

Synopsis


March 2010

Tax today*

A close-up, profile view of a woman with dark hair and bangs. She is looking off to the side with a thoughtful or concerned expression. Her right hand is raised to her face, with her fingers resting against her cheek and chin. The background is blurred, suggesting an office or meeting environment.

“Profits of a
capital nature”
decision causes
consternation

*connectedthinking

PRICEWATERHOUSECOOPERS 

In this issue

Profits of a capital nature” decision throws uncertainty over interpretation. 2

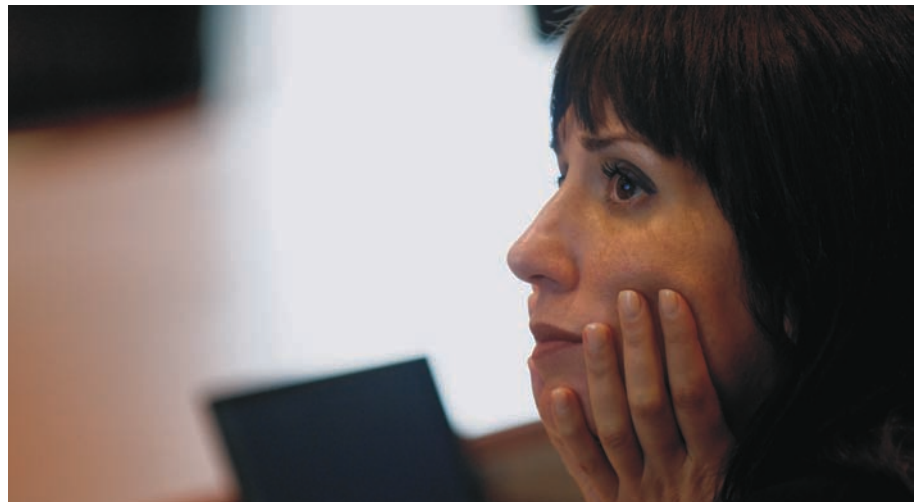
Australia - Innovative “test case” programme. 4

Does non-compliance with section 22 destroy a taxpayer’s claim to deduct a loss on the disposal of trading stock? . . . 5

Exemption from VAT – a cautionary tale 7

“Profits of a capital nature” decision throws uncertainty over interpretation

The recent (12 March 2010) decision of the Supreme Court of Appeal in *Defy Ltd v CSARS* [2010] ZASCA 11 concerned the liability of Defy Ltd for the payment of secondary tax on companies in respect of a particular dividend cycle.



Defy’s appeal to the Tax Court against an assessment for some R28 million had been unsuccessful, hence the direct appeal to the Supreme Court of Appeal.

A dividend qualifies for exemption from STC under subsection 64B5(c)(ii) of the Income Tax Act if it is distributed “in the course or in anticipation of the liquidation or winding up or deregistration of a company” and if, in addition, it is shown by the company to be a “distribution of profits of a capital nature” (subject to a qualification not presently material, that takes account of capital gains tax).

Defy had received a distribution made by a subsidiary company its winding-up. Defy treated this as a liquidation dividend and claimed that the amount by which this distribution

exceeded the historical cost of the shares was a profit of a capital nature.

A capital profit, for STC purposes, can only arise from a disposal

Defy’s argument (see the judgment at para [35]) was that it paid R28 451 459 to acquire the shares in its subsidiary and that it received R343 811 457 in return (being the total distribution by the subsidiary in anticipation of the latter’s winding up) and that Defy had thus profited on its capital investment in the amount of R315 359 998.

The court ruled in this regard (see para [34]) that this description may be true in a general sense, but that the STC system only exempts money from tax “if they have been yielded to the company as a capital profit” and that this means (see para [35]) that

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

The decision also throws into stark relief the distinction between a distribution made in anticipation or in the course of winding-up and a distribution on liquidation or winding-up.

there is an exemption only for the pecuniary gain that is earned on “disposal by the company of a capital asset”.

On the facts of this matter, there had been no “disposal” by Defy.

The court concluded (at para [41]) that, in this case, the money in question “was not a gain from the disposal by Defy of an asset”. The insurmountable difficulty for Defy, said the court (at para [43], was that it received its money by way of a dividend and not as payment for a disposal.

Giving the judgment of the court, Nugent JA concluded (at para [47]) that –

I do not think that any of the moneys that are now in issue were yielded to Defy as a capital profit and they were thus not exempt from STC.

The taxpayer’s appeal was dismissed.

The basis for the Court’s conclusion, namely that a capital profit can only arise from the disposal of an asset has thrown considerable uncertainty over the interpretation of the relevant exemption. As a unanimous decision of the Supreme Court of Appeal, this decision binds all lower courts that might be called upon to adjudicate on the issue.

