



Synopsis

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Tax today*

Cutting through
sham transactions

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Cutting through sham transactions



Business transactions invariably have a tax consequence. Depending upon the manner in which a transaction is implemented, the tax consequences may be optimised so that the net cost to the business is minimised. The question then arises whether the adoption of the most tax-effective alternative is a sham – a mere simulation to disguise the true intention – and whether the transaction can simply be ignored by the tax authorities and taxed on some other basis. This approach is frequently referred to as having regard to the substance of the transaction over the form.

Contractual sham

A recent and, as yet, unreported case in the Income Tax Court again raised the spectre of contractual sham. In this instance, a taxpayer that dealt in commodities required an amount of finance. A financier approached it with a proposal that it should borrow a larger sum for a fixed term at a fixed rate of interest and make repayment by delivering a defined quantity of a commodity at the maturity date at an agreed estimated future price. The interest was payable six-monthly in arrear over the term of the contract. A division of the financier was agreeable to entering into a forward purchase hedge with the borrower to deliver the required quantity of the commodity on the maturity date at the same future price. The agreements were entered into; the funds were advanced and the forward purchase was taken out.

The taxpayer claimed deduction of the interest as it was incurred, and, close to the maturity date requested the delivery of certificates of ownership of the commodity from the hedge counterparty to enable it to fulfil its obligation to deliver the commodity on maturity date. The financier claimed set-off of the reciprocal obligations to deliver and receive identical quantities of the commodity at the identical price. Set-off was applied and the obligation to repay the principal amount of the loan was extinguished.

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SARS disallowed the deduction of interest on the contract, claiming that the contract was a sham. It alleged that the parties intended to enter into a loan agreement for a lesser sum and that the contractual arrangements were a pretence that disguised this true intention. It asserted that the true intention was to borrow the difference between the principal and the forward purchase consideration, and that the interest on the principal amount was in effect the aggregate of the “true” principal loan and interest on that amount. To this end it placed reliance on the accounting treatment that its expert witness

testified should apply to the transactions, based solely on the cash flows that arose. It also pointed to a divergence between the forward delivery contracts and the terms of similar agreements traded on SAFEX or in over the counter deals as evidence that the forward agreements were not genuine.

On the accounting issue, the Court apparently considered that the legal substance of an agreement is not the same as its economic or commercial substance. The Court made the telling point that the approach of the accountant is different to that of

Historical perspective

From as early as 1941, the tax authorities in South Africa have attempted to set aside transactions that have the effect of avoiding a liability to tax as sham transactions. In the matter of *Commissioner of Customs and Excise v Randles Brothers and Hudson Limited* 1941 AD 369, a company adapted its transaction structure to ensure entitlement to a rebate. Whereas it had previously contracted with a manufacturer to produce garments from its materials, it now sold the materials to the manufacturer and purchased the finished garments. The economic effect of both transactions was identical, save that the first would have resulted in the denial of a duty rebate. The Court in that matter commented:

“[a] transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Court according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax.”

In 1996, in the matter of *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR* 1996 (3) SA 942 (SCA) the Supreme Court of Appeal held that a series of transactions were a sham, on the basis that the parties did not intend that they have effect according to their tenor, and that effect should therefore be given to what their intention really was. In that matter, a clause in a head lease entitled the lessee (a tax-exempt entity), in its discretion, to erect buildings on the leased property. The lessee, on the same day, entered into a sub-lease with a subsidiary of

the head lessor. In that sub-lease, the lessee (now sub-lessor) bound itself to erect certain buildings in accordance with a building contract and plans annexed to the sub-lease. The Supreme Court held that the real intention in entering into the head lease was that the lessee was obliged to effect the improvements, and that the head lessor was taxable on the value of those improvements.

