

Synopsis

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Tax today*

Which group company is saddled with a recoupment of previously-deducted tax allowances?

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'Group' taxation ruling proves costly to SARS

An "extra-statutory arrangement" does not alter the fundamental principles vis-à-vis the recoupment of deductible expenditure

The decision of a full court of the Cape High Court in *CSARS v Wooltru Property Holdings (Pty) Ltd* [2008] ZAWCHC 44 (judgment given on 7 August 2008) provides valuable guidance as to which company in a group is saddled with a recoupment of previously-deducted tax allowances in circumstances where SARS has consented to the filing of a consolidated income tax return and the group has undergone rationalisation.

An agreement of lease had been concluded between the Municipality of Cape Town and the Wooltru group of companies on 23 March 1982.

In terms of the lease, one of the subsidiaries in the Wooltru group, namely Wooltru Properties (Pty) Ltd – which was subsequently renamed Wooltru Property Investments (Pty Ltd – had acquired leasehold rights over a certain site known as "Mayor's Garden" on which the group's headquarters in Cape Town were situated.

Wooltru Properties was required to effect certain leasehold improvements to the leased property after which it claimed deductions totalling some R24 million for this expenditure in terms of section 11(f) and (g) of the Income Tax Act 58 of 1962.

Following a rationalisation by the Wooltru group, there was a transfer of the leasehold rights from Wooltru Properties to Wooltru House Properties (Pty) Ltd. Thereafter, the latter company, being now the holder of the leasehold rights, claimed similar allowances totalling some R26 million in respect of further improvements it effected to the leased property.

Wooltru House Properties went into voluntary liquidation, and the leasehold rights held by it were transferred to the group holding company, Wooltru Property Holdings (Pty) Ltd, as a liquidation dividend in specie at a value of some R82 million. This distribution constituted a receipt of a capital nature in the latter company's hands, and was thus not liable to income tax.

The latter company in turn disposed of the leasehold rights to a third party for R100 million.

The prior deductions for leasehold improvements had been recouped – but by which company?

SARS treated the last-mentioned disposal as a recoupment in terms of section 8(4)(a) of the Income Tax Act of expenditure totalling some R50 million, being the aggregate deductions claimed

In the result, the court reached a conclusion by applying one of the fundamental principles of tax law – that once income is received by or accrued to a taxpayer it forms part of his gross income for income tax purposes, and that no subsequent disposal of that income by the taxpayer can undo that fact.

for leasehold improvements, namely the aforementioned amounts of R24 million and R26 million.

Section 8(4)(a) provides that –

“There shall be included in the taxpayer’s income, all amounts allowed to be deducted or set off under the provisions of section 11 to 20 inclusive ... which have been recovered or recouped during the current year of assessment.”

The question was – which company in the group had recouped this expenditure?

SARS took the view that it had been recouped by the holding company, Wooltru Property Holdings.

The complicating factor in the application of section 8(4)(a) in this case was that, in the interim, SARS had approved a so-called “extra-statutory arrangement” with the Wooltru group whereby –

“the income and expenditure of the operating companies comprising the Wooltru property-owning sub-group within the Wooltru group of companies rendered a consolidated income tax return to [SARS] in the name of Wooltru Properties”.

This, the judgment tells us (at para [5]) was “resorted to as a practical method of reducing the tax compliance burden upon the sub-group of property-owning companies”.

The right to claim deductions in respect of leasehold improvements, which was initially held by Wooltru Properties,

passed, as a result of an intra-group rationalisation in terms of section 48 of the Taxation Laws Amendment Act 87 of 1988, to Wooltru House Properties.

The latter company had duly claimed and was allowed to deduct from its gross income expenditure totalling some R26 million in respect of further improvements to the leased property.

SARS’s approval of the rationalisation was conveyed by way of a letter which stated that –

“The current method of returning the income and expenditure of the subsidiary property-owning companies may continue and all the income and expenditure of the subsidiaries ... may be accounted for in the tax return of Wooltru Property Holdings (Pty) Ltd provided that, for each year of assessment, a balance sheet is nevertheless submitted for each of the affected subsidiaries.”

SARS took the view (see para [9] of the judgment) that the allowances previously granted to Wooltru Properties and the further similar allowances granted to Wooltru House Properties were recouped via the eventual sale of the leasehold rights to a third party and were recouped by the holding company, Wooltru Property Holdings.

The holding company, Wooltru Property Holdings, contended (see para [9] of the judgment) that no amount had been recouped by it, since it had neither claimed nor been granted, in its own right, any of the allowances in question

since these had been claimed by and granted to its subsidiaries.

