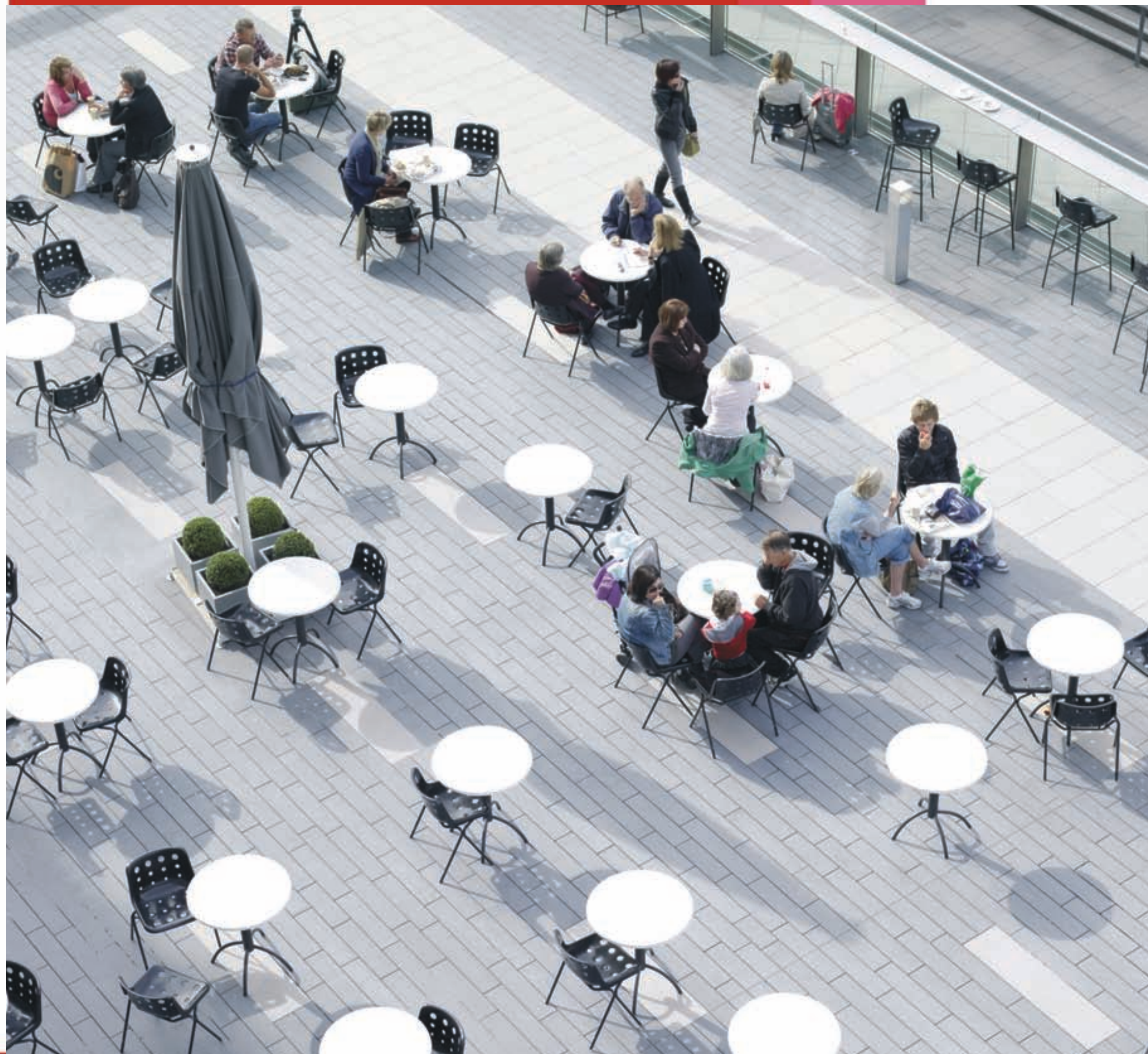
Synopsis
Tax today

March 2011

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.



pwc

Contents

1 Export of intellectual property: No approval necessary

4 Home office deductions

6 Launching the Tax Services Podcast Series!

7 Capital gains tax on ceasing to be a resident – treaty override

8 Corporate tax management - a changing landscape

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

Export of intellectual property: No approval necessary

The SCA overrides a Reserve Bank interpretation

For many years it has been considered that the Exchange Control Regulations impose a restriction on the disposal of intellectual property by a resident to a non-resident.

