



Synopsis

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through the procedural maze

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Seizure of goods – getting through the procedural maze

It is notorious that, world-wide, there is large-scale pirate manufacture and sale of consumer goods that are protected by copyright and trademark legislation.

There are many unscrupulous businesspeople who are happy to let someone else bear the cost of developing and marketing a successful product, and who then hijack the profits by flooding the market with cheap imitations.

Predictably, the holders of intellectual property rights are prepared to outlay large sums to take legal action to protect their products. This often necessitates litigation in many countries of the world.



The Crocs litigation in the South African courts

The latest flurry in the South African courts, in this regard, has centred on the internationally well-known Crocs range of casual footwear, which retails for R500 a pair and upward.

The decision of the Cape High Court in *Pick 'n Pay Retailers (Pty) Ltd v CSARS, The Commissioner for Customs and Excise, Crocs Inc, and the Magistrate, Cape Town* (case 13354/2007; judgment given on 6 May 2008, not yet reported) concerned the importation into South Africa from China of some 20 000 pairs of beach sandals, and the legal proceedings taken by a copyright holder to prevent these products entering the local market on the grounds that they were counterfeit copies.

In the Gauteng High Court, Crocs' copyright claims also featured in an appeal against a seizure order in the matter of *Moresport (Pty) Ltd v Commissioner for the South African Revenue Service* (case 36853/2006,

Editor: Ian Wilson

Written by R C (Bob) Williams

Sub-editor and layout: Carol Penny

Tax Services Johannesburg

Distribution: Elizabeth Ndlangamandla

Tel (011) 797-5835

Fax (011) 209-5835

www.pwc.com/za

judgment given on 27 March 2008; not yet reported).

The background

Crocs Inc, an American company that holds copyright and trademark in Crocs shoes, is engaged in a world-wide battle against the unauthorised copying and sale of its copyrighted line of footwear by unscrupulous manufacturers worldwide, particularly in China.

Crocs had instructed its South African attorneys to apply to the Commissioner of Customs and Excise in terms of section 15 of the Counterfeit Goods Act for the seizure and detention of all imported goods suspected of being counterfeit copies of Crocs shoes.

The Pick 'n Pay dispute

A customs officer, acting in terms of section 3(4) and section 4(1) of the Customs and Excise Act, issued a detention notice in terms of section 113A(1), and provided a copy to Crocs Inc. The latter's attorney thereafter provided the SARS officer with an affidavit attesting that, having studied the items in question, he had concluded that the goods were indeed counterfeit.

Consequent upon these events, SARS and the Commissioner for Customs and Excise applied to a Cape Town magistrate in chambers, and on an ex parte basis (that is to say, without notice to Pick 'n Pay, who were consequently

not represented at the hearing) in terms of section 6(1) of the Counterfeit Goods Act for a warrant to be issued for the seizure, removal, detention and collection of the goods in question. The magistrate granted the application and issued the warrant.

Pick 'n Pay immediately made urgent application to the Cape High Court for an order that the warrant be set aside, that the detention, seizure and removal of the 20 000 pairs of shoes be declared wrongful, and that they immediately be released to Pick 'n Pay and declared not to be counterfeit.

The application to set aside the warrant

Pick 'n Pay sought to have the warrant for the seizure and detention of the goods set aside on the grounds that it was improper for the warrant to have been applied for and granted ex parte, in other words, without Pick 'n Pay's being represented when application for the order was made to the magistrate.

In this regard, the court pointed out that a warrant for the seizure of goods in terms of the Customs and Excise Act is less invasive than an order that the goods be forfeited. The purpose of a seizure order is simply to preclude the goods from entering the marketplace pending a determination, under a separate section of the Act, as to whether they are counterfeit.

The court concluded that, properly interpreted, the Customs and Excise Act does not require that application for a warrant for seizure needs to be made in open court, rather than in chambers. The impairment of Pick 'n Pay's rights, consequential upon such a warrant would be of limited duration, pending a further application in which the full merits of the case would be aired and resolved.