SARS argued (see para [14] of the judgment) that the extra-statutory arrangement, agreed to by SARS whereby Wooltru Property Holdings was permitted to declare all the income and expenditure of its subsidiaries by way of a consolidated income tax return had the consequence that all income and expenditure reflected in the holding company’s returns had accrued to and been incurred by that company, and that its subsidiaries must be regarded as conducting business as its nominees or agents.

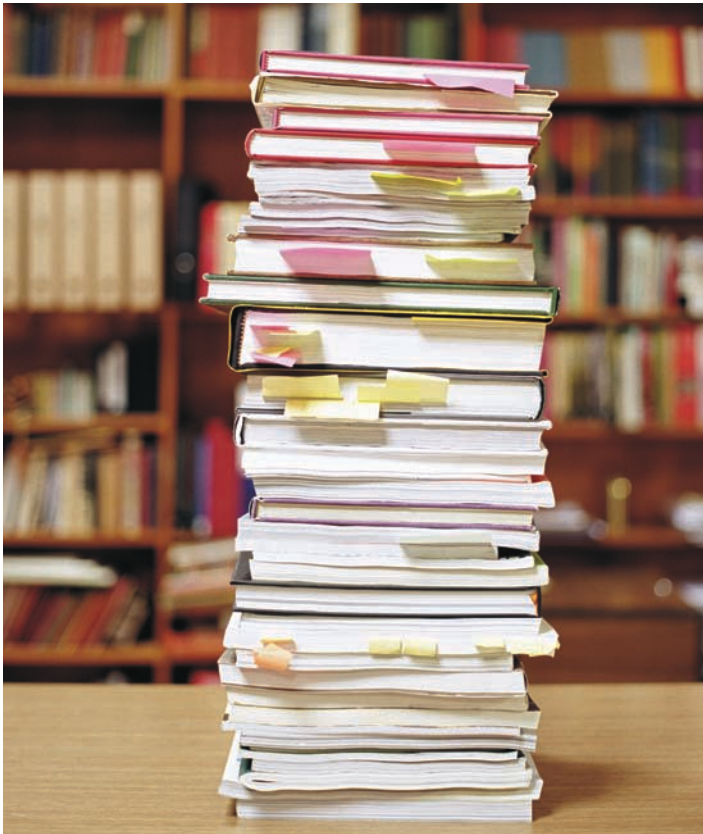
What was the effect of the consolidation in terms of the extra-statutory arrangement?

The court held (at para [18]) that, properly interpreted, SARS’s letter, quoted above, which allowed all the income and expenditure of the subsidiary property-owning companies to be accounted for in the tax return of the holding company, did not have the result that the income or expenditure of any of the subsidiaries ceased to be their income or expenditure.

Moreover, said the court (at [18]) –

“it was only after such income was received or had accrued and the expenditure had been incurred, that it was transferred to the holding company to be accounted for in the consolidated tax return.”

The court accepted that section 8(4)(a) of the Income Tax Act does not contemplate a recoupment of expenditure by a taxpayer where the latter was not the party who had incurred the expenditure.



It followed that, even after the extra-statutory arrangement was put into place, the subsidiaries continued to trade and derive income and become liable to tax (and entitled to deduct expenditure) in their own right.

The court said that there was no merit in the contention that, after SARS approved a consolidation of the accounts, the subsidiaries conducted business as nominees or agents for the holding company. Nor had they antecedently divested themselves of any income on which they would be liable to tax.

A fundamental tax principle resolved the case

In the result, the court cut through the tangle of facts and reached a conclusion by applying one of the fundamental principles of tax law, as laid down by the Appellate Division in *CIR v Witwatersrand of Racing Clubs* 1960 (3) SA 291 (A), 23 SATC 380, namely, that once income is received by or accrued to a taxpayer it forms part of his gross income for income tax purposes, and that no subsequent disposal of that income by the taxpayer can undo that fact.

In the current matter, the effect of the “extra-statutory arrangement” was that income had first accrued to the affected subsidiaries, thus fixing them with tax liability on that income, and the income was only thereafter transferred to the holding company.

Similarly, the subsidiary companies had incurred expenditure in their own right in effecting improvements to the leased property.

It followed, said the court (at [31]) that the subsidiary companies which had been granted the tax allowances for the leasehold improvements remained the entities in whose hands such allowances were recoupable.

The court accepted (at para [34]) that section 8(4)(a) of the Income Tax Act does not contemplate a recoupment of expenditure by a taxpayer where the latter was not the party who had incurred the expenditure.

In the present matter, the holding company had not been granted, in its own right, a deduction for expenditure on leasehold improvements and having not claimed such a deduction in its own right, it could not be liable for the subsequent recoupment of that expenditure.