The SARS Comprehensive Guide to Secondary Tax on Companies, which is a statement of SARS interpretation

makes it clear that SARS does not share the view of the Supreme Court, and in fact gives examples where a profit of a capital nature might arise in circumstances where there has been no disposal of an asset (for example, waiver of a debt, donation or inheritance – the list is not exhaustive).

It is a matter of concern that Counsel for SARS did not tender this information to the Court in the course of the argument, as the Court’s line of inquiry in this regard was patently inconsistent with SARS’s own view on the issue.

The decision also throws into stark relief the distinction between a distribution made in anticipation or in the course of winding-up and a distribution on liquidation or winding-up. It would appear from the interpretation of SARS (and of the Court in this matter) that the former does not potentially give rise to a profit of a capital nature as it has the status of an ordinary dividend (the shares in question not having been “disposed of” at the time), whereas the latter would give rise to a profit of a capital nature if the amount of the distribution exceeds the cost of the shares.

Unfortunate decision

It is submitted that this is an artificial and unwarranted distinction, particularly as the STC provisions

provide for relief in respect of distributions made in anticipation of liquidation, winding-up or deregistration, and include requirements for the implementation of the steps to give effect to that intention. Therefore, it is submitted, a distribution in such circumstances, which is followed by the requisite implementation measures, is a part payment of the liquidation proceeds, and should properly be given effect as such in the hands of the shareholder to whom it is paid.

It is to be hoped that SARS will respond early to inform the public of its interpretation of the exemption following this unfortunate decision.

Australia



Innovative “test case” programme

Courts of law are supposed to be courts of justice. That should be equally true of the Tax Court and of any other court that adjudicates in a dispute between a taxpayer and the South African Revenue Service in regard to a tax assessment.

Yet, where an assessment is the subject of such litigation and the point at issue is the proper interpretation of an ambiguous provision of the Income Tax Act or other tax legislation, there is an inherent injustice.

The injustice arises from the fact that the correct interpretation of the legislation is only known in hindsight, once the court has given its ruling.

If the ruling in a High Court tax case goes against the taxpayer, he would ordinarily be ordered, not only to pay the tax in dispute, but to pay SARS's legal costs – even though the point of interpretation for which the taxpayer argued was reasonable. And the taxpayer would of course have to pay his own legal costs as well.

In a High Court matter, those legal costs could easily amount to hundreds of thousands of rand. And more costs would be incurred if the matter were taken on further appeal to the Supreme Court of Appeal or the Constitutional Court.

In the Tax Court, the usual rule is that, irrespective of the outcome of the case, the taxpayer and SARS pay their own respective legal costs. Again, this is unfair to the taxpayer where he wins a case that involved the interpretation of an unclear provision of tax legislation.

Yet litigation that settles the interpretation of tax legislation that was previously uncertain is in the public interest.

It is in the interests of SARS, the taxpayer, and the country as a whole that the interpretation of tax legislation should be settled, and not left in doubt. Why, then, should one unfortunate taxpayer have to bear the financial burden, in the form of legal costs, of securing a clarification of the law that benefits the whole country?

The Australian solution

Australia has devised a process for shielding the taxpayer from the legal expense of contesting an assessment involving a provision of tax legislation whose interpretation is uncertain.

The solution takes the form of a formal “test case program” in which certain taxpayers who engage in litigation with

Does non-compliance with section 22 destroy a taxpayer's claim to deduct a loss on the disposal of trading stock?

Key aspects of the Supreme Court of Appeal decision in *Anglovaal Limited v CSARS* (2009) 71 SATC 293 (SCA), were discussed in the October 2009 and February 2010 issues of Synopsis.

A further important issue in that decision concerned the proper tax treatment of trading stock.

The case involved a holding company that had disposed of shares which it held directly in its sub-subsidiary at a substantial loss. The holding company had then claimed the loss as an income tax deduction on the grounds that the shares had been held for speculative purposes.

SARS regarded it as inconceivable that a holding company could speculate in the shares of its own subsidiary. It seems that SARS believed that the holding company in this case was merely capitalising on a sharp downturn in the share market to

crystallise, and thereby convert into a deductible loss, a substantial decline in the market value of those shares.

SARS alleged that there had been a lapse in-compliance with section 22

One of SARS's arguments was that, in the year of acquisition (namely, 1994) and in the ensuing several tax years, Anglovaal had not taken the acquisition cost of the shares into account, whether as opening stock, purchases or closing stock, in the manner required by section 22 of the Income Tax Act.

