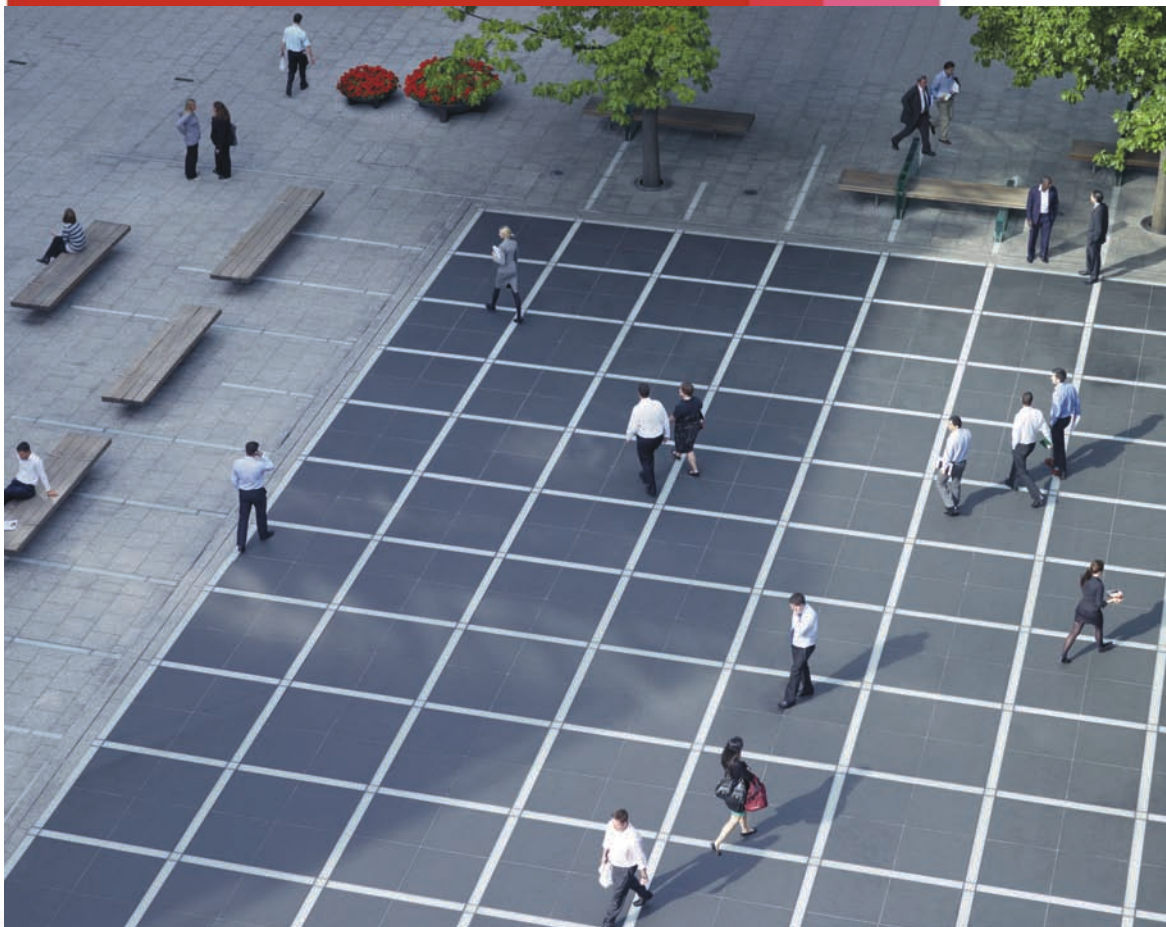


Synopsis

Tax today

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A monthly journal published by PwC South Africa providing informed commentary on current developments in the tax arena both locally and internationally. Through analysis and comment on new law and judicial decisions of interest, it assists business executives to identify developments and trends in tax law and revenue practice that might impact their business.



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Simulated transactions – moving the goalposts?

In the matter of C:SARS v NWK Limited [2010] ZASCA 168 (1 December 2010) the Supreme Court of Appeal found a financing transaction to have been a simulated transaction and upheld an assessment of the Commissioner disallowing certain amounts claimed as a deduction by the taxpayer.

The facts

The taxpayer had wished to obtain financing of R50 million over a five-year period. A bank had proposed that the taxpayer should instead enter into a loan arrangement in the sum of R96 million, paying interest annually in arrear and settling the capital amount of the loan on maturity by delivery of a specified quantity of maize in which the taxpayer traded. The taxpayer, as security for the obligation to effect delivery of the maize, was required to utilise R46 million of the loan to purchase a forward contract from a division of the lender for delivery of the same quantity of maize on the maturity date. This was then ceded to the lender as security for the future delivery of the maize.

