a price equal to the cost of the fabric and the fee previously charged for making the goods. The Commissioner contended that the purported purchase of the fabric and the sale of the garments were shams designed to gain access to the rebate and that the fabric was not in reality the property of the erstwhile subcontractor.

The Court in that matter found as a fact that the parties intended that ownership of the fabric should pass from the importer and that the erstwhile subcontractor was the owner of the fabric at the relevant time, with the result that the rebate was properly claimed.

## Recent disputes

Two recent decisions, also related to import duties, have cast further light on the question of simulation of transactions.

### • *The minibus case*

In 2006, SARS succeeded in the Supreme Court of Appeal (*C:SARS v*



*Motion Vehicle Wholesalers (Pty) Ltd* [2007] 4 All SA 1207) in establishing that the importation of motor vehicles, manufactured as eight-seater vehicles, but modified prior to importation by the repositioning of the third row of seats and addition of two seats in the luggage compartment so that they could ostensibly carry ten or more passengers, was a simulated transaction. Subsequent to importation of the vehicles, the two additional seats were removed from the luggage compartment by the importer and shipped back to the modifier (to be attached to subsequent imported vehicles) and the third row of seats was restored to its original position, after which the vehicles were sold as eight-seater vehicles.

The Supreme Court had no difficulty in concluding that the modifier and the importer had “attempted to disguise vehicles designed for the transport of eight persons as vehicles designed for the transport of ten or more persons, solely for the purpose of evading higher customs duty”.

### • *The plasma screens case*

In a matter decided in 2009, in the High Court in Gauteng, a dispute arose over the importation of two items which, when combined, became a television set. An Asian manufacturer produced plasma

screens and television tuners as separate items. The screens could be used either as display screens without the insertion of the television tuners, or, when the tuners were inserted, as television sets. The tariff heading under which the screens were imported entitled the importer to a rebate of import duty, which could not have been claimed had the screens been classified as “television sets” or “incomplete reception apparatus”.

SARS contended that the facts in this matter were identical to those in the Motion Vehicle Wholesalers Case, alleging that the screens and tuners were in reality television sets that had been deliberately separated to enable the screens to be imported under a tariff classification that afforded access to a rebate of duty.

Factually, it could be demonstrated that:

the manufacturer distributed the screens and the tuners as separate items worldwide and did not manufacture plasma screen television sets as such,

the tuners, owing to their lightness and compact construction, were packaged and imported in bulk by airfreight, whereas the screens were imported by sea;

the importer sold tuners and screens as separate items and did not itself combine the items for sale as television sets; and

the screens could be used for display purposes in business premises or public places without the installation of the tuners.

On this evidence, the Court was able to conclude that the facts before it were not analogous to the Motion Vehicle

# Interest on refunds of taxes overpaid

Companies, as provisional taxpayers, are obliged to pay provisional taxes, which are payments on account of the liability that will ultimately be assessed. Two compulsory payments of the estimated liability are made in respect of each year of assessment (at half-year and year-end), and taxpayers are entitled to make a subsequent “additional payment” to mitigate their exposure to interest in the event that the earlier payments should be considered to be less than the final anticipated liability. Should it transpire, on assessment, that the final liability is less than the amount paid, the excess becomes refundable with interest (as provided in section 89quat of the Income Tax Act).

This entire process came under close scrutiny in the matter of *KNA Insurance and Investment Brokers (Pty) Ltd (in liquidation) v SARS and C:SARS* (Case No. 15330/05, North Gauteng High Court, judgment delivered 17 April 2009). The principal dispute related to whether SARS was liable to pay interest in terms of section 89quat of the Income Tax Act.

In this instance, the company had been operated fraudulently by a director with the result that, in the year ended 31 March 1999, it had sustained a loss. The director had nevertheless informed the company’s auditor (who apparently assisted the company with its income tax compliance) that the company had made a substantial profit. The company,

on the auditor’s advice, made an additional payment of provisional tax of R6 300 000 not later than 30 September 1999 to avoid exposure to interest on underestimation of its income tax liability for the year ended 31 March 1999.

The company was placed in liquidation. The liquidator asserted that the payment of R6 300 000 had been made in error and claimed a refund of this amount from SARS. In 2002, after negotiation with the liquidator, SARS agreed to refund the amount of R6 300 000, before the company had filed a return of income for the relevant year of assessment and without making an assessment. However, no interest was paid, and after the liquidator’s demand for payment of the interest was refused, application for an order compelling payment was brought.

The liquidator’s case was simply that the company had made a payment of provisional tax of R6 300 000, the company had no liability for the year of assessment and as a result tax was overpaid and became refundable with interest.