SARS attempted to apply these principles in *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd)* 1999 (4) SA 1149 (SCA) in which a company that required finance for its business operations raised the necessary finance through a sale and leaseback transaction, in which it sold certain of its assets to a financial institution and then leased these back. This transaction was selected by the taxpayer as the preferred transaction because, in addition to raising the required cash, it offered substantial tax saving in comparison with a conventional loan. The assets to be sold were valued and, following conclusion of the agreements of sale and lease back, legal delivery of the assets to the financier was effected. SARS sought to set aside the transactions as a sham, asserting that the real intention was a loan of money and not a sale and leaseback. The Supreme Court found that the uncontradicted evidence was that the parties intended to enter into and implemented the agreements of sale and leaseback. In effect, the contracts were genuine.

Sham transactions

the Court. The purpose of the accountant is to give a fair reflection of a financial state, whereas the Court's purpose is to establish the true agreement on which to base a liability to tax. It cited with approval the statement of *Corbett CJ in CIR v Felix Schuh (Pty) Ltd* 1994 (2) SA 801 (A) that:

"... the court is concerned with deductions permitted in terms of the Act and not with debits or other provisions made in the taxpayer's accounts, even though these may be regarded as prudent and proper from an accounting point of view."

With regard to the second issue it was accepted that both parties to the forward sale transactions were experienced and major traders in the commodity, and that they were satisfied that the terms of the contracts were sufficiently explicit for the purposes of their transactions. In any event the taxpayer intended that it should deliver back whatever was required to be delivered under its forward purchase agreement. The risk therefore resided with the financier.

It was held, on the evidence, which was found to be reliable and credible, that the parties intended to conclude and implement the agreements in accordance with their tenor. Consequently the agreements were not a pretence, but seriously entered into with a two-fold purpose, namely to procure finance and to derive tax benefit.

It is to be expected that this is not the end of this dispute, as the matter will likely find its way to the Supreme Court of Appeal. Because the economic effect and the legal form in this matter are very clearly identifiable, it provides an opportunity for further clarity on the application of the so-called "substance over form" doctrine.

Challenging SARS's determination of an arm's length price

As a general rule, it is for the parties to a business deal involving a sale or the supply of goods or services to determine the price or the fee. For tax purposes, the payer will then be allowed to deduct the contract price, and the payee will be taxable on the contracted amount received.

However, where the parties to the contract are "connected persons" (for example, companies in the same group) and one of the parties to the transaction is a non-resident, the potential exists for them to shift the profits out of South Africa and into a low-tax jurisdiction by setting an artificial price or fee to be paid by or to the South African resident – so-called "transfer pricing".

To nullify this stratagem, section 31 of the Income Tax Act 58 of 1962 provides that where, in these circumstances, the price fixed in the contract is not the arm's length price (in other words, more or less than the price that would have been charged if each of the parties had been trying to drive the best bargain for itself), SARS can ignore the actual contract price and (for tax purposes) substitute the arm's length price. If SARS exercises these powers, it can have a major financial impact on the parties involved.

Frequently, the parties may wish to dispute SARS's determination of an arm's length price in substitution for the contracted price.

Is the taxpayer entitled to demand that SARS disclose what factors it took into account in determining an arm's length price? This is a crucial issue, particularly if the taxpayer suspects that SARS is hiding behind the rule that says that a tax assessment stands unless the taxpayer can prove it is wrong.

No judicial authority on this point exists in South Africa, but a recent decision of

the Australian courts provides interesting guidance.

Australian taxpayers cannot demand particulars of how the tax authorities arrived at their determination of an arm's length price

In *WR Carpenter Holdings (Pty) Ltd v Federal Commissioner of Taxation* (2008) 161 ATR 636 the Federal Court of Australia held, vis-à-vis Australia's similar counterpart to section 31 of our Income Tax Act, that this statutory provision does not impose an "incontestable tax", in other words, it does not allow the tax authorities to impose a tax consequence that the taxpayer has no way of challenging.

The court held that the way in which a taxpayer must challenge the revenue authority's determination of an arm's length price is to show that the true arm's length price is a lesser figure.

In other words, the taxpayer cannot seek to have the determination set aside by the strategy of demanding that the tax authorities explain their methodology in arriving at their figure for an arm's length price, and then shoot holes in that methodology. It is for the taxpayer to prove, affirmatively, what the correct arm's length price is.