Regulation 10(1)(c) provides that "no person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose . . . enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic."

The official interpretation of Regulation 10(1)(c) in so far as it relates to intellectual property is found in the following extract from section 6.1.2.3 of the Exchange Control manual issued by the Financial Surveillance Department of the South African Reserve Bank:

"South African owned Intellectual Property may not be transferred by way of a sale, assignment or cession and/or the waiver of rights in favour of non-residents in whatever form, directly or indirectly, without the prior approval of the Financial Surveillance Department."

This interpretation has been rejected by the Supreme Court of Appeal in the matter of Oilwell (Pty) Ltd v Protec International Ltd and Others [2011] ZASCA 29 (judgment delivered on 18 March 2011).

In this case, a party had sought an order to set aside an earlier disposal of a trademark by a resident to a non-resident on the ground that it was an export of capital which had been effected without authorisation of the South African Reserve Bank, and therefore void. Reliance for this proposition was based on a decision in the matter of *Couve v Reddot International Ltd* 2004 (6) SA 425 (W), in which it was held that rights to patent applications were capital and that an assignment of such rights by a resident to a non-resident without prior approval of the SA Reserve Bank was a contravention of Regulation 10(1)(c) and invalid.

The Gauteng North High Court had rejected the application, and the matter came on appeal before the Supreme Court of Appeal.

In determining whether a trademark was capital as contemplated in the regulation, Harms DP, who delivered the judgment, made it clear that the determination in this regard applied equally to other forms of intellectual property such as patents, designs and copyright.

It was clear from an examination of dictionary meanings that the term "capital" has a number of possible meanings, depending largely on the context in which it is used. In *Couve's* case it had been held that the term meant "anything ... with monetary value". The Court suggested that the appropriate definition was to be found when the term is used in a financial context, namely "cash for investment [,] money that can be used to produce further wealth."

This definition was tested by reference to Regulation 10(1). The Court found (at paragraph 11):

After an exhaustive examination of a number of conflicting decisions, the Court concluded that a contravention of the Exchange Control Regulations did not render a contract void at the instance of a party.

"There are also other textual indications in reg 10(1) where paras (a) and (b) deal with the export of 'goods' while para (c) speaks of the export of 'capital'. This means, according to ordinary rules of interpretation, that there must be a difference between 'capital' and 'goods' and that the terms do not overlap."

The broad definition applied in *Couve's* case was inappropriate. Rather, the Court found (at paragraph 12):

"... a restrictive interpretation is called for, particularly in view of the fact that any legislation that creates criminal and administrative penalties, as the Regulations do, requires restrictive interpretation."

The Court criticised the decision in *Couve's* case on a number of other issues, including the reliance that had been placed on provisions of the Income Tax Act which regard expenditure on the acquisition of patents and trademarks as "capital expenditure". This reliance was found to be misplaced:

"How something that is capital for purposes of income tax can determine the meaning of the word in unrelated legislation dealing with currency is not understood."

It was therefore found that the trademarks in question had correctly been found not to be capital for purposes of Regulation 10(1)(c). For this reason the appeal could not succeed.

It follows that intellectual property may be exported from South Africa without prior approval of the Financial Surveillance Department of the SA Reserve Bank.

The Court also dealt with the question whether a contravention of a criminal provision rendered a contract void.