The only flows to the taxpayer were a receipt of R96 million and a payment of R46 million on inception date (net receipt R50 million) and payment of R75 million of “interest” over five years.

The issue

SARS contended that the transaction was a sham. It argued that the parties had actually intended that there be a loan of R50 million, and that the loan should be repaid in five equal annual instalments, comprising interest and capital. It sought therefore to disallow R50 million of the interest claimed as a deduction by the taxpayer on the ground that it was, in reality, a repayment of the intended loan capital.

The taxpayer, on the other hand, pointed to the actual agreements and argued that it had intended that these should have effect according to their terms. It had performed its obligations in conformity with the stipulations in the agreement. Therefore the form and substance of the agreements were identical.

The judgment was delivered by Lewis JA, in which all five Justices of Appeal concurred.

Substance versus form

The Court summarised the principles on which it would be guided by reference to judicial precedent, and, after referring to the relevant decisions, concluded (paragraph [55]):

“In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. *If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated.* And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.” (Emphasis added)

The “purpose” test should be questioned

It is questionable whether the conclusion that the purpose of the



The Supreme Court of Appeal appears to have established a new principle that blurs the distinction between purpose and intention in determining whether there is a simulation.

parties is the decisive test was correctly distilled from the authority cited by the learned Justice of Appeal. There is no authority for the proposition that there will be no simulation where the parties intend to perform the obligations in terms of the contract. The authority for applying the purpose test cited by Lewis JA, was a *dictum* of Nienaber JA in *Hippo Quarries (Tvl) (Pty) Ltd v Eardley* (1992 (1) SA 867 at 877):

“Motive and purpose differ from intention. If the purpose of the parties is unlawful, immoral or against public policy, the transaction will be ineffectual even if the intention to cede is genuine. That is a principle of law. *Conversely, if their intention to cede is not genuine because the real purpose of the parties is something other than cession, their ostensible transaction will likewise be ineffectual. That is because the law disregards simulation.* But where, as here, the purpose is legitimate and the intention is genuine, such intention, all other things being equal, will be implemented.”

It is evident that Nienaber JA did not find that a transaction that has an unlawful purpose is a simulation. It is therefore difficult to understand that a conclusion was reached that the true test should be that a transaction where the purpose is to evade a peremptory law will be a simulation .

The purpose test thus stated overrides the principle established in *Dadoo*

Limited and Others v Krugersdorp Municipal Council (1920 AD 530) that the law does not forbid a transaction that is designed to circumvent a legal prohibition. In that case, two persons of Indian extraction were prohibited by law on racial grounds from owning certain property. They formed a company and became the holders of its entire issued share capital. The company then acquired the property which was registered in its name. The municipal council sought to have the transaction declared unlawful, claiming that the company was a sham - a “front” for the Indian shareholders who in reality controlled the property - and was utilised solely to circumvent a legal prohibition. The Court there held (at page 548):

“But an Act thus construed may nevertheless be evaded; parties may genuinely arrange their *transactions so as to remain outside its provisions.* Such procedure is, in the nature of things, perfectly legitimate.

There is nothing in the authorities, as I understand them, to forbid it. Nor can it be rendered illegitimate by the *mere fact that the parties intend to avoid the operation of the law*, and that the selected course is as convenient in its result as another which would have brought them within it. An attempted evasion, however, may proceed on other lines. The transaction contemplated may in truth be within the provision of the statute, but the

parties may call it by a name or cloak it in a guise, calculated to escape those provisions. Such a transaction would be in *fraudem legis*; the Court would strip off its form and disclose its real nature, and the law would operate.” (Emphasis added)

The majority, in *Dadoo’s* case drew a clear distinction between the purpose of the parties and their intention. It recognised that the structure of the transaction was designed to circumvent a legal prohibition. Notwithstanding this, it examined the intention of the parties in entering into the transactions. It found that the company, as a separate legal person with capacity to contract in its own right, was the lawful owner of the property for its own account, and was not, in law, an agent of the shareholders. In the result, the substance of the transactions was no different to the form.