This argument was accepted by the Tax Court which held (see para [36] of

the judgment of the Supreme Court of Appeal) that –

the actual deduction in respect of the cost price (of the shares) must have been made and taken into account in the determination of taxable income in the year of their acquisition (in terms of section 11(a)) and in addition in each year thereafter until disposition, there must be appropriate figures for closing and opening (stock) in terms of section 22.

It is worth pausing to reflect on the significance of this argument.

It is generally taken as trite that the manner in which a taxpayer makes up his books of account cannot, of itself, determine issues of taxability, such as whether assets are income or capital or whether expenditure is or is not deductible. >> 6

[continued from page 4](#)

the revenue authorities over the proper interpretation of tax legislation can have the legal costs borne by the Australian Tax Office (which is the counterpart of the South African Revenue Service).

There are of course criteria on the basis of which cases are selected as test cases in this regard to be funded from the public purse.

As the Australian Tax Office explains:

We have a responsibility to administer a range of laws fairly so as to ensure that taxpayers have access to their entitlements and comply with their obligations. This seeks to achieve a level playing field for taxpayers in accordance with the legislative intent.

We make decisions based on our view of the law that sometimes people disagree with. ... Ultimately, it is the

courts that have the final say in determining what our laws mean. Usually the funding of a taxpayer's litigation is a matter for them, although taxpayers who are proven right may be reimbursed for their legal costs. ...

There are however some issues where it is in the public interest to have the law clarified through litigation. It is only the taxpayers that can commence such litigation.

Under the test case litigation program, the ATO provides financial assistance to taxpayers whose litigation is likely to be important to the administration of Australia's revenue and superannuation systems. The aim of the program is to develop legal precedent – that is, legal decisions that provide guiding principles on how specific provisions we administer should be applied more broadly.

We are guided in the decision to fund such cases by ... a test case litigation panel. The panel includes members of the accounting and legal professions, to ensure that we fund issues of importance to the community.

The South African Revenue Service is known to keep a sharp eye on tax developments in Australia, whose tax system is fairly similar to our own.

Perhaps South Africa will introduce its own "test case" program on a similar basis to that which has been adopted in Australia.

In the computation of taxable income, the tax return requires the disclosure of information in relation to the company's income statement. Nowhere in this section does one find a requirement to note purchases of trading stock nor the amounts taken into account as opening stock or closing stock. How, then, can a taxpayer "comply" with section 22?

SARS's argument was (in essence) that this proposition does not hold true in relation to trading stock, and that a lapse in the proper accounting treatment of trading stock can, in and of itself, disqualify the taxpayer from entitlement to deduct the acquisition cost of such trading stock when it is eventually disposed of.

SARS argument was thus that uninterrupted compliance with section 22 from the time of acquisition through to the time of disposal of trading stock is an essential prerequisite for the loss to be deductible if that stock is eventually sold for less than its acquisition cost.

This argument had found favour with the Tax Court which held that, even if Anglovaal proved that it had acquired the shares in question as part of a scheme of profit-making and that the shares were part of its trading stock, the cost which had been incurred in the year of acquisition (1994) could not be claimed as a deduction in the year of disposal (1999) because Anglovaal had not, in 1994 and the ensuing tax years, properly taken the expense into account as opening stock, purchases or closing stock.

The Tax Court pointed out that the purpose of section 22 of the Income Tax Act, which governs the tax treatment of trading stock, was to prevent fraud and abuse and that its provisions must be strictly complied with.

Is compliance with section 22 a substantive prerequisite for the deductibility of a loss on resale of trading stock, or a mere evidentiary requirement?

In essence, SARS's argument was that, where trading stock is concerned, the taxpayer's financial statements are not merely of evidentiary value in determining the deductibility of the acquisition cost, but that compliance with section 22 is a substantive requirement in its own right, and that non-compliance in any intervening years between acquisition and disposal is fatal to a claim for deduction of the loss on disposal.

SARS's contention, on the facts of this particular case (see para [43] of the judgment), was that no account had been taken of Anglovaal's expenditure in respect of the acquisition cost of the shares from the year of acquisition (1994) for the following three years and that, as no account of such expenditure had been claimed during those years –

there is no basis upon which deduction pertaining to the cost price [of the shares] can suddenly be claimed in the 1999 year of assessment for expenditure already incurred in the 1994 year of assessment.

The ruling of the Supreme Court of Appeal

Immediately after summarising SARS's argument in this regard, Streicher JA (giving the judgment of the Supreme Court of Appeal) stated (at para [44] of the judgment) that –

In my view there is no merit in the submission.

