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SYNOPSIS

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In this issue

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Interim response to Discussion Paper on tax avoidance

Section 103 to be given a face-lift

SARS has released a 35-page "Interim Response" to its discussion paper on the proposed amendment of section 103 of the Income Tax Act.

The Interim Response contains a summary of comments received on the discussion paper from various individuals and entities, and SARS's reaction to those comments.

Overall, SARS has not changed its view that tax evasion is a serious problem, which is best addressed by a substantial revamping of section 103. It is clear from the Interim Response that this is also a widely-held view amongst the respondents.

Tax avoidance and tax evasion

On the hoary issue of the distinction between legitimate "tax avoidance" and impermissible "tax evasion", SARS says that "the term 'tax avoidance' has become hopelessly ambiguous in today's world, and "whether or not a simple dichotomy between 'tax evasion' and 'tax avoidance' has ever existed anywhere in the world, it certainly has not been the case for many, many years".

The preceding discussion paper explicitly recognised a taxpayer's right to mitigate or even eliminate tax liability through legitimate tax-planning. Indeed, this principle was recently affirmed by the Supreme Court of Appeal in *CIR v Conhage (Pty) Ltd* 1999 (4) SA 1149, 61 SATC 391.

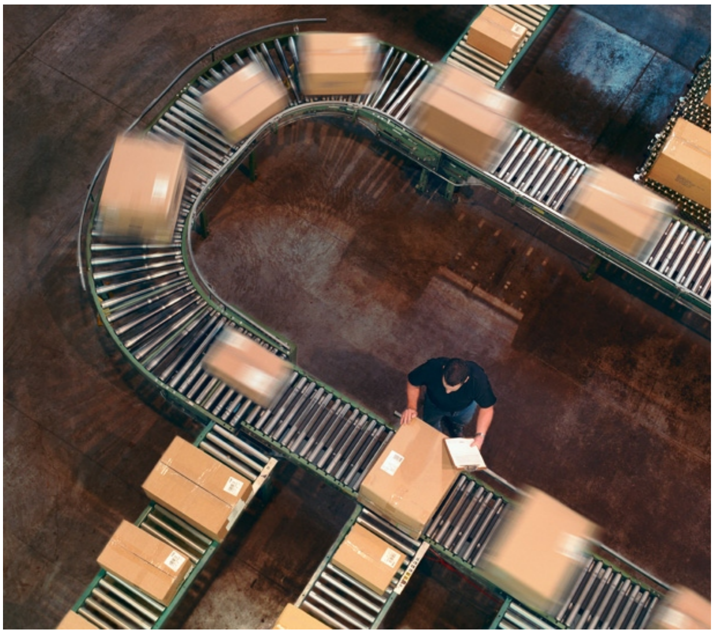
Proposed changes to the abnormality and purpose tests

A key aspect of the proposed revision of section 103 is that eleven non-exclusive objective factors are to be used in the determination of "abnormality", and there is to be a presumption of abnormality in circumstances where one or more of these factors is found. SARS concedes that many of these objective factors are already inherent in the present abnormality requirement, but is of the view that making them explicit will enhance clarity and certainty.

Two major changes are proposed to the present requirement that tax avoidance must be the sole or main purpose of the taxpayer in entering into the transaction, operation or scheme.

The first change would make the taxpayer's subjective purpose irrelevant, and instead require a determination of the purpose of the transaction from the standpoint of a "reasonable person". The second is to clarify how it would seek to apply the proposed new requirement that the avoidance of tax be the sole purpose or one of the main purposes. SARS has taken note of the concerns that have been raised in this regard, and says that one option may be to include a specific

"SARS and National Treasury would be left on an endless treadmill, always one or two steps behind the developments in the marketplace."



proviso that the requisite purpose would not exist "where tax avoidance is only an incidental, subsidiary or secondary purpose".

SARS has indicated its receptiveness to the proposal that an interpretation note should accompany the enactment of the new section 103, and says that it is "exploring the feasibility of a centralised body to review and approve the application" of the new provision as one way of ensuring consistency.

SARS indicates that it is not in favour of introducing additional specific anti-avoidance provisions rather than revamping section 103. SARS believes that, without an effective general anti-avoidance provision, It would be naïve to conclude that the proposed tightening of the application of section 103 is likely to relieve SARS from having to amend the Income Tax Act regularly, whether in response to judicial decisions or to interpretations by taxpayers which may conflict with its own interpretations. The general anti-avoidance provision is, by definition, not specifically targeted at particular transactions or practices, and the proposed amendments will not sharpen its focus. It will remain a back-up to targeted anti-avoidance provisions.