Intention and purpose (objective) are apparently treated as the same in the NWK Case. The Court adopted a more restrictive view that if the purpose of the transaction is “to allow the evasion of tax, or of a peremptory law” it will be regarded as simulated. This contrasts sharply with the view that even though a transaction may escape the provisions of a law, it will be regarded as a simulation only if it is cloaked in a guise that conceals the true intentions of the parties.

It is submitted that the true test should remain whether the intention of the parties is other than what the contracts represent. A commercial objective to pay less tax or to achieve a result that may in other circumstances be prohibited in law should not be the sole or conclusive test.

Conflicting statements in the judgment

It appears that the Court, in applying the test to the evidence, applied the

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purpose test as the sole determinant, as demonstrated in the following statements from paragraphs [80] and [86]:

“The intention to perform in accordance with the terms of the contract is accordingly questionable, and the Tax Court should have considered this. It should have asked whether there was actually any purpose in the contract other than tax evasion. This is not to suggest that a taxpayer should not take advantage of a tax-effective structure. But as I have said, there must be some substance – commercial reason – in the arrangement, not just an intention to achieve a tax benefit or to avoid the application of a law. A court should not look only to the outward trappings of a contract: it must consider, when simulation is in issue, what the parties really sought to achieve.”

“As I have said, the appropriate question to be asked, in order to determine whether the loan and other transactions were simulated, is whether there was a real and sensible commercial purpose in the transaction other than the opportunity to claim deductions of interest from income tax on a capital amount greater than R50m.”

The Court concluded (at paragraph [90]):

“In view of the conclusion that I have reached that the loan for R96 415 776 was a transaction *designed to disguise the real agreement between the parties* – a loan of R50m – the Commissioner’s assessments were correct, and the appeal against the decision of the Tax Court in this respect must succeed.” (Emphasis added)

Strangely, the conclusion states the correct basis that should have been applied to determine whether there was a simulation. However, the stated legal test underlying the conclusion was that the purpose was to evade tax, and therefore the transaction was a simulation. Reliance on the purpose of the parties as the indicator which distinguishes substance from form is directly in conflict with the decision in the Dadoo case, a decision that has been a cornerstone of our company law for 90 years.

It would not have been difficult in the *NWK* case for the Court to have applied the intention test laid down in the precedents. The parties initially negotiated to enter into a R50 million term loan. By adding elements that had

no commercial or monetary effect, they “pumped up” the loan capital amount, so that the term loan appeared to be an entirely different transaction, yet the financial obligations and cash flows of the borrower were substantially the same as the term loan that was originally envisaged. It would (and should) have been determined by application of the intention test that the transaction was a sham, not because the purpose was to achieve a significant tax benefit, but because, in reality, it was intended that the taxpayer should raise a term loan of R50 million at interest, and the transactions that were entered into were intended to disguise the true intention.

A warning to tax planners

Unfortunately, the Supreme Court of Appeal appears to have established a new principle that blurs the distinction between purpose and intention in determining whether there is a simulation.

The principle laid down in the *NWK* case marks a clear departure from a number of earlier decisions. As a unanimous judgment of the Supreme Court of Appeal, it has binding authority as a precedent on all lower courts and may only be departed from if it can successfully be distinguished on a factual basis. The Supreme Court of Appeal might also find itself reluctant to disregard such authority unless it should itself subsequently determine that the appeal was decided on an incorrect basis in law.

It stands as a strong warning to tax planners.

Trends in tax governance and the relationship with revenue authorities

Managing tax compliance has become an increasingly complex issue with constantly changing assurance, regulatory and tax compliance requirements.

Globally, companies are now reassessing how they meet their obligations to file timely and accurate tax returns. In addition, global trends show that revenue authorities are serious about risk in the large business sector and are expecting tax payers to have proper frameworks in place to manage their tax risk.

The board of directors is expected to have active involvement in setting the risk appetite in relation to managing tax, in particular having an overview of the company's tax obligations and the tax outcomes associated with major transactions, agreements and strategies, and assessing the impact of its decisions on the company's ability to withstand scrutiny by the revenue authority.

Tax risk, which had often previously been delegated to tax departments and outsourced to consultants, may re-emerge in corporate boardrooms. In some jurisdictions the chief executives may now be held personally accountable for failures in the tax risk management of their companies.

International trends in enforcement based on risk

The Australian Tax Authority (ATO) relies extensively on a risk differentiation framework to profile large business taxpayers as low, medium or high risk. All large business taxpayers are regularly scanned using a variety of risk filters to detect issues that the ATO believes may cause concern. The ATO then adopts a risk management stance based on the perception of risk. If the likelihood and consequence of non-compliance are considered to be high, the ATO will target the taxpayer for a review or audit. Attention is attracted where a weakness in the compliance, structures, processes and approaches of a taxpayer to tax risk management is perceived. Therefore, a taxpayer's approach to tax risk will determine the nature of their interactions with the ATO.