The short-term impairment of Pick 'n Pay's rights, had to be weighed against the immediate and irreversible harm to the interests of the copyright holder if the goods were released into the marketplace, and were later found to be counterfeit.

The court therefore concluded that the Customs and Excise Act did not require Pick 'n Pay to be represented at the hearing when the warrant was applied for.

A further ground on which Pick 'n Pay sought to have the warrant for detention and seizure of the goods set aside was that Crocs Inc had failed to act in the utmost good faith and make full disclosure of all material facts to the court which heard the ex parte application for the warrant.

However, the court held that there had been no failure to make full disclosure to the court; Crocs Inc had informed the court of Pick 'n Pay's wish to be granted a hearing, but Pick 'n Pay had no right to a hearing, and the magistrate had acted

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properly in exercising her discretion to decide the matter on an ex parte basis.

The Moresport dispute

In July 2006, Moresport (Pty) Ltd, a South African company carrying on business as an importer and distributor of footwear, had imported some 5 000 pairs of shoes into South Africa, having purchased them from a company in Vancouver.

These shoes were detained by the customs and excise division of SARS on suspicion of being counterfeit reproductions of the well-known Crocs brand of shoes, the copyright in which was held by Crocs Inc, an entity incorporated in the USA.

Over the next couple of months, correspondence ensued between Crocs Inc and Moresport (Pty) Ltd, in which Crocs stated that they were holders of the copyright in Crocs shoes, and that the shoes imported into South Africa by Moresport were unauthorised reproductions whose importation by Moresport amounted to dealing in counterfeit goods in terms of South Africa's Counterfeit Goods Act 37 of 1997.

In this correspondence, Crocs demanded that Moresport hand over all the imported shoes for destruction and give a written undertaking never again to import goods that infringed Crocs's copyright.

In response, Moresport's attorneys wrote to Crocs Inc, denying that they had infringed the latter's copyright, and averring that, on the facts of the matter, a statutory exemption from copyright infringement was applicable in terms of section 15A(3) of the Copyright Act 98 of 1978.

This section permits reproductions to be made available to the public where those reproductions have a primarily utilitarian purpose and were made by an industrial process. In the alternative, Moresport averred that it had not engaged in "counterfeiting" as defined in the Counterfeit Goods Act, and that, at the time of importation, it was not aware that Crocs Inc was the owner of any applicable copyright.

Moresport called on Crocs Inc to instruct SARS to release the detained goods.

Subsequent to that exchange of correspondence, Crocs Inc applied to a magistrate ex parte, in chambers at the Cape Town Magistrates' Court for a search and seizure warrant in respect of the consignment of shoes in question, as the statutory sequel to their initial detention on suspicion of being counterfeit goods.

The application was supported by affidavits lodged on behalf of Crocs Inc and, on the basis of those affidavits, the magistrate granted the search and seizure order. The affidavit filed by Crocs

Inc did not disclose the prior exchange of correspondence in which Moresport had set out its defence to the claim of copyright infringement and dealing in counterfeit goods.

Since this was an ex parte application, the court granted the order without the magistrate's hearing Moresport's version of events or submissions on the law, and the goods were duly "seized".

Moresport then applied to the Gauteng High Court for an order setting aside the search and seizure warrant that had been issued in chambers by the magistrate in Cape Town.

Counsel for Moresport argued that SARS and Crocs Inc had failed to disclose to the magistrate the correspondence between the two contesting parties in which Moresport had set out in detail the basis of its defence to the claim of breach of copyright and dealing in counterfeit goods.

Crocs Inc argued that this non-disclosure was not material.

In its decision, the High Court quoted the judgment of the Supreme Court of Appeal in *National Director of Public Prosecutions v Basson 2002 (1) SA 419* where the court held that –

"Where an order is sought ex parte it is well established that the utmost good faith must be observed. All material facts must be disclosed which might influence a court in coming to its

decision and the withholding or suppression of material facts, by itself, entitled a court to set aside an order, even if the non-disclosure or suppression was not wilful or mala fide.”

