

Synopsis

June 2010

Tax today



Two co-conspirators
become enmeshed in the
web of their own deceit

In this issue

Two co-conspirators become enmeshed in the web of their own deceit 2

The tax-deductibility of audit fees 4

Can SARS introduce new reasons for assessment at the appeal stage? 6

New Zealand - Incorporation of a professional practice 7

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

Tax evasion

Two co-conspirators become enmeshed in the web of their own deceit

South Africa's income tax and capital gains tax system relies to a considerable extent on taxpayers to voluntarily disclose, fully and accurately, any taxable transaction they have entered into.

Inevitably, some taxpayers are tempted to understate the amount of a taxable receipt, or to overstate their deductible expenses.

Before succumbing to the temptation, such taxpayers would do well to ponder the implications of section 104(1)(d) of the Income Tax Act 58 of 1962 which provides that—

Any person who with intent to evade or to assist any other person to evade assessment or taxation —

...

d) makes use of any fraud, art or contrivance whatsoever, or authorizes the use of any, such fraud, art or contrivance,

shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding five years.

Is the potential gain from tax evasion worth the risk of acquiring a criminal record, incurring a hefty fine, and perhaps spending an uncongenial period of up to five years behind bars? Those are the countervailing considerations that any intending fraudster needs to weigh on the scales.

Where the proposed tax evasion requires the complicity of another party, the risk of exposure is of course immeasurably greater. For if a co-conspirator's scruples are flexible enough not to balk at cheating the revenue authorities, can he be trusted not to cheat his partner in crime?

The recent decision of the Durban High Court in *Accolla v Pillay* 2010 (3) SA 116 is a case study in how two co-conspirators in a tax scam



became enmeshed in the web of their own deceit.

In this case, a close corporation had sold its business to a certain Pillay.

The real selling price was R4 million but (so the purchaser later alleged) in order to reduce the seller's liability for capital gains tax, the sale agreement falsely reflected the selling price as R900 000.

But of course, the seller needed to be sure that he would be paid the true purchase price.

To this end, the seller therefore required the purchaser to sign (in addition to the agreement of sale reflecting a price of R900 000) a "consent to judgment" in the sum of R3.1 million in which the purchaser agreed to make an initial payment of R1 million, and to provide seven post-dated cash cheques for R300 000 each, payable to the seller.

The purchaser paid the first of these three cheques, but countermanded payment of the remaining four.

When the plaintiff sued, by way of a provisional sentence summons, for payment of those four cheques, the defendant pleaded that the reason that the purchase price was split between

Did the purchaser not realise that, even if he succeeded in warding off the seller's claim for payment of the balance of the contracted selling price, the judge would inevitably order that the court papers were to be referred to the revenue authorities?

the agreement of sale and the consent to judgment was "to save the seller of the business capital gains tax".

The purchaser went on to claim that the agreement of sale "was accordingly illegal as it was prohibited by statute" (namely, section 104(1) of the Income Tax Act, quoted above), that he was therefore not bound to the agreement, and that—

the purpose of both parties ... was to deceive the receiver of revenue into levying a lesser amount in respect of capital gains tax in respect of the sale than would be the case if the receiver were aware that the true sale price was R4 million.

It is of course extraordinary that the purchaser would go on record in this self-incriminating fashion in documents filed in open court.

Did the purchaser not realise that, even if he succeeded in warding off the seller's claim for payment of the balance of the contracted selling price, the judge would inevitably – as indeed transpired – order that the court papers and his judgment were to be referred to the revenue authorities?

In the event, the seller denied any attempt at tax evasion, but failed to put forward any explanation as to why the transaction had taken the form that it did. The court held that, in the circumstances, an explanation was required by the seller, and that the latter's silence could amount to a damaging admission.

The court ruled that the defendant had succeeded in establishing, on a balance of probabilities, that the sale agreement had been structured so as to deceive the tax authorities into levying capital gains tax on sale price of R900 000 when the true price was R4 million.

The civil consequences of the contract in question

Since this was a civil action between the two contracting parties (as distinct from a dispute between a taxpayer and SARS) the court had to determine whether, in the circumstances, the contract of sale was illegal and unenforceable, in which event the parties would be unable to claim specific performance or payment in terms of the contract.

In this regard, said the court, the question was whether the intent of the legislature, in relation to section 104(1) of the Income Tax Act, quoted above, was to render an offending contract null and void, or whether the legislature was content with merely attaching a penalty to those who contravened this provision of the Act.