The court ruled that the taxpayer has no right, in law, to ask the revenue authorities to disclose what factors they took into account in their determination of an arm's length price.

South Africa's PBO tax regime a superior model

If we look at overseas case law in which charitable and similar organisations have litigated with the revenue authorities in regard to a claimed exemption from income tax, it becomes clear that South Africa's tax-exemption regime for public benefit organisations – while not perfect – is a superior model.

Take for example the New Zealand case of *Wellington v Regional Stadium Trust v Attorney-General* [2005] 1 NZLR 250.

In this case, the Wellington City council had decided in 1994 to construct a new sports stadium, and established the Regional Stadium Trust as a charitable trust.

The question before the court was whether the trust was indeed a charitable trust and consequently entitled to an exemption from tax, or whether it was operating as a trading undertaking with the purpose of making a profit.

The weakness in the New Zealand tax regime is that the issue of tax-exemption is determined in hindsight. In other words, the professed charitable organisation first derives income, lodges a tax return in which it claims tax-exemption, and then the revenue authorities refuse to recognise it as a genuine charity, and assess it to tax.

South Africa determines tax-exempt status prospectively

By contrast, the strength of South Africa's tax-exemption regime for charitable and similar organisations is that the organisation must, in terms of section 30(3) of the Income Tax Act



apply, in advance, for the Commissioner's approval as a public benefit organisation.

It is then determined, at the outset, whether the organisation satisfies the statutory criteria for tax-exemption, *inter alia*, whether its sole or principal object is to carry on a "public benefit activity" as defined in the Ninth Schedule to the Act.

If the organisation fails to satisfy these statutory criteria, and the Commissioner declines to grant approval, the taxpayer has two choices. Firstly, it can restructure itself, by redrawing its constitution or taking whatever other action is necessary to bring itself within

the rules for tax-exemption, and then re-apply to SARS for approval as a public benefit organisation. This is usually the sensible and quick solution.

Alternatively, the organisation can challenge, in court, the correctness of the Commissioner's decision to refuse to approve it as a public benefit organisation.

In South Africa, the issue of tax-exemption is thus decided prospectively, not retrospectively.

Certainly, one can criticise the appropriateness of some of the statutory criteria that the South African Income Tax Act lays down for qualification as a public benefit organisation – but that is another issue.

At least the matter is determined in advance, and the organisation is not (as a general rule) faced with the difficulty that it first earns income and thereafter comes under challenge from the revenue authorities (perhaps on a technical point that could have been corrected if it had come to light earlier) as to its tax-exempt status, which it must then contest in the courts and, perhaps, face an unforeseen and unbudgeted tax liability, plus the expenses of the litigation.

Reportable arrangements – heading for a log jam?

The provisions in the Income Tax Act that were enacted in 2006 to bolster SARS's anti-avoidance arsenal in respect of compelling reporting of transactions that might require investigation by the South African Revenue Service came into effect from 1 April 2008. At the same time the Minister of Finance, by notice in the Government Gazette, specified the arrangements that are excluded from the requirement of reporting.

There are a number of situations where reporting may be required. These are arrangements where a tax benefit will be derived or will be deemed or assumed to be derived, and:

Where the cost of finance is wholly or partly dependent upon the tax treatment of a party to a transaction;

Where the transaction exhibits the following characteristics or characteristics that are substantially similar – round-trip financing, accommodating or tax indifferent parties or elements that are self-cancelling;

Where the transaction will be disclosed by any participant as giving rise to a financial liability under generally accepted accounting practice but not for tax purposes;

Where there is no reasonable expectation of a pre-tax profit for any participant; or

Where the pre-tax profit will not exceed the present value of the tax benefit or assumed tax benefit.

In addition, the following are reportable arrangements:

Arrangements that would be regarded as hybrid equity instruments if redemption or disposal were to be within a ten-year period;



Any debt convertible into equity within a ten-year period, other than securities listed on the JSE; and

Any arrangement specified by the Minister as likely to give rise to an undue tax benefit.