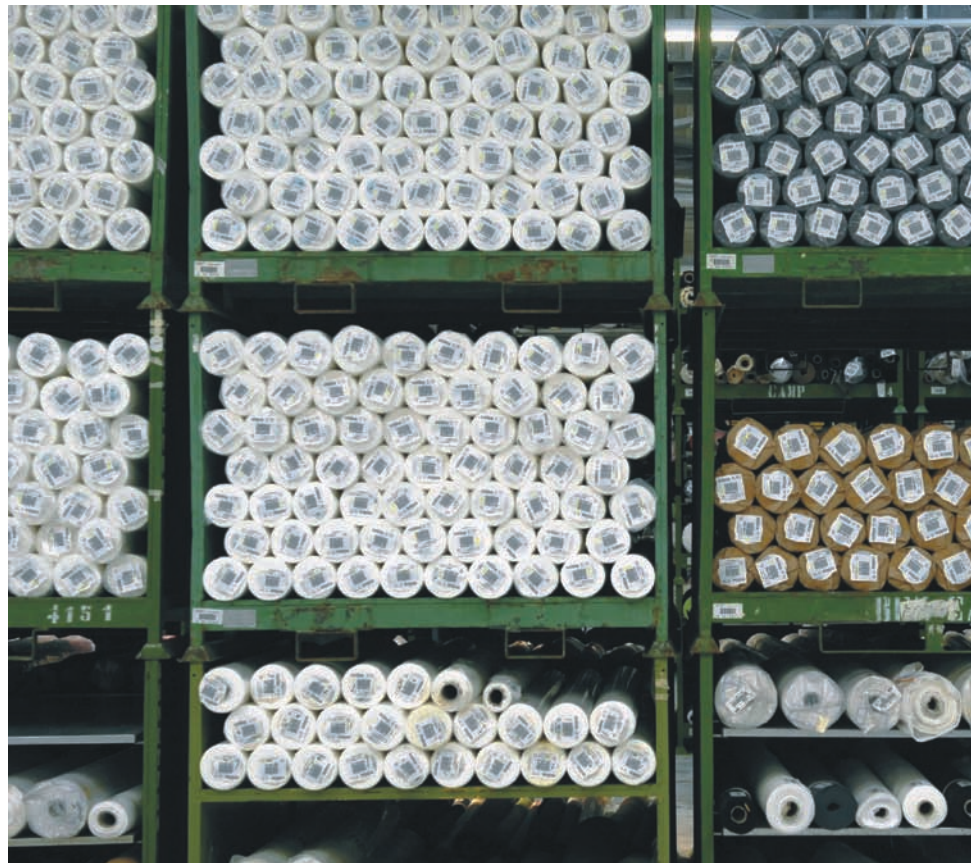
The court in the present matter held that the defence raised by Moresport in its correspondence with Crocs Inc was relevant and material and ought to have been disclosed to the magistrate, that there was no justifiable reason why it had not been disclosed. The court set aside the warrant, and ordered SARS to pay Moresport’s legal costs.

It is noteworthy that, in this appeal, Moresport did not have to prove that the magistrate would not have granted the warrant of search and seizure if Moresport’s letter to Crocs Inc, setting out the former’s defence, had been disclosed in the papers laid before court.

The mere fact of non-disclosure to the magistrate was sufficient grounds for the High Court to set aside the search and seizure warrant issued by the magistrate.

Lessons for importers?

A particular difficulty facing importers is that they have no first-hand knowledge as to whether or not a breach of copyright has occurred in the manufacture of the imported products. It is therefore difficult – indeed impossible – for them to lay evidence before the court to controvert the prima facie evidence of copyright infringement adduced by the owner of copyright.



A difficulty facing importers is that they have no first-hand knowledge as to whether or not a breach of copyright has occurred in the manufacture of imported products.

In the wake of these decision, it seems that importers of goods which might come under suspicion of being counterfeit would be well advised to require the overseas manufacturers to provide documentary evidence that there had been no breach of copyright or trademark in the manufacturing process.

Further, where infringement is alleged it is vitally important that the importer

engage with the authorities in writing, setting out their case. This places the authorities under the obligation to disclose the importer’s defence at the time of applying for a search and seizure warrant, and these submissions must be taken into consideration in determining whether a warrant should be issued.