The court noted that it was held in *McLoughlin NO v Turner* 1921 AD 537 at 544 that, in the case of a revenue statute, the mere imposition of a penalty for the purpose of protecting the revenue does not invalidate the transaction in question.

However, the court in the present case went on to say that an important issue is whether the object of the legislature was not exclusively to protect the revenue, but also to protect the public.

The court noted that one reason for declaring a prohibited act to be invalid is that, to recognise the act, would "give legal sanction to the very situation which the Legislature wishes to prevent". (See *Pottie v Kotze* 1954 (3) SA 719 (A) and *Absa Insurance Brokers (Pty) Ltd v Luttig and others* NNO 1997 (4) SA 229 (SCA) at 239H.)

In the present case, the court held that the object of section 104(1)(d) of the

Income Tax Act, quoted above, is to criminalise any fraud committed with the intent to evade tax.

The mischief at which this provision was aimed, said the court, was not solely to protect the revenue but was also –

to protect the public who have a legitimate interest in the fair and equitable assessment and levying of taxation.

The court commented that –

it has to be borne in mind that the parties to the transaction have actively conspired to perpetrate a fraud upon the revenue

from which the court concluded that a declaration of invalidity would not bring about inequitable results as between the parties concerned.

In the result, the court held that –

the intention of the legislature in enacting section 104 of the Act was to invalidate a transaction, one of the objectives of which was to perpetrate a fraud upon the revenue, in order to evade assessment or taxation.

The court held accordingly that the sale agreement in question was illegal and unenforceable, and that the plaintiff in this case, who was a party to the illegality, could not claim payment in terms of the contract.

The court therefore dismissed the plaintiff's claim for provisional sentence on the cheques in question.

However, the court also ordered that the papers in this case and the judgment be referred to the Commissioner of the South African Revenue Service "for his consideration and any further action he might deem appropriate".

The tax-deductibility of audit fees

The decision of the Gauteng Tax Court in case 12401 (judgment given on 15 March 2010) concerns the tax-deductibility or otherwise of audit fees and professional consulting fees incurred by the taxpayer in question, a listed public company that was, in the words of the judgment, an “an investor in shares and a lender of funds”, and which thus derived income in the form of both dividends and interest.

At issue was whether, in relation to this particular taxpayer, the expenditure on audit fees and certain professional consulting fees qualified for deduction in terms of the Income Tax Act 58 of 1962.

To satisfy the requirements of the general deduction provision in section 11(a) of the Act, the taxpayer bore the onus of proving that, in the particular circumstances of the case, the audit fees were –

incurred in the production of income; and were not of a capital nature.

Also at issue was whether this expenditure was barred from deduction by virtue of the disqualifying criterion laid down in section 23(f), namely that the expenditure in question was incurred –

in respect of any amount which did not constitute “income” as defined in section 1 of the Act.

The significance of the latter provision is that dividends are not “income” as defined in section 1 of the Act, since they are exempt from tax.

Consequently, expenditure incurred in the production of income from dividends is not deductible.

By contrast, interest is ordinary income and, in principle, expenditure incurred in the production of interest income is deductible, provided that, in relation to the production of such interest, the taxpayer was “trading”, as



required by the opening words of section 11.

The judgment therefore concerns the important question as to whether (and if so on what basis) expenditure on the annual audit of the company can be apportioned into a deductible and a non-deductible component where it is incurred by a company that derives part of its income in an exempt form.

The deductibility of the audit fees

Section 11(a) of the Income Tax Act provides that, in determining the taxable income derived by a person from carrying on any trade, a deduction can be claimed in respect of –

expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature

These words have been the subject of a great number of judicial decisions, and the interpretation of the various component phrases in this provision deviates considerably from their apparent meaning.

Thus, for example, it has been held that, for expenditure to be incurred “in the production of income”, it is not necessary that the expenditure actually produce any income.

What the law requires is that the expenditure be incurred by the taxpayer for the purpose of producing income (irrespective of whether any income actually results) and that there

The court noted that an audit fee is not based only on time, nor on the charge-out rates of the persons performing the audit, and that the risk involved and the complexity of the audit are also taken into account.

must be a close link or nexus between the expenditure in question and the taxpayer's income-earning activities. (See *Port Elizabeth Electric Tramway Co v CIR* 1936 CPD 241, 8 SATC 13.)