The facts showed that the parties at the time of the transaction did not contemplate having to obtain Reserve Bank approval for the assignment of the rights. It was noted that reference to intellectual property in the context of Exchange Control Regulation 10(1)(c) was only inserted into the Exchange Control Manual (which, the Court emphasised, has no legal standing) two years after the transaction. Therefore they did not have the intention of contravening the regulations.

After an exhaustive examination of a number of conflicting decisions the Court concluded that a contravention of the Exchange Control Regulations did not render a contract void at the instance of a party. This view is summarised in the following statement (in paragraph 24):

"The Regulations are, accordingly, for the public interest and not to protect any private interests. They were adopted for the sake of The Treasury and not for the sake of disgruntled or disaffected parties to a contract."

The Court was at pains to explain that parties to contracts that may be affected by the regulations are obliged to seek the necessary consents as a matter of good faith, but that, if consent was not obtained but performance had occurred, lack of consent would not be regarded as a ground for restitution. The remedy would lie with Treasury, who could exercise its powers to undo the contract.

Editor's note: It might be expected that the Exchange Control Regulations will be amended to address this interpretation.

Interpretation Note 28 (Issue 2)

Home office deductions

The decision of the Transvaal Provincial Division in Kommissaris van Binnelandse Inkomste v van der Walt 1986 (4) SA 303 (T) was a glorious but fleeting victory for salary and wage-earning employees in their otherwise dismal and one-sided bondage to the fiscus.

The decision in van der Walt held that a salaried university lecturer was, in that capacity, carrying on a "trade". That simple proposition opened the door to his (and all employees') being entitled to claim a raft of section 11(a) deductions for expenses incurred for the purpose of producing income.

In van der Walt's circumstances, such deductible expenditure was held to include the cost of maintaining a home study in his private residence in which to carry out academic research and interview students.

It was also held that, to be entitled to a section 11(a) deduction for his home study expenses, van der Walt did not have to show that he was under a specific contractual obligation to maintain such a study, but only had to show that a study was necessary to enable him to fulfill the terms of his employment.

It was held that, to establish the requisite *nexus* between the incurring of expenditure and the production of income in the form of his salary, van der Walt merely had to show that he had bona fide incurred the expense for the more efficient fulfilment of his duties.

However, in the aftermath of this judgment, it was not long before the Golden Rule asserted itself (the *Golden Rule*, for those not familiar with the wisdom of the comic-strip character, *The Wizard of Id,* decrees that whoever has the gold makes the rules). SARS soon instigated a series of amendments to the Income Tax Act to clamp down on the range of deductible expenses claimable by wage and salary-earning employees, irrespective of whether such expenses were incurred in order to produce income.

As matters stand today (save for employees who earn more than 50% of their remuneration in the form of sales or turnover-based commission) all that survives of an employee's entitlement to section 11(a) tax-deductible expenditure in general and home office expenses in particular are the pitiful remnants provided for in section 23(m) read with section 23(b).

Home office expenses

It is astonishing that, when there is consensus on the dire need for South Africa to have a more productive workforce, the Income Tax Act should impose restrictions on the deductibility of home office expenses, and consequently on the increased productivity that could result from taxpayers working or studying after hours in their home office, that is to say, in a part of their private residence.

As far as employees or office-holders whose earnings are not mainly commission-based are concerned , the Income Tax makes it irrelevant that the work and study carried out in their home office increases their income or enhances their productivity. The Income Tax Act obdurately refuses them any deduction whatsoever for home office expenses.

Why is this so? It may be inferred that one reason is the mindset that is bound to pervade any society where so many people work for the state and semi-governmental organizations, namely, that since you get your salary or wage irrespective of how much work you do, there's no point in taking work home with you.

The interplay of sections 23(m), 11(a) and 11(d) and 23(b).

Interpretation Note 28 is a useful source of information on the current labyrinthine interplay of section 23(m) with section 11(a), section 11(d) and section 23(b).

It is astonishing that, when there is a dire need for South Africa to have a more productive workforce, the Income Tax Act should impose restrictions on the deductibility of home office expenses, and consequently on the increased productivity that could result from working or studying after hours in home offices.