The provisions of sections 101 and 102(1) of the Act require that any person carrying on business in the Republic must keep books, accounts and documents relating to his transactions, and produce them on demand.

The approach of the Supreme Court of Appeal

SARS took the matter on appeal to the Supreme Court of Appeal, which held that the sole issue was the reasonableness of the suspicion on the part of the SARS officer that the goods were imported goods and that further investigation would establish that they were subject to forfeiture under the Customs and Excise Act.

The court pointed out that SARS's hand in this regard is strengthened by the provisions of sections 101 and 102(1) of the Act, which require that any person carrying on business in the Republic must keep books, accounts and documents relating to his transactions, and produce them on demand.

The court said that the High Court had overlooked an important factor, namely that the taxpayer had not at any stage contended that the goods had not been imported. It followed that the High Court had erred in concluding that the SARS officer should have investigated whether the goods were imported goods.

The Supreme Court of Appeal went on to say that, when considering whether the

SARS officer had reasonable grounds for seizing the goods, there were a number of material facts.

First, the goods were marked as being made in China and bore Chinese inscriptions, and the taxpayer had not contended that the goods were made locally.

Second, the inability of the taxpayer to produce any books or documents recording where and from whom the goods had been purchased.

Third, the suspicious conduct when the manager had said, in Mr Chen's presence, that he did not know where the owner was and then, on a subsequent occasion, introduced Chen to SARS as the owner.

Fourth, that Chen had produced false VAT and income tax numbers.

Fifth, that despite telling the SARS officer that he had bought the goods in Chinatown, Chen had been unable to produce documents in the form of invoices or duplicate receipts from the suppliers.

The Supreme Court of Appeal said that it took issue with the High Court where the

latter held that the SARS officer had to do more by way of investigation than wait for the requisite documentary proof from the taxpayer. The taxpayer was under a statutory duty to maintain books of account and documents to reflect from whom the goods had been purchased.

The Supreme Court of Appeal concluded that the taxpayer's inability to produce such documents, together with the other suspicious conduct, were sufficient grounds for the SARS officer to conclude that the goods were liable to forfeiture, and that SARS was therefore entitled to seize them.

The Supreme Court of Appeal upheld SARS's appeal against the High Court judgment, and set aside the order made by the latter.

Assessed losses carried forward

Carrying forward a company's tax loss requires a continuity of trading plus the derivation of some income

The general rule of income tax is that a taxpayer's taxable income is determined for each tax year in isolation. In other words, each tax year is a closed compartment, not affected by tax events that occurred in previous tax years. Thus, the general rule is that, in a given tax year, a taxpayer can claim a deduction in respect of expenditure only if it was incurred in that tax year.

An important exception to this rule is that the Income Tax Act permits taxpayers, both individuals and companies, to carry forward the balance of an assessed loss incurred in the previous tax year into the current tax year, to be off-set against the income of the latter year.

Where companies are concerned, section 20(1)(a) of the Income Tax Act allows an assessed loss incurred by the taxpayer company to be carried forward and set-off against income of a later year which is derived from carrying on any trade.

By implication, therefore, such a balance of assessed loss cannot be set off against income derived otherwise than from trade. Moreover, if the company has not traded at any time during the current year, there can be no set-off of prior years' losses in computing the taxable income of the current year.

It was held in *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A), 18 SATC 240 that section 20(1)(a), properly interpreted, means that where a taxpayer has not traded at any time during the current tax year, there is nothing against which the assessed loss brought forward from previous years can be set-off in that year.

In *New Urban Properties Ltd v SIR* 1966 (1) SA 217 (A) this logic was taken a step further, and it was held that in such a situation there is no "balance of assessed loss" that can be carried forward into the following tax year.

In *Robin Consolidated Industries Ltd v CIR*, (1997) 59 SATC 199 (A) the taxpayer challenged the interpretation of the Act as laid down in these two

decisions, but the Appellate Division held that they were "clearly right".