An arrangement is excluded from the requirement of reporting if the tax benefit or assumed tax benefit does not exceed R1 million or if the tax benefit is not the main or one of the main benefits.

A tax benefit is effectively any avoidance, postponement or reduction of a liability to any tax administered by the Commissioner.

The term "arrangement" encompasses any transaction, operation or scheme.

Defining the boundaries

Given such a broad canvas, how does the average businessman know where

the line is drawn? The following examples highlight the problem with defining the boundaries.:

Company X owns all of the issued shares in Company Y. The sole asset in company Y is a vacant piece of land which it acquired in 2002 for R10 million, and which now has a value of R18 million. X and Y enter into an agreement in terms of which Y sells the property to X at its book value of R10 million. The companies agree that they elect the application of section 45 of the Income Tax Act. The result is that the capital gain that Y would have realised is deferred and rolled over to X. The tax benefit is R1 120 000. However, because the transaction has been effected at the book value, Y makes no pre-tax profit.

Here, the parties would have made use of a valid exclusion in the Income Tax Act, but, unless they are satisfied that the rollover benefit was not the main or one of the main benefits of the transaction, the transaction would apparently be reportable.

The problem may become more acute if the transaction is part of a greater series of transactions, like a global reorganisation. Here, the issue is defining the "arrangement". Is the arrangement the entire global reorganisation, and should this be reported, although the local component may be a single transaction or relatively

The safest response in case of any doubt would appear to be to report. The initial disclosure requirements are not onerous. If this is the course of action that is generally adopted, the focus then shifts to SARS.

few of a large number of transactions, or is the arrangement only the onshore component? It is likely that the global reorganisation has in mind benefits that are remote from and far greater than minimising the tax cost of the local transaction; so, it is questionable whether the SA tax benefit is the “main or one of the main benefits”.

A non-resident owner of a SA company replete with cash elects to expatriate the cash through a capital reduction instead of a dividend. The capital was originally contributed by the non-resident shareholder, and there is no pre-tax profit. The SA company is not subject to secondary tax on companies, as the amount distributed is not a dividend.

By not making the distribution out of accumulated reserves, the company defers its liability to STC. Is there an avoidance, postponement or reduction of tax as contemplated in the reportable arrangements requirements, and would this transaction be reportable?

Intellectual property is developed in a tax haven. The developer then sells it, at an arm's length price, to a company resident in a jurisdiction that has entered into a double tax convention with SA in terms of which the exclusive right to tax the royalty payable is reserved to the jurisdiction where the licensor is resident. The right to use the intellectual property is granted under licence to a SA user who pays a royalty in respect of

such use. The non-resident company amortises the cost of acquiring the intellectual property and makes a small pre-tax profit. By virtue of the double tax convention, its liability to tax on the royalty in SA is reduced to zero.

Are the sale of the intellectual property and the licence agreement a reportable arrangement if the treaty relief on the royalty exceeds the pre-tax profit of the licensor?

To be or not to be ...

These are a few examples of the kinds of problems that businessmen and their advisors will face on a daily basis. Transactions that, on the face of it, are not manipulative of the taxing laws, and merely avail of benefits that the law clearly allows appear to carry the taint of reportability and risk of investigation. At the root of the problem is the lack of precision in the legislation.

What makes matters worse is that the responsibility to report falls on a promoter, if a resident, or, if there is no promoter or the promoter is a non-resident, any participant. There is therefore a risk that an SA party in a transaction over which it has no control could end up with a reporting requirement if the law is interpreted and applied widely. As the purpose of the legislation is only to require the furnishing of information, it is likely that these requirements will be liberally

interpreted in our Courts, on the basis that an honest taxpayer should suffer no prejudice in furnishing information on a legitimate transaction.

The penalty for a failure to report an arrangement timeously is R1 000 000. Such penalty may be remitted in only two circumstances; namely:

If the Commissioner is satisfied that there are extenuating circumstances and the participant remedies the failure within a reasonable time; or

If the penalty is disproportionate to the assumed tax benefit.

The severity of the penalty and the limited circumstances for remission place considerable risk on any party to a transaction that may possibly be reportable. A decision not to report in case of doubt leaves little margin for comfort.