Promoters of tax avoidance schemes to be penalised

The proposal that penalties should be imposed on promoters of "abusive avoidance schemes" has elicited some anxious responses.

SARS acknowledges that the penalties should target true scheme promoters, and not tax advisers who, acting in their professional capacity, give advice for which they charge a time-based fee, and not a fee that is linked to the success or otherwise of the scheme in question.

SARS says that the word "penalty" is not intended to connote that the conduct in question will be criminalised, and suggests that the sanction could be expressed as "additions to tax" in terms of section 76 of the Income Tax Act.

Taxpayer's obligation to pay tax not suspended by objection or appeal

'Pay now, argue later' CAN be waived

A taxpayer's obligation to pay income tax due in terms of an assessment, against which he has lodged an objection or appeal is not suspended by that objection or appeal unless the Commissioner so directs; (section 88(1) of the Income Tax Act 58 of 1962).

The constitutionality of the "pay now, argue later" principle in matters of tax has been upheld by the constitutional court (see *Metcash Trading Ltd v CSARS* 2001 (1) SA 1109 (CC)) and is now beyond dispute.

The Commissioner's practice

Taxpayers and their advisers can take some comfort from the judgment in *Hindry v Nedcor Bank Ltd*, 1999 (2) All SA 38 (W), 61 SATC 163 at 181 which quotes from an affidavit filed by the Commissioner in which he said that –

"where it is merited by a particular case, I do not hesitate to suspend the payment of taxes as envisaged by s 88(1). I am particularly inclined to do so where the taxpayer provides me with adequate security."

The power of the High Court

The Supreme Court of Appeal has held in relation to the Value-Added Tax Act that "a court may, in the exercise of its discretion, withhold a winding-up order in respect of a deemed debt if it is shown that the debt is disputed on bona fide and reasonable grounds"; (Hawker Air Services (Pty) Ltd [2006] SCA 55 (RSA) at paragraph [21].)

The same principle, it is submitted, applies to a disputed income tax assessment.