In the Netherlands **the Dutch Tax Authority (DTA)** has for some time amended its approach by placing reliance on the taxpayer's tax control framework instead of executing detailed testing of tax compliance. The monitoring methodology of the DTA changed from a data based approach to a control and process based approach. In this new "Horizontal Monitoring" programme reliance is placed on generally accepted internal control risk

management frameworks like the COSO Integrated Internal Control model or the COSO Enterprise-wide Risk Management Model.

The approach of **HM Revenue & Customs (HMRC)** focuses on understanding how taxpayers' governance and processes manage its tax risk. The intention is to move away from enquiries which work backwards from disclosures on tax computations, to understanding a taxpayer's processes and systems for compiling information disclosed in the tax computations or returns. The HMRC profiles taxpayers as low risk" and "non-low risk" customers. The relationship with Low Risk customers can be summarised as one which is open and transparent. Where it is believed that a customer is either not managing tax compliance risk adequately or takes a position which, because of its innovative nature and/or its intended tax effect, presents a significant risk the HMRC will deploy the full range of specialist resources to work intensively with that customer to enable rapid reduction in their risk profile. Techniques used include interviews, walkthroughs of end-to-end processes and detailed systems audits to identify risk areas to obtain assurance that there is a robust process for producing tax return numbers.



broader scale assurance activities with greater focus on early detection and resolution of issues and a focus on issue based audits.

tailored specialist services, as required.

The core objective of tax administration is to foster voluntary compliance, which will undoubtedly require SARS to strengthen its risk identification and compliance research capacity and resources. Similar to its counterparts in other countries, SARS intends implementing world class risk engines and a centrally coordinated risk system to ensure an integrated intelligence gathering approach, detailed analysis and early detection of risks.

It is understood that SARS Large Business Centre has already begun a process whereby it will profile and rate taxpayer compliance levels, which will serve as an input into its risk profiling, audit case selection and auditing activities, focusing on high risk taxpayers. Undoubtedly these investigations will focus on the taxpayer's existing framework for the management and detection of tax risk, its compliance activities (registrations, filings, payments and disclosure) and its overall behaviour.

The purpose of the revenue authorities

It would appear that revenue authorities seek to ensure that tax is on the Board's agenda. This includes appropriate oversight, sound systems, clear accountabilities, strong controls, ethical behaviours, highly skilled people supported by robust processes and procedures, and the capacity to identify, assess and mitigate tax risks. A robust approach to tax risk management will function on two levels – strategic and operational. There is an expectation to see both strong corporate governance structures, and effective accounting and control mechanisms to meet day-to-day compliance and reporting obligations.

Key indicators that may attract attention when the revenue authorities undertake risk profiling may include effective tax rates, significant transactions, unexplained losses and tax outcomes that are inconsistent with industry patterns or with intent of the law, significant variation in tax payments, history of aggressive tax planning and unexplained variation between economic performance and tax performance.

Tax administration in South Africa – transparency and collaboration

The South African Revenue Service (SARS) has recognised that tax administration in South Africa must adapt and follow international best practice. Areas of focus include:

- a drive for more collaborative relationships.
- increasing use of sophisticated risk tools for audit case selection.

What does this mean for your business?

Boards of directors will need to re-evaluate their tax risk management processes, to ensure that their companies are appropriately placed to operate in a changing environment of tax enforcement.

Revenue Authorities will continue to put pressure on large business to manage tax risk in line with their expectations. In response to this, boards, audit committees and tax functions should internally debate and agree what their approach to tax governance and risk management should be, and ensure that both their documentation and practices reflect this.

In the interim, an opportunity arises for companies to both improve the robustness of their processes and systems and deliver efficiency savings. The new culture adopted by revenue authorities significantly increases their armoury in this area and its potential personal impact will undoubtedly have a mind-concentrating effect on the CFOs and others in large companies who will want to ensure that adequate tax control frameworks and systems are in place to report tax liabilities correctly. CFOs and those responsible will undoubtedly be wanting to consider the implications sooner rather than later and would be ill advised to wait until formal regulation is implemented.