Nor is it necessary, in order to fulfil the requirements of section 11(a), that there be a causal connection between the expenditure in question and the income derived by the taxpayer. (*CIR v Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475 (A) at 479H-480A.)

In the present case, the court acknowledged (at para [13] of the judgment) that the taxpayer, being a public company, was legally obliged to have its financial records audited, but the court pointed out that such legal compulsion does not, of itself, mean that the expenditure so incurred is necessarily tax-deductible.

The court also acknowledged (at para [16]) that it is conceivable that particular expenditure may have been incurred for a dual purpose, that is to say, for the purpose of producing "income", as defined in the Income Tax Act, and also for producing amounts that are not "income", as so defined.

The significance of this principle in the context of the present case is that, as was noted above, expenditure incurred to produce dividends falls into the latter category, since they are exempt from tax.

The court in the present case said (at para [22]) that –

In order to weigh up the relative importance of a company's annual audit for its interest income as against its dividend income, regard should be had to the duties of a company's auditor, as set forth in section 300 of the Companies Act, 1973.

The taxpayer placed evidence before the court that only about 6% of the time spent by the auditors in carrying out an audit of the company related to its revenue from

dividends, but that "much work" in this regard was done in respect of the taxpayer's interest income.

The taxpayer argued that only 6% of the audit fees should therefore be disallowed as a deduction.

On the other hand, the evidence was that, over the four years in question, the taxpayer's dividend receipts (that is to say its exempt income) constituted on average about 95% of its total receipts and accruals.

The court concluded (at para [24]) that neither a time-based apportionment of the expenditure on audit fees (contended for by the taxpayer), nor a revenue-based apportionment (as contended for by SARS), would be a fair basis of apportionment in the circumstances of this case.

The court noted in this regard (at para [25]) that an audit fee is not based only on time, nor on the charge-out rates of the persons performing the audit, and that the risk involved and the complexity of the audit are also taken into account.

It was held (at para [26]) that since neither the taxpayer nor SARS had suggested an acceptable basis of apportionment, the court was free to devise a fair basis of apportionment, and that, "all in all", a 50/50 apportionment would be just and equitable.

Such an apportionment, said the court – will recognise not only the greater importance of the audit for the dividend-earning operations, but also the longer time spent by the auditors on the interest-earning operations.

In terms of the judgment, therefore, the taxpayer would be entitled to claim 50% of the audit fees as a deduction from its income in respect of each of the four years of assessment in question.

Can SARS introduce new reasons for assessment at the appeal stage?

In a recent decision (Case VAT 189, judgment given in the Tax Court, Johannesburg on 6 May 2010) the Court was required to adjudicate on an application by an appellant vendor to set aside an assessment to VAT or, alternatively, to set aside the grounds of assessment that had been filed by SARS in response to the Notice of Appeal in terms of Rule 10 of the rules for the conduct of objections and appeals (“the Rules”).

The dispute between SARS and the vendor had endured for a number of years and there had been correspondence between the parties before the issue of the assessments in question. The vendor had objected to the assessments and the objection had been disallowed. The vendor thereafter noted an appeal against the disallowance of the objection.

In the grounds of appeal filed by SARS in response to the notice of appeal, SARS adopted a new basis for assessing certain of the input tax that had been disallowed in the earlier assessment, by arguing, in the alternative, that this portion of the input tax should, if not disallowed in full, be apportioned. The apportionment basis had expressly been rejected by SARS in the course of the earlier correspondence.

The issue was summarised as follows:

“The question which requires an answer is whether or not it is permissible for SARS to include in the Rule 10 statement the new basis for supporting the assessments raised by SARS which is not only contrary to but also absent from the correspondence preceding the filing of the Rule 10 statement.”

In the absence of precedent in relation to the specific Rule, the Court placed reliance on the language used in the Rules themselves. The finding is encapsulated in paragraphs [18] to [20] of the judgment:

[18] On a pure linguistic interpretation according to the “golden rule”, the present tense would indicate that the statement is to set out the current grounds and material facts as at the date of its filing and not the grounds

as at the date when the disallowance took place. I am fortified in this conclusion by comparing the similar present tense wording used in the statement of the grounds of appeal to be filed by the taxpayer in accordance with Rule 11. In terms of Rule 11(2) (d) the taxpayer is obliged to set out the material facts and legal grounds upon which he or she “relies” and not “relied” for such appeal. The duties flowing from the parties to the appeal as set out in Rules 10 and 11 seem to me to oblige both parties to set out the various grounds and facts which each will rely on when the appeal is

In light of this decision it would be prudent for potential appellants in tax disputes to request written reasons for the disallowance of their objection in terms of Rule 3 before filing a notice of appeal.

heard. In fact, in common parlance, it has become accepted terminology to refer to these two statements as the “pleadings” filed by the respect parties in any appeal.