In its basic form, the current determination of what constitutes a dividend is made by ascertaining whether the distribution results in a reduction in the retained income or in the contributed capital. If it is out of retained income (including capitalised profit), then, subject to certain limited exceptions, it is a dividend. If out of contributed share capital or share premium, it is a capital distribution. This is substantially similar to the basis applied under company law.

Tax and company law concept of dividend

The Draft Revenue Laws Amendment Act contains proposed new legislation that will potentially sever the tax concept of dividend from the company law concept. It is proposed is that the definition of what constitutes a dividend should in future be determined by reference to the “contributed tax capital” of a company. Any distribution, to the extent that it is not distributed out of contributed tax capital, will constitute a dividend for tax purposes.

Contributed tax capital is the aggregate of the tax base of all assets that are acquired by the company in exchange for shares. Under this concept, cash contributions would be recognised at full value. Shares issued in exchange for assets acquired at market value where the seller after the transaction holds less than 20% of the share capital will also be recognised at full value.

However, where the transferor of the assets acquires a 20% holding or greater in the transferee, different principles will apply. Here, to the extent that shares are issued to a seller and the seller is not liable to tax on the full market value of the shares, the untaxed amount will not be included in contributed tax capital. This

Draft legislation published for comment has shed light on Treasury’s intentions regarding the switch from secondary tax on companies to a dividend withholding tax and the base broadening that was presaged in the Budget Speech in February 2007.

Since the announcement in 2007, amending legislation has been passed, modifying the definition of what constitutes a dividend for tax purposes. These amendments continued to give effect to the common law concept of what constitutes a dividend, based on a well-developed body of precedent. To most this is seen as a sensible and supportable basis for understanding the nature of transactions in law and applying principles of taxation.

There is likely to be wide consultation by Treasury and SARS with companies and intermediaries before implementation, and there is every indication that the changeover will be efficient and effective.

would apply, for instance, where a resident company acquires assets from another resident company subject to rollover relief under the group reorganisation rules in the Income Tax Act. In such an event, the company is deemed to have acquired the assets at the base cost of the transferor, and the transferor is deemed to have acquired the shares at a value equal to the base cost of the assets that have been exchanged for the shares.

Notwithstanding that the transaction may have taken place at market value (namely, the market value of the shares issued is equal to the market value of the assets exchanged) the value of the share capital and share premium account for tax purposes will only be equal to the base cost of the assets acquired. If the company were in the future to reduce its capital by repaying share premium, then a portion of that distribution may be classified as a dividend, to the extent that it exceeds contributed tax capital.

The problem becomes more acute if the seller is not taxed in South Africa and holds more than 20% of the share capital. A non-resident holding company may wish to transfer shares in a number of companies under its control to a wholly-owned South African holding company (for instance to ensure a single entry into South Africa to facilitate the reorganisation of the South African group) in exchange for shares. If the non-resident is not subject to tax on any capital gain (because the companies are not property holding companies or by reason of an exclusion in a double tax

convention), the contributed tax capital becomes a matter of conjecture. Is it equal to the market value of the assets acquired or some other value? The draft legislation states that the value of the contributed capital should be equal to the base cost of the asset plus or minus any capital gain or capital loss, all determined in terms of the Eighth Schedule to the Income Tax Act. However, the assets fall outside the scope of the Eighth Schedule. It is understood that, in this case, the contributed tax capital should be equal to the market value of the shares issued, as the assets received in exchange only enter the SA tax domain once they fall within the scope of capital gains tax.

Dividend withholding tax

Hand in hand with the conceptual change, secondary tax on companies is set to disappear and be replaced with a dividend withholding tax. The proposal is that a 10% tax will be imposed on dividends. This tax will be collected at the point where the dividend leaves the corporate net. Dividends flowing between SA resident companies will be exempt. There is a wide range of persons who will be exempt from the tax, and a procedure is envisaged in terms of which they will be able to give notice of their exempt status to the entity that pays the dividend. It is also intended that companies should be able to utilise and recover credits for STC, although the precise mechanics are still under consideration. The proposal in the draft legislation envisages a compulsory credit of unutilised creditable STC dividends

against all dividends paid under the withholding tax regime (including those that are exempt from the tax), and that unutilised creditable dividends should be declared forfeit after the elapse of a period of three years.

Passive holding company

The final element of the changes will be the introduction of the concept of a passive holding company. This is a company that is utilised by wealthy persons to invest in shares and financial instruments and reducing tax cash flow by damming the receipts in the holding company. By such a manoeuvre, it is possible to pay tax on interest at the rate of 28%, as opposed to the 40% marginal rate applicable to individuals and avoid or indefinitely defer the 10% dividend withholding tax. The proposal envisages that companies that derive more than 80% of their gross income in this manner, and do not intend to expend the income in the conduct of an active trade should be taxed on their non-dividend income at 40% and dividends at 10%, but should thereafter not be subject to dividend withholding tax on distributions to their shareholders.