Voluntary disclosure programme – SARS and SARB gear up

The voluntary disclosure programme (VDP) for tax and exchange control is now in its third month. The programme was announced by the Minister of Finance in the 2010 Budget Speech and has been in effect since 1 November 2010. However, as with other voluntary programmes, uptake has been muted in the early months. SARS and the Financial Surveillance Department of the SA Reserve Bank have therefore embarked on a programme of dissemination of information to intermediaries and financial advisors to explain the benefits and implications.

The tax programme

From a tax perspective, the VDP offers taxpayers an opportunity to right any evasion of tax that may have been perpetrated prior to 17 February 2010. The key trigger for access to the VDP is that there must have been a “default”.

A default may comprise:

- submission of inaccurate or incomplete information to the Commissioner;
- failure to submit information; or
- adoption of a tax position as a result of which the taxpayer:
 - was incorrectly assessed to tax;
 - paid the incorrect amount of tax; or
 - received a refund of tax.

The VDP allows taxpayers to make a full disclosure to SARS of the default, and for SARS to recover the tax that was not correctly paid or to recover any unjustified refund. The benefit to the taxpayer is that no interest or penalty will be imposed and immunity from prosecution will be given.

The VDP is not available to persons who are under investigation by SARS at the date of filing an application, except to the extent that they are able to satisfy the Commissioner that the default would not be expected to have been identified in the course of the investigation. In such an event, if qualified access is granted, the benefits of the VDP will apply with the exception that the remission of interest will be limited to 50% of the interest that would otherwise have been payable.

The exchange control programme

The exchange control VDP covers exchange control violations and is not linked to the tax VDP. Applications for tax and exchange control relief are required to be made separately. The exchange control VDP relates to contraventions of the exchange control regulations on or before 28 February 2010. By submitting a full disclosure of the irregularity it is possible for the applicant to regularise the position with the SA Reserve Bank without risk of prosecution or forfeiture subject to a potential liability to pay a VDP levy.

A number of circumstances may be regularised without payment of a levy.

For companies these include:

- failure to submit annual financial statements and progress reports on approved foreign investments;
- failure to lodge share certificates for approved foreign investments with authorised dealers;
- failure to obtain approval for disposal of approved foreign investments or failure to repatriate the proceeds;
- the holding of unauthorised foreign investments that meet the minimum criteria for foreign direct investment; and
- the raising of foreign loans where the loan funds have been repatriated to South Africa but no disclosure made to the Reserve Bank..

For individuals, regularisation without potential liability to a levy is available in respect of:



The VDP net is cast wide and access is afforded to all persons from the smallest individual to the largest corporate group.

Financial Intelligence Centre Act

The VDP does not afford complete protection to advisors who are subject to the requirements of FICA. However, it should be borne in mind that a reporting obligation does not arise where the income or foreign assets were derived from a lawful source (i.e. were not the proceeds of unlawful activity) and where, in addition, the professional advisor is assisting the client to absolve himself of a liability which would otherwise have arisen from past non-compliance with a tax or exchange control obligation. Therefore assisting clients who in good faith are contemplating application under the VDP should not be expected to expose the advisor to significant adverse risk under FICA.

The VDP is available to everyone

The VDP net is cast wide and access is afforded to all persons from the smallest individual to the largest corporate group. Compliance officers have an opportunity to examine tax and exchange control practices within the entities to which they are responsible, with a view to eliminating or mitigating risks that may have arisen from past non-compliance. In this regard, the adoption of tax positions in relation to tax-structured transactions may be a significant issue of concern, particularly in light of the principles laid down in the Supreme Court of Appeal in the matter of *C:SARS v NWK Limited* reported in this edition.

The VDP will be available for applications submitted no later than 31 October 2011.

failure to declare foreign assets on immigration;

failure to declare inheritances received before 17 March 1998; and

failure to repatriate foreign earned income derived before 1 July 1997.

In all other cases regularisation may be accompanied by a liability to pay a levy of 10% of the value of the unauthorised assets (subject to a reduction in the case of individuals in respect of unutilised foreign investment allowances), which must be funded out of foreign cash resources. In the event that the foreign assets are illiquid, it may be possible to negotiate payment out of local assets, in which case the levy will be 12%.

Practical guidance is available

Both SARS and the SARB have established specialised units to assist the public in determining the application of the VDP. It is possible for potential applicants or their representatives to approach these units on a no-name basis with a sanitised disclosure and seek a non-binding opinion on the application of the VDP. Such an approach protects persons who are considering an application, but wish to understand the full impact of such a step.

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