In essence, the philosophy is to deny employees and office-holders other than "agents" and "representatives" whose remuneration is mainly and normally derived from commission on sales or turnover, any home office expenses.

The latter statutory concession recognises the intellectual propensities of commission-based sales staff who are notorious for closeting themselves away until the small hours in their home office, studying psychology and marketing, and therefore deserve a fiscal benefit. By contrast, salaried accountants, attorneys, doctors and the like spend their evenings asleep in front of the television.

The Interpretation Note makes the point that, in the context of section 23(m), the term "employment" should bear the narrower meaning of an employer-employee relationship. Consequently, independent contractors fall outside the strictures of this statutory provision.

The further useful point is made that the "holding of an office", as envisaged in this provision, usually flows from an appointment, such as a judge or company director, whereas employment is based on a contract.

The Interpretation Note acknowledges that where a particular taxpayer receives two or more streams of income, section 23(m) will apply to those streams in respect of which "remuneration" is derived (except where more than 50% of such remuneration is mainly and normally commission-based) and will not apply to an income stream derived from the taxpayer's activities as an independent contractor.

The deduction of home office expenses

Home office expenditure typically includes rent, mortgage interest and repairs and may also include telephone expenses, stationery, rates and taxes, cleaning and office supplies. Where capital assets are concerned (such as computers, printers and photocopiers) the expense may take the form of lease payments or, where the items are owned, depreciation and wear and tear.

The Interpretation Note points out that, in order for any such expenses to be deductible, the requirements of section 11, section 23(b) and section 23(m) must all be met. The criteria

Launching the Tax Services Podcast Series!

Our tax experts will regularly give informed commentary on the tax issues of the day affecting your business and industry.

Our first topic deals with the recent NWK case. SARS has issued a warning that from 15 February 2011, it intends to use the NWK judgment to intensify its crackdown on simulated transactions.

Go here to listen to and/or download the podcast: http://www.pwc.com/za/taxcast.

from page 5

for deductibility in terms of section 11 are usually easily satisfied where the underlying asset is not of a capital nature. These expenses would include a proportion of rates and taxes on the property and wear and tear allowances on office equipment. Clearly, consumables such as stationery and ink cartridges are non-capital expenses.

However, section 23(m)(iv) makes clear that, where section 23(m) is applicable, the only section 11 expenses that the taxpayer is entitled to claim are those in respect of rent, repairs or "or expenses … to the extent that the deduction is not prohibited under [section 23(b)]".

Having cleared these hurdles, a taxpayer who claims entitlement to home office expenses must then satisfy the draconian requirements of section 23(b) which permits the deduction of –

domestic or private expenses, including the rent of or cost of repairs of or expenses in connection with any premises not occupied for the purposes of trade or of any dwelling-house or domestic premises except in respect of such part as may be occupied for the purposes of trade: Provided that—

a) such part shall not be deemed to have been occupied for the purposes of trade, unless such part is specifically equipped for purposes of the taxpayer's trade and regularly and exclusively used for such purposes; and

b) no deduction shall in any event be granted where the taxpayer's trade constitutes any employment or office unless—

i) his income from such employment or office is derived mainly from commission or other variable payments which are based on the taxpayer's work performance and his duties are mainly performed otherwise than in an office which is provided to him by his employer; or

ii) his duties are mainly performed in such part.

The Interpretation Note examines and explains these requirements seriatim, as follows –

the part of the premises must be specifically equipped for purposes of the trade, in other words, the part of the domestic premises in question must be fitted with the instruments, tools and equipment required to conduct that trade. (Whether a simple desk and chair would meet these requirements is arguable.)

a separate office must be maintained. (An open plan house would, it seems, rule out any deduction, although it may be arguable that a partitioned-off area may suffice.)

the part must be exclusively used for purposes of the trade. (It seems, therefore, that if the office doubles, for example, as a children's playroom, no deduction is claimable. Whether the presence of a television set or music centre in the home office would automatically rule out a deduction is uncertain.)

the taxpayers duties "must be performed mainly (more than 50%) in that part of the private premises occupied for purposes of trade". Perversely, therefore, a salesperson who spends eight hours a day doing the rounds of clients' premises canvassing for orders would not be entitled to a home office deduction unless he or she spends another eight hours of the day working in the home office.