There are likely to be detail changes before the new law is implemented, but the conceptual basis now appears clear. It is pleasing to note that there is likely to be wide consultation by Treasury and SARS with companies and intermediaries before implementation, and there is every indication that the changeover will be efficient and effective.

A major setback for SARS in a tax-avoidance judgment

SARS has often complained that the anti-avoidance provisions of our Income Tax Act are inadequate to cope with sophisticated tax avoidance stratagems, particularly those involving complex financial arrangements.

The recent decision of the Johannesburg Income Tax Court in ITC 11345 (not yet reported; judgment handed down on 4 July 2008) may at first reading seem to corroborate SARS's view in this regard. We commented on the judgment insofar as it related to the substance of transactions for tax purposes in our July edition.

In this issue, we examine whether the outcome of this matter hinged on a strategic error by SARS in the legal route it took to challenge the arrangement in question.

The judgment identified the issues at stake as follows (emphasis added) –

“[16] The Commissioner's principal contention is that whilst the loan to the [taxpayer] has been represented by all the parties to the transactions as a loan of R96 415 776,00, in substance and reality it is a loan of R50 million. It argues that in consequence the [taxpayer] should only be allowed an interest deduction based on interest on a capital amount of R50 million with any excess disallowed, and that interest and a 200% penalty should be levied on the consequent underpayment of tax, *on the basis that the transaction involved deliberate simulation and intentional tax evasion*. ...

[17] ... the Commissioner contends that the tax returns rendered by the [taxpayer] contained incorrect statements ... to the effect that the transaction was a genuine commercial transaction and that portion of the deductions claimed in the [taxpayer's] tax returns for the years of assessment ending 1999 to 2003 were represented to be in respect of interest payable in terms of the promissory note payments, when in reality they were in respect of repayments of capital. Consequently the additional tax and interest were leviable.

[18] In the alternative, the Commissioner seeks to rely on an application of section

103 of the [Income Tax] Act. The submission is that the series of transactions constituted a “*transaction, operation or scheme*” as contemplated therein which had the effect of avoiding, postponing or reducing the [taxpayer's] liability for income tax in the 1999 to 2003 years of assessment, and should therefore be set aside.”

The court concluded that the taxpayer had discharged the onus of proving that its true intention was to contract with the bank on the terms reflected in the agreements to which it was a party, and that the taxpayer had intended to give effect to those agreements in accordance with what they said.

The court therefore set aside the additional assessments spanning the five year period of the loan.

SARS's alternative argument

SARS added a second string to its bow in arguing that the taxpayer should be entitled to deduct only interest on a loan of R50 million, not a loan of R96 million.

SARS contended that section 103 of the Income Tax Act (the general anti-avoidance provision) gave it the power to disregard any abnormal transaction that the taxpayer had entered into for the purpose of avoiding tax.

Under the new general anti-avoidance rules, it is now expressly provided that the anti-avoidance provisions may be invoked by SARS as an alternative for or in addition to any other basis for assessment.



Embarrassingly for SARS, it found itself checkmated on this argument.

The court held that it was not open to SARS to argue, firstly, that the loan agreement was a disguise and, secondly, to argue that it avoided tax.

The court pointed out that these arguments were mutually inconsistent, and that SARS must nail its colours to the mast one way or the other. Either the loan agreement was genuine or it was a disguise. SARS must make up its mind which of these propositions to argue for.

If the agreement was a disguise, then once the court penetrated the disguise and gave effect to the true underlying agreement, no tax was avoided.

If the agreement was genuine, then no tax had been avoided, for the taxpayer was entitled to the tax deductions arising out of the agreement.

In the current case, SARS had chosen to argue that the taxpayer had not succeeded in avoiding tax, because the loan agreement was a disguise, and once the disguise was penetrated, it was not entitled to the deduction it had claimed.

The court said that, having presented its case on the basis that no tax had in fact been avoided, SARS could not now argue that the taxpayer had indeed avoided tax and was caught by the anti-avoidance provisions of section 103.

It is indeed likely that this is not the last that will be heard of this dispute, and the matter may well be expected to come before the Supreme Court of Appeal. However, it is noteworthy that there are now new general anti-avoidance provisions in the Income Tax Act, which, had they been in effect at the time of the transactions under dispute in this matter, might well have resulted in a different outcome.

Under the new general anti-avoidance rules, it is now expressly provided that the anti-avoidance provisions may be invoked by SARS as an alternative for or in addition to any other basis for assessment. Had this provision been in force at the time, the Court in this matter would have been compelled to consider the application of anti-avoidance principles.