The Supreme Court of Appeal vindicates SARS's actions

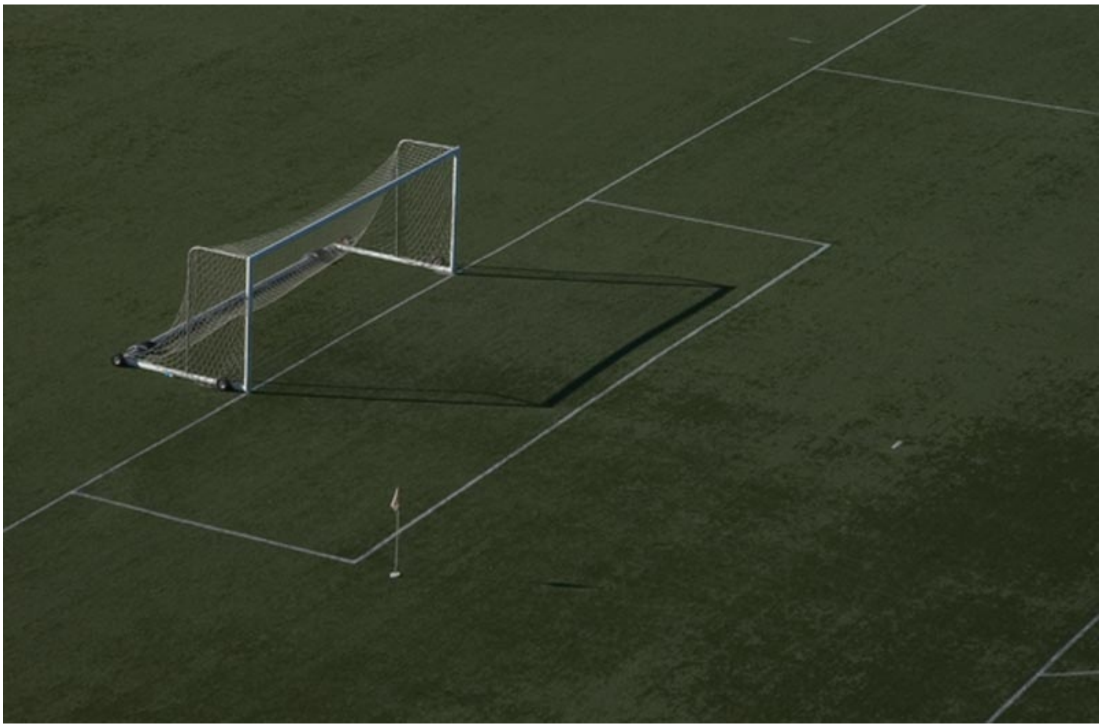
SARS wins this round

In the June 2005 issue of Synopsis we noted that, in CSARS v Hawker Air Services (Pty) Ltd (2005) 67 SATC 10, the Transvaal High Court had delivered a blistering criticism of SARS for "abusing the process of the court" in its attempt to recover the outstanding tax in this matter. The judge held, in effect, that SARS had acted in an "unprincipled" manner, had engaged in an "illegitimate punitive expedition" against the taxpayer and was guilty of a "misuse of fiscal power".

This unprecedented judicial slur on its competency and integrity gave SARS little choice but to take that judgment on appeal to the Supreme Court of Appeal. (The judge in the Transvaal High Court was so sure of the correctness of his judgment that he refused leave to appeal.) It is not surprising that, when the Supreme Court of Appeal's judgment – which fully vindicated SARS – was handed down on 31 March of this year, SARS immediately took out advertisements in the national press which named both the judge in the High Court matter and the principal taxpayer involved in this lengthy and highly publicised dispute.

Ulterior purpose and impermissible collateral challenge

It was of great importance for SARS to overturn (as the Supreme Court of Appeal has now done) the decision of the Transvaal High Court in regard to what constitutes an "ulterior purpose" and an impermissible "collateral challenge" in relation to actions taken by SARS to recover outstanding tax.



"There was thus no impropriety, ulteriority or impermissibility in SARS seeking to pursue its purposes through liquidation and sequestration proceedings".

There is no doubt that the law discourages repeated litigation of the same issues, except by way of an appeal. It is also well established that it is an abuse of the process of the court to mount a "collateral challenge" to a court order, by instituting fresh proceedings to try to secure an order that a court, in earlier proceedings, has already refused to give.

In this particular matter, SARS had obtained a court order that a certain aircraft (the only asset from whose sale the outstanding tax could be recovered) be returned to South Africa. That order had been suspended by an appeal. SARS had brought a further urgent application for an order that, notwithstanding the pending appeal, the aircraft must be returned to South Africa forthwith. This urgent application had been turned down by the High Court.

It was clear that what SARS was trying to do, in commencing further High Court proceedings for the liquidation of the company and of the partnership which owned the aircraft, was to compel the immediate return of the aircraft to South Africa. The Transvaal High Court held that this was an impermissible "collateral challenge", for it sought to achieve what the High Court had already refused to order in the earlier urgent application. Moreover, the High Court said that SARS was acting with an "ulterior purpose" in that the real purpose of the liquidation proceedings was to force the return of the aircraft to South Africa, despite the fact that it had failed, in the earlier proceedings, to persuade the court to make such an order.

The Supreme Court of Appeal overturned the High Court judgment

On appeal, the Supreme Court of Appeal (at paragraph [3] of its judgment) curtly brushed aside the High Court judgment, saying, "Though it is unnecessary to traverse all its findings, the judgment is incorrect and the criticism of the Commissioner and his staff unjustified."

On the crucial issue of whether the actions of SARS had constituted an impermissible "collateral challenge" conducted with an "ulterior purpose", the Supreme Court of Appeal held (at paragraph [22]) that there was "no merit" in these contentions, and went on to say that, "the real motive of SARS was plainly to collect VAT" and that the liquidation and sequestration applications, with their focus on securing the recovery of the aircraft, did not constitute an ulterior purpose. Nor were the applications for the liquidation of the companies and the partnership collateral challenges to the earlier refusal of the High Court to grant an interim enforcement of the order to return the aircraft; these applications were (said the court) legitimate measures entailing alternative means to achieve the same end. "There was thus no impropriety, ulteriority or impermissibility in SARS seeking to pursue its purposes through liquidation and sequestration proceedings".

In the result, the Supreme Court of Appeal set aside the order of the Transvaal High Court, and ordered the winding up of the company and partnership in question.

Practical pointers

The decision in *Tuck v CIR* 1988 (3) SA 819 (A) established the principle (which was not seriously in doubt, but which had never been authoritatively affirmed in South Africa) that an amount – in cash or otherwise – received by or accruing to a taxpayer in consideration for agreeing to a restraint of trade is of a capital nature, and thus not subject to income tax.