Capital gains tax on ceasing to be a resident – treaty override

A person who ceases to be a resident faces a potential tax exposure by virtue of the operation of paragraph 12(2)(a) of the Eight Schedule to the Income Tax Act. This provision deems such a person to have disposed of all of his (or its, in the case of a company) assets for a consideration equal to their market value. Paragraph 13(1)(g)(i) deems the disposals to have taken place on the date immediately before the person ceased to be a resident. An anomalous position arose in 2003 when a company ceased to be a resident as a result of an amendment to the Income Tax Act.

Prior to 26 February 2003, the definition of "resident" in section 1 of the Income Tax Act treated any company incorporated in South Africa or which had its place of effective management in South Africa as a resident for income tax purposes. It was therefore possible that a company that was incorporated in South Africa but had its place of effective management outside South Africa, could be a resident of two jurisdictions.

In order to resolve this anomaly an amendment was enacted that provided that any person that was exclusively a resident of another jurisdiction in terms of a valid double tax agreement which South Africa had concluded with that jurisdiction would not be regarded as a resident for South African income tax purposes.

In Case 12432 in the Tax Court (judgment given on 16 November 2010), the effect of the change in the law was placed in issue.

Briefly a company incorporated in South Africa resolved to move its place of effective management to Luxembourg in 2002. An executive director remained in South Africa for a period after this resolution was taken, but left South Africa to relocate to Europe on 29 January 2003. On 26 February 2003 the amendment to the definition of "resident" came into force. At that time, the company had established its place of effective management in Luxembourg, and, in terms of the double taxation agreement between the two jurisdictions, it was regarded as exclusively resident in Luxembourg. The company therefore ceased to be a resident with effect from 26 February 2003. The company's sole asset at the time comprised of shares in another company.

SARS sought to assess the company to tax on capital gains on the basis that it was deemed to have disposed of its assets on 25 February 2003 for a consideration equal to their market value and was deemed to have derived a capital gain.

The company objected to SARS' assessment, on the ground that on 25 February 2003 it was regarded as exclusively a resident of Luxembourg under the provisions of the double tax agreement, and that the provisions of Article 13(4) of that agreement gave the exclusive right to Luxembourg to levy tax on capital gains in respect of the alienation of shares. In short, it claimed, SARS did not have jurisdiction to tax the amount.

The counter argument from SARS was that Article 13(4) did not apply in these circumstances. Article 13 applied in respect of gains from "the alienation of any property" and there had been no alienation in this instance – only a deemed disposal. Therefore, it argued, it retained a right to levy tax on the capital gain.

The judgment noted (at paragraph 10) that the double taxation agreement between South Africa and Luxembourg was gazetted by proclamation on 6 December 2000:

"The provisions of the DTA accordingly became applicable to South Africa in respect of years of assessment beginning on or after 1 January 2001, with the effect that for as long as the agreement remains in operation, its provisions, so far as they relate to immunity, exemption or relief in respect of income tax in the Republic, have effect as if enacted in the Act." (Section 108(2) of the Act. See also *Secretary for Inland Revenue v Downing* 1975 (4) SA 518 (A) at 523 A-B).

The Court rejected SARS' argument, finding (at paragraph 14 of the judgment):

"I am unable to accept this argument. In terms of paragraph 2(1)(a) of the Schedule, capital gains tax becomes payable in respect of 'the disposal of any asset of a resident'. Subparagraph 12(1) and 12(2) of the Schedule provide that upon an event occurring in terms of those provisions 'a person will be treated for the purposes of this Schedule as having disposed of an asset'. I am unable to see any reason why a deemed disposal of property should not be treated as an alienation of property for purposes of Article 13(4) of the DTA. I agree in this regard with counsel for the Appellant, who argued that it would be absurd if a taxpayer were to be protected in terms of Article 13(4) from liability for tax resulting from a gain from an *actual* alienation of property, but not from a *deemed* alienation of property."