In particular, (see the judgment at para [44]) it was held that Anglovaal's expenditure in acquiring the shares –

had no effect on such computation [of taxable income] as it was cancelled out by the book value of the shares at the end of the particular tax year as required by section 22. For purposes of computing [Anglovaal's] income

tax liability, it acted in accordance with the provisions of section 22.

Should the Supreme Court have endorsed the Tax Court's finding in principle?

The Supreme Court's judgment highlights the practical implications of returning information for tax purposes, namely that a deduction in relation to purchases of trading stock is never separately claimed in the year in which the expenditure is incurred – it is an element of the cost of sales, in which the value of opening and closing stock are also elements – and will have no effect on taxable income until the trading stock is disposed of.

In the computation of taxable income, the tax return (Form IT 14) requires the disclosure of information in relation to the company's income statement. Nowhere in this section of the return of income does one find a requirement to note purchases of trading stock nor the amounts taken into account as opening stock or closing stock. How, then, can a taxpayer "comply" with section 22?

It is therefore suggested that the Tax Court's statements on "compliance with section 22" displayed a lack of appreciation of the actual disclosure requirements of the Income Tax Act, and that whether the proceeds on disposal of an asset are of a capital or revenue nature remains a question to be determined in light of the particular facts and circumstances.

Exemption from VAT – a cautionary tale

It is not often that a VAT case comes before the Supreme Court of Appeal. That alone would make the decision, handed down on 12 March 2010, in *TCT Leisure (Pty) Ltd v CSARS* [2010] ZASCA 10 a noteworthy event.

The substance of the judgment is of great significance to anyone who gives advice on how to structure a business for maximum tax-effectiveness.

In this case, a business which had hitherto paid VAT on the product that it supplied, underwent a restructuring, after which it ceased to pay VAT on the (arguably) different product that it was now supplying, in the belief that VAT was no longer payable.

The question before the court was whether the business, in its restructured form, had indeed succeeded in qualifying for VAT exemption on its supplies.

A company that sold time share was restructured to sell preference shares linked to accommodation rights

Before the restructuring, TCT Leisure (Pty) Ltd (“TCT”) sold holiday accommodation in the form of time-share “points” to members of the public. It was common cause that these transactions constituted a taxable supply on which VAT was payable.

After the restructuring, TCT sold preference shares in a company called Leisure Holiday Club Ltd (“LHC”). These shares were linked to rights of use at timeshare resorts.

TCT argued that that what it was now supplying were VAT-exempt “financial services” in the form of “equity securities”.

The VAT Act 89 of 1991 exempts “the supply of any financial services” and provides that “financial services”



The judgment is of great significance to anyone who gives advice on how to structure a business for maximum tax-effectiveness.

includes “the issue, allotment or transfer of an equity security”.

An “equity security” is defined in the Act as –

any interest in or right to a share in the capital of a juristic person.

The essential question before the court was whether, after the restructuring of TCT’s business, the basis of the time-share scheme was changed from one in which “points” were sold to one in which “shares” were sold.

The evidence laid before the court was that, after the restructuring, members of the public could enter into a standard agreement with TCT which recorded that the company –

hereby sells to the Investor who hereby purchases in perpetuity, upon the terms of this agreement, a share

interest in the company, referred to as a Points Rights in the Scheme, which entitles him/her to be credited each year with the number of Points as determined in Schedule 2 hereto.

The sale was not of shares, but of shares plus points rights

The Supreme Court of Appeal held that what the taxpayer was selling was not simply shares, but share plus points rights.

Moreover – and this was the pivotal finding of the court – it was not the “share interest” in the company that entitled the purchasing member of the public to be credited each year with points rights, which in turn entitled the purchaser to accommodation rights in terms of the scheme. It was the points rights, said the court, that conferred the entitlement to accommodation.

The court went on to say that –

The fact that the taxpayer, as a matter of commercial practice only sold points together with shares ... does not result in a merger of the rights attaching to each, nor does it entitle the shareholder qua shareholder to exercise the rights of a points holder ...

The court concluded that –

the right to occupy was supplied, not as an incident of share ownership, but as a discrete element (in the form of points rights).

It followed that the taxpayer was not entitled to the exemption applicable to a person whose enterprise was that of supplying “financial services”, and that the full consideration payable by members of the public for the composite purchase of shares and points rights was subject to VAT.

This publication is provided by PricewaterhouseCoopers Inc. for information only, and does not constitute the provision of professional advice of any kind. The information provided herein should not be used as a substitute for consultation with professional advisers. Before making any decision or taking any action, you should consult a professional adviser who has been provided with all the pertinent facts relevant to your particular situation. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by the author, copyright owner or publisher.

© 2010 PricewaterhouseCoopers Inc. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. PricewaterhouseCoopers Inc is an authorised financial services provider.