These principles are extremely important in corporate tax-planning.

In relation to taxpayers other than companies, section 20(2A) explicitly nullifies the requirement that a taxpayer can only set-off the balance of an assessed loss against income from "trade", but this restriction is operative in relation to companies.

Consequently, if a company fails to trade for an entire tax year, it loses forever the right to carry forward any balance of assessed loss from a previous year, even if it thereafter resumes trading.

It was held in *SA Bazaars (supra)* that if a company trades at any time during the year, it escapes this restriction; it is not necessary that the company should trade continuously throughout the year.

An important unresolved issue

An important issue which has been left open in all these High Court decisions is whether it is necessary, in order to escape the restriction on striking a balance of an assessed loss in the current tax year or on carrying-forward that balance into a future year, that the company, in addition to trading, actually derive income from the trade.



To the dismay of taxpayers, the tax court decision in ITC 664 (1948) 16 SATC 125 held that it was indeed necessary for such a company to derive income from the trade.

Taxpayers would much prefer that the answer to this question is in the negative, so that a company which, for whatever reason – and there could be many – does not derive any income during a given tax year, can nonetheless carry forward the balance of an assessed loss into the following year.

To the dismay of taxpayers, the tax court decision in ITC 664 (1948) 16 SATC 125 held that it was indeed necessary for such a company to derive income from the trade.

But taxpayers' spirits lifted when no subsequent judicial decision affirmed that interpretation, and spirits soared when, in ITC 777 (1953) 19 SATC 320, SARS did

not even try to argue that the latter was the correct interpretation. This case concerned a company that owned fixed property which it had unsuccessfully tried to let, and therefore derived no rental income during the year.

Academic writers and tax practitioners seemed to be generally of the view that it was illogical for a company to be barred from carrying forward an assessed loss merely because it did not derive income in the current tax year.

After all, they point out, a company is entitled to a deduction for non-capital business expenditure even where that expenditure produced no income, for example, an advertising campaign that did not generate any sales, or travelling expenditure incurred in an unsuccessful attempt to secure a particular contract.

Why then, it was asked, should the derivation of income be a requirement for the carry-forward of an assessed loss?

Of course, the resolution to this issue lies, not in abstract logic or even commercial pragmatism, but in an interpretation of the words of the Income Tax Act.

In Practice Note 33, SARS gave notice that it took the view that section 20 of the Income Tax Act imposed both a trading requirement, and an income requirement.

Practice notes do not have the force of law; they merely indicate how, as a matter of practice, SARS interprets provisions of

SARS will not universally adopt an “all or nothing” approach on the income requirement, but will be prepared to allow an assessed loss where it may be clearly demonstrated that the lack of income was reasonable in the circumstances, provided that a trade is being carried on.

the Income Tax Act whose interpretation is still uncertain.

Gloom has descended again with a recent tax court decision

Unfortunately for corporate taxpayers, in the recently reported decision of the Gauteng Tax Court in ITC 1830 (2008) 70 SATC 123 it was held that a company that has incurred a trading loss in a particular tax year can carry that loss forward to the following tax year only if it derived income in the current tax year.

Unlike decisions of the High Court, decisions of the tax court are not, strictly speaking, “precedents”. That is to say, a decision of the Tax Court need not be followed by other tax courts. This decision is therefore not, technically, binding in future decisions of the various tax courts or the High Court.

In practice, however, this latest decision is likely to be followed in other cases that come before the tax courts, unless and until this interpretation is overruled by the High Court.

SARS’s approach

The following extract from Interpretation Note No. 33 provides some prospect of sanity, and demonstrates the approach of SARS to the issue:

“SARS is of the view that section 20 contains a trade requirement and an income from trade requirement. Both these requirements must be satisfied before an assessed loss may be carried forward. SARS does, however, accept that this may have some unintended results.

In dealing with the problem, SARS will accept that as long as the company has proved that a trade has been carried on during the current year of assessment, the company will be entitled to set off its balance of assessed loss from the preceding year, notwithstanding the fact that income may not have accrued from the carrying on of that trade. This concession is limited to cases where it is clear that trade has been carried on. SARS will apply an objective test in order to determine that a trade has in fact been carried on. It will not be sufficient that there was a mere intention to trade or some preparatory activities. The fact that no income was earned during the year of assessment must be incidental or result from the nature of the trade carried on by the company.”