It must be emphasised that this decision related to unique circumstances. However it reinforces the principle established in *Secretary for Inland Revenue v Downing* that the effect of section 108(2) of the Income Tax Act is that provisions of a double tax agreement modify the domestic law and will apply in preference to the domestic law to the extent that there is conflict with the domestic law.

Editor's note: It is considered that, even if SARS's argument that Article 13 of the DTA does not apply is correct, this would not guarantee success. The gain from the deemed disposal would fall within the scope of Article 21 (Other income) and the right to tax the amount would, in any event, be reserved to the country of residence (i.e. Luxembourg).

Corporate tax management - a changing landscape

The National Budget Speech is one of the most anticipated events in every tax professional's diary, as it presages potential tax proposals, legislative changes and compliance developments. Tax legislative changes need to be interpreted, not only from a legal compliance point of view, but also in relation to how they may affect business risks, processes and controls.

International standards and regulations are becoming more burdensome. Tax managers need to assume corporate governance and risk management responsibilities that extend far beyond compliance and risk functions within an organisation. The impact of tax issues now needs to be considered in light of the changing governance and risk landscape of an organisation. Increased regulation and focus on corporate governance and active risk management that flowed from the corporate failures in 2001 (and the more recent financial crisis) demand a new breed of tax professional in commerce and industry.

Domestically, development imperatives and a slowing economy have forced the fiscus to look at ways to increase the tax base and improve tax morality. SARS Commissioner, Mr Oupa Magashula, has emphasised this and made it clear that tax morality is not negotiable - taxpayers should pay the right amount of tax and be tax compliant. The SARS banking accord signed with the Banking Association in 2009 was one such initiative to promote the concept of being a good corporate citizen and abstaining from aggressive tax structures that will erode the tax base.

Tax professionals must operate in business environments where improved governance, adequate risk management practices, improved transparency and disclosure to the board, audit committee and stakeholders are expected. They may, in many instances, not have a risk, governance and compliance proficiency, resulting in the gap between tax procedures and enterprise risk management and corporate governance leaving organisations exposed.

Recent data published by PwC in the Non Executive Director report indicated a seven percent decline from 2010 in the number of non-executive directors available to serve boards and committees. This was as a result of the increased personal risk exposure and reduced fees earned in relation to the risks that the directors accept. This places further emphasis on the need for internal assurance, as boards and audit committee members will start raising questions and looking to management teams across the organisation to provide comfort.

Tax risk, which includes all tax types and tax liabilities, is considered to be one of the top 10 risks in any organisation. With increased awareness and tax risk maturity in the market place improving, management will be under increased pressure over the next three to five years to provide assurance in response to the concerns of the board, audit committee and external stakeholders, like SARS, on tax risk, and the tax control environment. Governance, enterprise risk management and the concepts of risks, controls and combined assurance frameworks will soon form part of a tax professional's lexicon. In order to meet the demands and requirements of stakeholders, various functions across an organisation will look to the company's tax professionals to assist with integration of tax risk into the organisation's risk frameworks and governance structures to demonstrate that it is a good corporate citizen, that risk management requirements are met and an adequate and effective tax control environment exists.

This increased need for risk information and internal assurance on tax risk, which is an area of specialism, will require the market to respond to a need to equip tax professionals with skills and expertise that will satisfy enterprise risk management as well as governance and assurance needs and responsibilities.

Having an effective tax function alone will not achieve the value required by stakeholders. Integration and synergies with co-assurance providers will not only be an enabler for the tax function, but will ensure that the board, audit committee and stakeholders can rely on the tax risk control environment.

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.

© 2011 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.