[19] Rule 12 dealing with the issues in the appeal expressly state the following:

“12. The issues in an appeal to the Court will be those defined in the statement of the grounds of assessment read with the statement of the grounds of appeal.”

It will be noticed that the rule does NOT state that the issues are defined by any preceding correspondence.

[20] I have no doubt that the legislative intention as well as a proper construction of Rule 12, leads one to conclude that the issues before the Tax Court are those defined in the pleadings i.e. the Rule 10 and 11 statements filed by the parties. The issues before Court are

therefore limited to those set out in the pleadings. There is in my view no ambiguity as far as these 3 (three) rules are concerned.

Following this conclusion, the Court dealt with submissions by the vendor’s counsel supporting the vendor’s contentions that the change in approach was not permitted.

In the course of the consideration of these arguments, the Court made the point that the Rules provide the vendor with the right to request reasons for disallowing the objection before filing an appeal against the disallowance. The Court noted that such an action would “no doubt” have caused SARS to disclose the new or different grounds, which the vendor could then have addressed in the objection.

The judgment did not, however, consider the position if the reasons for disallowing the objection supplied in terms of Rule 3 were not to include the new reason for assessment subsequently disclosed in a statement filed under Rule 10, and it is therefore unclear whether the vendor might have succeeded had there been a statement under Rule 3 which did not contain all of the grounds relied upon in a Rule 10 statement.

In light of this decision, and the open question as to whether SARS might be bound by the reasons given in a Rule 3 statement, it would be prudent for potential appellants in tax disputes to request written reasons for the disallowance of their objection in terms of Rule 3 before filing a notice of appeal.

Incorporation of a professional practice

A recent decision in the New Zealand Court of Appeal in the matter of *CIR v Penny and Hooper* [4 June 2010] NZCA 231 dealt with the disposal by two medical practitioners of their respective practices to companies by which they were subsequently employed and from which they drew salaries.

It was found that each practice had initially been disposed of to a first company for a relatively low value, of which the principal element was goodwill. Thereafter, the practice was on-sold to a second company at a considerably increased value, of which the principal element was again goodwill. The tax-free capital gain that resulted was then distributed to the practitioner as a dividend and used to settle personal debt.

The share capital in the second company was owned by a family trust. The company operated the practice and employed the practitioner at a salary. The salary derived by the practitioner from the company was a fraction of the income that he had derived as a sole practitioner prior to the transfer of the practice, with the result that a considerable portion of the income accrued to the company.

The rates of tax on companies and individuals (maximum marginal rate) were 33% and 39% respectively.

The company then distributed its after-tax income to the family trust, which, in turn advanced the moneys to the practitioner on interest-free loan.

The Commissioner attacked the schemes as tax avoidance schemes, maintaining that the purpose was to take advantage of the tax rate differential between companies and individuals. The practitioners countered that the purpose of the restructure had been to protect their personal assets from the risks of litigation not covered



by the government's accident compensation scheme.

The Supreme Court found in favour of the Commissioner. It found that "the salaries adopted were so far removed from commercial reality as to be contrived and artificial". It noted that the salary levels increased in conformity with the increase in the tax threshold for the application of the maximum marginal rate of tax.

The significant level of goodwill ascribed to the practices added to the artificiality of the transactions.

Although it did not take issue with the use of a corporate vehicle, it found that in combination with the surrounding circumstances, they had facilitated a significant reduction in tax liability.

In addition, the deployment of the profits back to the practitioners through

the family trusts enabled the practitioners to enjoy the full benefit of the income derived by the practices.

The argument of mitigation of personal liability was not accepted.

This matter is reminiscent of the South African decision in *CIR v Louw* 45 SATC 113 (A) from 1983, in which many of the elements were similar to those in the recent New Zealand decision, and in which the Appellate Division held that the anti-avoidance provisions in the Income Tax Act were applicable.

It is interesting to note that in the New Zealand and the South African cases, the Courts found that there was nothing improper in conducting a practice in a corporate vehicle, but found the avoidance to arise from the implementation of the transactions through which this was effected.

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.