It seems clear that, notwithstanding the decisions in the Courts, SARS will not universally adopt an “all or nothing” approach on the income requirement, but will be prepared to allow an assessed loss where it may be clearly demonstrated that the lack of income was reasonable in the circumstances, provided that a trade is being carried on.

Sand case highlights need for clearer law on trading stock

The Supreme Court of Appeal, in an as yet unreported judgment, has again held that the proceeds from the disposal of sand found on an agricultural property are of a revenue nature. In the matter of *Ernst Bester Trust v C:SARS* [2008] ZASCA 55 (Case No:282/07), delivered on 26 May 2008, it dismissed the taxpayer's appeal.

The taxpayer had acquired the property by inheritance in 1989, and leased it to a connected person, who carried out farming operations thereon. The lease rental was significantly less than the proceeds from the sale of sand. The sand was sold under a contract, originally entered into in 1994, which entitled a contractor to extract sand in a piece of ground, some 18 hectares in extent. The contractor was entitled to extract the sand as and when it required it, and was obliged to pay a market price per cubic metre for the sand that it extracted. The contractor obtained a mining licence entitling it to mine for the sand in the defined area, and, over a period of years, extracted sand on an irregular basis and made payments to the taxpayer.

The taxpayer was assessed to tax on the proceeds of the disposal for the 1999, 2000 and 2001 years of assessment.

The taxpayer raised two arguments to the assessment:

that the proceeds were of a capital nature; and

if the proceeds were of a revenue nature, it was entitled to claim a deduction for the value of the sand disposed of as this was its trading stock.

The theoretical framework

Before examining the judgment, it is relevant to consider the theoretical framework.

Prior to 1 October 2001, the determination whether an amount was of a revenue nature and taxable or of a capital nature and not taxable was based upon the intention with which the asset was acquired, dealt with and realised. If it was found that it was the intention of the taxpayer was to dispose of the asset, by using it in a scheme of profit-making as its stock in trade, then the proceeds of the disposal would be regarded as not of a capital nature and taxable.

With effect from 1 October 2001, capital gains became taxable, and the theoretical framework changed. The interaction between the taxation of capital gains on conversion of an asset to trading stock and the disposal of the trading stock now became the subject of specific legislation. This is well documented in the SARS Comprehensive Guide to Capital Gains Tax (paragraph 6.2.2). When a capital asset is converted to trading stock, the provisions of paragraph 12(2)(c) of the Eighth Schedule to the Income Tax Act deem there to have been a disposal of the asset for a consideration equal to its

market value, and tax is imposed on the capital gain so arising. Then, for income tax purposes, section 22(3)(a)(ii) of the Income Tax Act provides that the person shall be deemed to have acquired that trading stock for a consideration equal to its market value.

Thus, in theory, before the sand is mined, it forms part of the capital asset. However, when the intention of the owner changes, the sand becomes trading stock. There are therefore two taxable transactions, namely the conversion to trading stock, which is a capital gains tax event, and the disposal of the trading stock, which is subject to normal tax.

The SCA decision

The SCA held that the proceeds from the sale of sand were revenue and taxable as ordinary income. The Court held that:

“there can be no doubt that the amounts received by the taxpayer ... represented gains made in the operation of an ongoing scheme of profit-making over many years out of the sales of sand ostensibly at a market-related price. There was nothing of chance in such a consequence. It was the result of a contractual relationship designed for that purpose.”

It is not clear whether this was indeed the basis for the decision in this matter



"one must have regard not so much to the form as to the real character of the transaction."

Despite this, it would appear that the Court was of the view that the proceeds were in fact from the sale of sand, as it went on to consider the second point of objection (which would have been unnecessary had it held that the real character of the transaction was a mining lease).