Judgment provides indicators for drafting a restraint of trade provision in which the consideration will be of a capital nature

With effect from 23 February 2000, paragraph (cA) of the definition of "gross income" in section 1 of the Income Tax Act 58 of 1962 provides that in relation to a natural person, labour broker, personal service company or personal service trust, "compensation for any restraint of trade" is included in the recipient's gross income – in other words, such amounts are deemed to be of a revenue and not of a capital nature.

Consequently, restraint of trade payments are effective as a tax-reduction strategy only for taxpayers outside of these categories.

Considerations when drafting a restraint of trade agreement

The decision in case 11100 (decided in the Pretoria Tax Court and not yet reported) concerned a restraint of trade payment received by an individual taxpayer prior to the coming into force of paragraph (cA). The judgment provides useful insights for tax planning in the restricted sphere in which a restraint of trade agreement still provides tax-saving opportunities.

In September 1998, the taxpayer, one of the key personnel of A (Pty) Ltd, had entered into service and restraint agreements with that company. In the restraint agreement, the taxpayer agreed that he would have access to the company's trade secrets and confidential information, and he undertook that he would not, while in the company's employ or for three years after leaving its employ, be involved in any similar business anywhere in the Republic.

The agreement went on to provide that, in consideration for this restraint, he would receive 120 000 non-voting ordinary shares in the company. The service part of the agreement recorded that the taxpayer would perform stipulated executive duties on a full-time basis for the company.

After entering into the restraint and service agreement, the taxpayer continued to receive the same salary as before.

Settlement agreement entered into for a potential delictual claim for damages

The value of the shares, received by the taxpayer, declined sharply in value. It was agreed that the taxpayer had a claim for damages in respect of misstatements regarding the anticipated value of the shares. To forestall litigation in this regard, it was agreed that the taxpayer "would be paid R1 million to compensate him for his loss" and that he would return the shares in question.

The judgment [at paragraph 24] found it unnecessary to decide whether the R1 million was paid in respect of the restraint of trade agreement or in settlement of a delictual claim for damages; on either basis, the payment was of a capital nature.

The major interest of the judgment for tax practitioners is the practical pointers which it provides for contractual draftspersons who are attempting to craft a restraint of trade provision in which the consideration will be of a capital nature.

- Firstly, the fact that **the taxpayer's salary remained the same** after he had signed the restraint of trade agreement was (although the judgment does not overtly make this point) corroboration that the consideration for the restraint was not a disguised payment of salary. Any tax-planner who is drawing a restraint of trade agreement would thus be well advised not to couple it with a salary sacrifice.

- A second issue is the **fundamental nature of a restraint of trade agreement,** in terms of which compensation is paid for the restraint. After all, if a taxpayer enters into an ordinary service agreement in terms of which he is to work 9 to 5 for an employer, this necessarily restrains him from working for anyone else during those times. The court seemed to accept that such a restraint is merely incidental, and that all of what is paid to the taxpayer in such circumstances would be for the rendering of services, and hence would be income.

- It is thus vital, when drafting a contractual restraint of trade clause, to make **a clear differentiation** between what is paid for services, and what is paid for the restraint.

- The judgment highlights the point that (which does not seem to have been clearly articulated in previous judicial decisions) that in any employer-employee relationship, the common law imposes duties on an employee not to compete with or cause harm to the employer. A contract will only qualify as a "restraint of trade" agreement if it **imposes restraints which go further than those common law restrictions** and imposes "a substantial derogation from [the taxpayer's] freedom to trade". This is an important factor for a contractual draftsperson to bear in mind when writing a restraint of trade provision.

In the judgment under discussion, it was held that the amount of R1 million accruing to the taxpayer was consideration either for the contractual restraint of trade or in lieu of his claim for delictual damages, and in either event was of a capital nature and not subject to income tax.

Accommodation provided to expatriate employee working temporarily in South Africa

Home and away

Generally, the Seventh Schedule taxes the cash equivalent of non-monetary fringe benefits provided by an employer to an employee. In a significant exception to this general rule, paragraph 9(7) provides that no rental value is to be placed on any accommodation –

"away from an employee's usual place of residence provided by his employer while such employee is absent from his usual place of residence for the purpose of performing the duties of his employment."

The meaning of the phrase "usual place of residence" is the focus of the decision of the Cape Town Tax Court in case 11253 (20 October 2005; not yet reported).