The safest response in case of any doubt would appear to be to report. The initial disclosure requirements are not onerous. If this is the course of action that is generally adopted, the focus then shifts to SARS. Will it be able efficiently to handle a plethora of reports, or will the aims of the legislation be emasculated through burial under a mountain of paperwork?

A red rag to the fiscal bull

Nothing raises the ire of SARS as much as an employer who collects PAYE from employees, and then fails to pay it over to the fiscus. With justification, SARS views such conduct as fraud, if not theft. The funds belong to the employee, and are payable to SARS on their behalf. The South African courts share SARS's view on the gravity of such misconduct.

Thus, in *Estate Agency Affairs Board v McLaggan* 2005 (4) SA 531 the Supreme Court of Appeal held that such conduct was "intrinsically dishonest", that it "entails deception of employees", that "it is dishonest as far as the fiscus is concerned" and that it is conduct "that would be regarded by the public in general as lacking in probity".

The court's ruling that this breach of the Estate Agency Affairs Act 112 of 1976 was an offence involving dishonesty had serious consequences for this taxpayer, as it resulted in the lapsing of his fidelity fund certificate, without which he could not practise as an estate agent.

Comparison with the attitude of the Australian courts

It is interesting to compare this decision with that in *Deputy Commissioner of Taxation v Dick*, where a similar scenario played itself out in the courts of New South Wales.

A striking difference between the two judgments is the detached view that the Australian courts seemed to take of the failure to remit PAYE to the fiscus, as though it were a mere technical statutory offence, in comparison with the stern, moralistic rhetoric of our Supreme Court of Appeal.

Amateur psychologists may read into this disparity a sub-text of the Calvinist influence in the shaping of South Africa, versus the less than spotless pedigree of the first European inhabitants of Australia and the enduring legacy of antagonism

toward oppressive governmental authority, particularly where, as in Dick's case, a working man's football club was involved.

In *Dick*, a director of the Northern Spirit Football Club Pty Ltd had failed to remit to the fiscus the monthly PAYE that had been deducted from the wages of the company's employees.

The Australian Tax Office gave the director three penalty notices, but still the director did not comply with his statutory duty under Australia's Income Tax Assessment Act to remit the funds.

The upshot was that the revenue authorities levied the director with a penalty of some A\$150 000, which was an amount equal to the PAYE collections that the company had failed to remit to the fiscus during his period in office.

The director disputed his liability for the penalty, and – with ingenuity, not to say chutzpah – argued in the New South Wales Supreme Court that the court should exercise its discretion in terms of the Corporations Act 2001 (the Australian counterpart to our Companies Act) to excuse him for his negligence or default.

The relevant provision (section 1318) of Australia's Corporations Act reads as follows –

"If, in any civil proceedings against a person to whom this section applies for negligence, default, breach of trust or breach of duty, ... it appears to the court ... that the person ... has acted honestly and that, having regard to all the circumstances of the case ... the person

ought fairly to be excused for the negligence, default or breach, the court may relieve the person either wholly or partly from such liability on such terms as the court thinks fit".

This wording is very similar to the provisions of section 248 of the South African Companies Act of 1973. Hence, the taxpayer's contention and the court's response to it are relevant in the context of South Africa's tax law.

A surprising decision by the Supreme Court was reversed on appeal

Astonishingly, the New South Wales Supreme Court was persuaded by the taxpayer's argument that the court could and should, under this provision of the Corporations Act, "excuse" his misconduct, and made an order accordingly.

Not surprisingly, the tax authorities took the judgment on appeal to the New South Wales Court of Appeal, arguing that the discretionary powers of the court in terms of section 1318 of the Corporations Act to excuse negligence, breach of duty or breach of trust do not extend to obligations incurred outside of that Act.

However, the victory was short-lived. On appeal (see *Deputy Commissioner of Taxation v Dick* (2008) 242 ALR 152) the New South Wales Court of Appeal reversed the decision of the Supreme Court and ruled in favour of the tax authorities.

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