Here it rejected the arguments of the taxpayer, that section 22(4) and section 22(3) of the Income Tax Act provided for a deduction of the market value of the trading stock, it held that the sand was never subject to section 22, as this section has no bearing on assets that are acquired and disposed of in the same year. The Court made the comment that:

"Such transactions are relevant for tax purposes purely for the purposes of s 11 (a) and for the amount of profit or loss that they contribute to the income statement."

The judgment proceeded to hold that, because the sand was never stockpiled but that delivery took place at the time that the contractor extracted it and removed it from the premises, and that these events occurred in the same year of assessment, section 22 could not apply to the sand that was extracted.

The Court held that:

"no ascertainable part of the sand deposit could fairly be described as trading stock held by the taxpayer."

Given that it held that the taxpayer was trading in sand, this is a most surprising conclusion. There seem to be only two possibilities – the sand became stock in trade when the 1994 contract was

concluded, or it became stock in trade when it became saleable.

The Court found that the taxpayer had not persuaded it that there was a practice on the part of SARS to allow a deduction for the market value of stock acquired for no consideration. However, in a footnote the following statement is made:

"De Koker and Urquhart ... say the following:

'In practice the market value of trading stock acquired for no consideration is allowed as a deduction if that stock is not on hand at the end of the year of assessment in which acquired. This is clearly not authorized by the Act, since the provision described deals with the cost of trading stock which forms part of opening or closing stock, but it is submitted that, on a holistic interpretation, this is the intention of the legislature.'

The statute was not thus interpreted to us by counsel and it is unnecessary to do so *mero motu*."

The upshot is that, despite identifying an interpretation which would have provided a just and equitable outcome on the basis contended by the taxpayer, the Court rejected it purely for the reason that the point had not been so argued.

Legislation needed

It is high time that this issue be clarified by the introduction of legislative provisions that provide for consistency of treatment, in line with the basis set out in the Comprehensive Guide to CGT. It is unsatisfactory that the provisions of section 22 should not be linked, where appropriate, to section 11(a) so that taxpayers are entitled to the appropriate treatment when their intention in relation to a capital asset changes, even if the change of intention and the realisation of the asset occur within the same year of assessment.

as the Court then went on to liken the contract to a mineral lease:

"In the case of a mineral lease, the value of the land is diminished by the extraction of the minerals, yet the owner's compensation (rent or royalties) is taxable. I agree with counsel for the respondent's submission that it does not matter whether the rent is a fixed recurrent amount or whether it is linked to the quantity of minerals removed ..., or to the gross profits made by the lessee ...

Thus, where the taxpayer permits another to enter his property and remove sand against a monthly consideration calculated with reference to the volume removed, he is productively employing his capital asset (the farm) in a way which is, at least for fiscal purposes, not materially distinguishable from a lessor under a mineral lease. As was said by Innes CJ [*in Modderfontein B Gold Mining Limited v CIR* 1923 AD 34 at 44]



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The Business Partners in Africa Conference is the annual meeting place for the PricewaterhouseCoopers (PwC) firms in Africa and their clients. The conference in September 2008 is the eleventh such conference and the first time it will be held in North Africa.

In previous years, the conference has dealt with predominately corporate tax issues; however, the agenda now covers general business topics relevant to Africa, HR issues as well as taxation.

PwC partners and staff from approximately 20 African countries will be present and client attendees have the opportunity to network with them informally, or via pre-arranged client service meetings. The client service meetings are free of any additional charge.

In addition to the plenary and workshop sessions, there is a keynote address at the opening dinner, a country expo, and several themed dinners and excursions.

Registration, welcome cocktails and the country expo will open at 14:00 on Sunday, 21 September 2008. For those arriving early on Sunday, there is a tour of the Pyramids at Giza, returning to the hotel at lunch time. An exclusive dinner will take place on board The Nile Maxim starting at 19:00, and a guest speaker will set the scene for the conference.

The conference begins on Monday, 22 September, with the first workshops commencing at 09:30. The formal workshops will end at 14:30 on Wednesday, 24 September.

For further information, please contact Sonja Nel on +27 11 797 4207 or sonja.nel@za.pwc.com.

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