The taxpayer in this case was an employee of "A UK", a United Kingdom company, who was assigned to "A SA", a South African company, for a period of two years as from 1 July 2000. His period of assignment was thereafter extended by a further eight months, after which he left South Africa, and returned to live and work in the UK.

Whilst he was in South Africa, he was paid by A SA, and this company was obliged to provide him with residential accommodation for the duration of his assignment in South Africa.

In compliance with this arrangement, A SA leased residential accommodation in its own name and paid the rental whilst it was occupied by the taxpayer for the period of his South African assignment. The company added the rental to the taxpayer's salary, grossed this amount up to reflect a notional pre-tax amount on the basis of a 42% tax rate, then paid the net amount to the taxpayer and remitted the tax to SARS. This, the company believed, was the "safe" way to deal with the tax aspects of the accommodation provided to the taxpayer.

SARS assessed the taxpayer to tax on the rental that had been paid by A SA on the grounds that –

"those amounts were taxable in his hands in terms of paragraph (c) of the definition of "gross income" in section 1 of the Income Tax Act;

alternatively, that those amounts were taxable benefits in terms of paragraph 2(d) of the Seventh Schedule, read with paragraph (i) of the definition of "gross income".

The taxpayer objected to the assessment on the grounds that his "usual place of residence" was not South Africa and that, in terms of paragraph 9(7) of the Seventh Schedule, no value should be placed on the residential accommodation that had been provided to him.

" ....the place where he or she would naturally and as a matter of course return from his or her wanderings ... would be described more aptly than other places as his/her real home."

Did the taxpayer receive a housing allowance taxable under para (c)?

Was the value of the taxpayer's right to accommodation taxable in terms of paragraph (c) of the definition of "gross income"? This paragraph provides for the inclusion of –

"any amount … received or accrued in respect of services rendered or to be rendered … provided that the provisions of this paragraph shall not apply in respect of any benefit or advantage in respect of which the provisions of paragraph (i) apply."

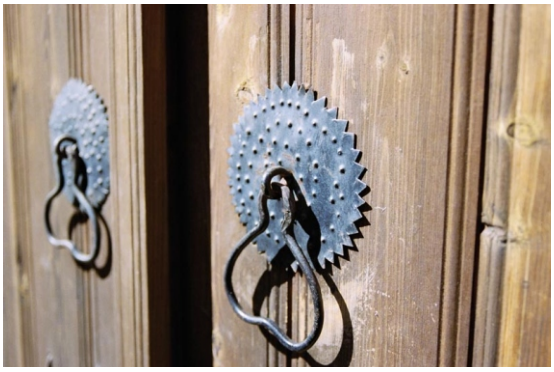
The court held (at para 17) that the taxpayer "did not receive nor was he entitled to receive any allowances" and that therefore paragraph (c) did not apply.

With respect, the conclusion on this point is right, but the reason is wrong. The true reason (it is submitted) why paragraph (c) did not apply is that what the taxpayer received (accommodation) was not an "amount" because it was neither money nor capable of being turned into money. (Compare *Stander v CIR* (1997) 59 SATC 212 (Cape Provincial Division).)

Was the accommodation to be assigned a nil value in terms of paragraph 9(7) of the Seventh Schedule?

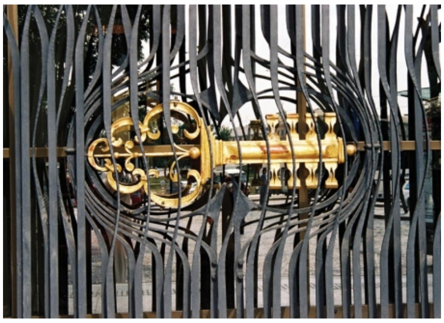
This question turned on whether the accommodation, provided to the taxpayer, was away from his "usual place of residence … while such employee is absent from his usual place of residence for the purpose of performing the duties of his employment".

SARS contended that, on the facts of this matter, the taxpayer's "usual place of residence" while rendering services to A SA was not the United Kingdom, but South Africa.



In seeking to interpret the phrase "usual place of residence", the court looked to the judgment in *CIR v Kuttel* 1992 (3) SA 247 (A) which held that "a person is 'ordinarily resident' where he has his usual or principal residence, ie what may be described as his real home".

The court in the present case held that it followed from the decision in Kuttel's case that a person's "usual place of residence", as contemplated in paragraph 9(7) of the Seventh Schedule, is "the place where he or she would naturally and as a matter of course return from his or her wanderings and it would be described more aptly than other places as his/her real home."