SARS argued that the payment of R6 300 000 was not a payment of provisional tax. It based its case on the matter of *Commissioner for Inland Revenue v Bowman* NO 1990 3 SA 311 (SCA) in which it had been found that payments made in respect of amounts of

fictitious income could be recovered by a liquidator as a disposition for no value. In fact, it said, no tax was ever legally payable, and the payment had been procured by the director’s fraudulent misrepresentations to the auditor in order to cover up the director’s fraud. The company therefore never intended to pay provisional tax. It had therefore agreed to refund the moneys on the basis that it had been unjustly enriched and not because the company had overpaid tax.

The Court, placing reliance on averments in the liquidator’s application that the payment of R6 300 000 had been made “without any legal liability” to do so, found that the payment could not “by any language, be termed a payment of provisional tax as defined...”

The liquidator was accordingly found not entitled to the payment of interest in terms of section 89quat of the Income Tax Act.

It is interesting to consider whether the outcome may have been different had the liquidator merely filed a return of income and awaited a refund instead of making a request for refund in respect of an erroneous payment.

Wholesalers matter. As a result, the Court rejected SARS’ contentions and found that there was no evidence that the separate manufacture, importation and sale of the two components was a stratagem designed to evade customs duty payable on the importation of television sets. It was held that the screens were designed to serve more than one market, namely the domestic

television market and the commercial market (as display screens without the incorporation of a tuner), and that they had been correctly classified by the importer under a tariff heading that entitled the importer to a rebate of duty.

The Court also supported an application by the importer for a punitive costs award against SARS, awarding costs on

the attorney and client scale, finding that the relevant officials had acted in an unreasonable manner in this matter by repeatedly ignoring or rejecting evidence tendered to them by officials of the importer. This again emphasises the willingness of our Courts to come to the aid of taxpayers that suffer unreasonable treatment at the hands of State officials.

# Compensation for premature termination of a contract

## Lucid explanation of the distinction between contracts that form part of the income-earning structure and contracts that are related to income-earning operations

An hotelier, a close corporation, had managed to secure a lucrative contract with a South African company, in terms of which it undertook to provide accommodation over a period of approximately 2 years to successive intakes of non-resident “students” from the Middle East who were undergoing training in this country. Immediately following the 11 September 2001 attacks in the United States of America, and midway through the contract period, the students left and no further intakes were received. The hotelier negotiated a settlement for the premature termination of the contract with the South African principal and received a sum as compensation. A substantial portion of the compensation was applied towards the repair and replacement of premises and contents that had been damaged during the period of occupancy by the students.

The hotelier had claimed that the amount received as compensation was a capital receipt. SARS had assessed the amount to tax as a receipt of revenue. The Tax Court and the High Court had, in successive appeals, ruled against the hotelier which then appealed to the Supreme Court of Appeals (*Fourie Beleggings v C:SARS* (168/08) 2009 ZASCA 37 (31 March 2009)).

The hotelier’s case was founded on the basis that the contract was an asset of the business and that the amount that was received in compensation was a



payment for the loss or “sterilisation” of an income-earning asset and therefore should be regarded as a receipt of a capital nature. Three decisions in the South African courts were relied upon in support of this assertion.

The Supreme Court of Appeal accepted that, in certain cases, an amount paid as compensation for the loss of a contract may be capital in nature, but hastened to add that, in the matters relied upon by the hotelier, the contracts had been used by the taxpayer for the purpose of generating income. The contracts in those cases had provided the taxpayers with the ability to derive income.

A distinction was drawn between a contract that is a means of producing income and a contract that is directed towards earning income. In the former case, termination of the contract would eliminate the source of the income, while in the latter case, on termination of the contract, the source of the income would remain intact.

The Court held [paragraph 15]:

“In the present case, the appellant traded as a hotelier before the contract and continued to do so, both once it had commenced and after it had been cancelled. The contract did not operate as a means by which the appellant generated business or through which it acquired business or obtained opportunities from which to earn income. It was merely a memorial of business the appellant had concluded, in which the number of persons it had agreed to accommodate, when that would take place and the rate that would be charged, were recorded. It may be that the appellant stood to earn a great deal from the contract which was to form the major source of its income during the period it lasted but that, and its anticipated duration of more than two years, did not transform it into part of the appellant’s income-producing structure. That structure was made up of its lease of the hotel and the use to which the hotel was put. The contract the appellant agreed with [the SA principal] was concluded as part of its business of providing accommodation. It was therefore a product of the appellant’s income earning activities, not the means by which it earned income.”

It was therefore held that the compensation received was of a revenue nature and that the assessment as such had been properly made.

This decision is a most useful addition to our tax law by virtue of the lucid explanation of the distinction between contracts that form part of the income-earning structure and contracts that are related to income-earning operations.