The court went on to hold (at paragraph [32]) that "a person's usual place of residence is synonymous with his/her "ordinary residence" which, on the facts of this matter, was the United Kingdom, as was evidenced by the fact that the taxpayer retained his home there whilst in South Africa and that he had returned to work and live in the United Kingdom.

The court pointed out that the taxpayer had not been transferred to new employment in South Africa; he had merely, for a temporary period, been allocated duties to another company for and on behalf of his principal.

The court said (at paragraph [36]) that SARS's practice of regarding paragraph 9(7) of the Seventh Schedule as applicable only to periods of 12 months or less was not acceptable. The period of time, said the court, "cannot be randomly determined" by SARS and legislative intervention may be required in this regard.

Is "usual place of residence" synonymous with "ordinarily resident"?

Conceptually, there may be difficulty in regarding a person's "usual place of residence" for the purposes of paragraph 9(7) of the Seventh Schedule as synonymous with the place where he is "ordinarily resident" for the purposes of the definition of "resident" in section 1 of the Act.

A taxpayer's "ordinary residence", in the context of the definition of "resident", is determined as being a particular country, namely the country to which he intends to return from his wanderings and which is his real home.

By contrast, a taxpayer's "usual place of residence" for the purposes of the Seventh Schedule, (it is submitted) was intended to indicate a particular place of abode, which need not necessarily be the country where he is "ordinarily resident".

Thus, it is submitted, it is readily conceivable that a taxpayer could have a "usual place of residence" in South Africa without being "ordinarily resident" in this country, because he intends in due course to return to another country which is his real home.

One of the issues in the case under discussion was the fact that the taxpayer retained his UK home while in South Africa. The Court thus had to take account of the fact that the taxpayer had more than one place of residence available to him, and to make a decision as to which of these should be regarded as his usual place of residence. In the absence of this factor, the mere fact that the taxpayer was not "ordinarily resident" in South Africa might not have been regarded, in principle, as a bar to his having a "usual place of residence" in South Africa.

The real issue (it is suggested) was whether living in employer-provided accommodation for somewhat in excess of two years was a long enough period to make that accommodation the taxpayer's "usual place of residence" for the purposes of paragraph 9(7) of the Seventh Schedule.

This matter serves to demonstrate that it is not always possible to prescribe with precision the circumstances in which a particular provision of the law might apply. The Court was called upon to determine where the employee's usual (customary or habitual) place of residence was situated. As the law provided no criteria within which to limit or confine its determination, the Court was justified in examining the full spectrum of circumstances in coming to its decision.

In this regard, the laying down of a criterion for a "usual place of residence" in the form of an arbitrary time period would make for certainty and consistency, but this is more appropriately done by Parliament than by rules of practice laid down by SARS.

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PricewaterhouseCoopers is pleased to announce the launch of a new service, ***Tax Technical Training for Taxpayers***, aimed specifically at those responsible for their company's tax affairs.

Training will initially be presented in Cape Town and Johannesburg.

Training Topics and Dates for 2006

Wed 31 May Thurs 1 June	Cape Town Johannesburg	**Fixed Assets** - Capital allowances, recoupments, capital gains tax, roll-over relief, intellectual property, interest, leasing.
June 2006 (date to be advised)	Cape Town only	**International Transfer Pricing** - A high-level full day 'specialist' seminar. Date and course fee to be confirmed.
Tues 4 Jul Thurs 6 July	Cape Town Johannesburg	**Employers and Directors** - Employees' tax compliance, company cars, travel allowances, medical aid, other fringe benefits and allowances, pension deductions, directives, foreign employees, employee share schemes.
Tues 1 August Thurs 3 August	Cape Town Johannesburg	**Shares and Shareholders** - Dividends, STC, corporate group relief, CGT on share disposals, loan waivers, liquidations, hybrid instruments, foreign equity instruments.
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Thurs 5 October Thurs 12 October	Cape Town Johannesburg	**Small businesses and individuals** - Exemptions, small business corporations, provisional tax, basic VAT, basic CGT
Tues 7 November Thurs 9 November	Cape Town Johannesburg	**Update - Case law and Interpretation Notes** - An update on the most recent tax cases and SARS Interpretation Notes
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As an introductory offer for 2006, the fee for the training seminars will be R570 (including VAT) per person. The only exception is the full-day specialist Transfer Pricing seminar scheduled for late June; the exact date and cost for this will be confirmed closer to the time.

For further information and bookings contact:

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