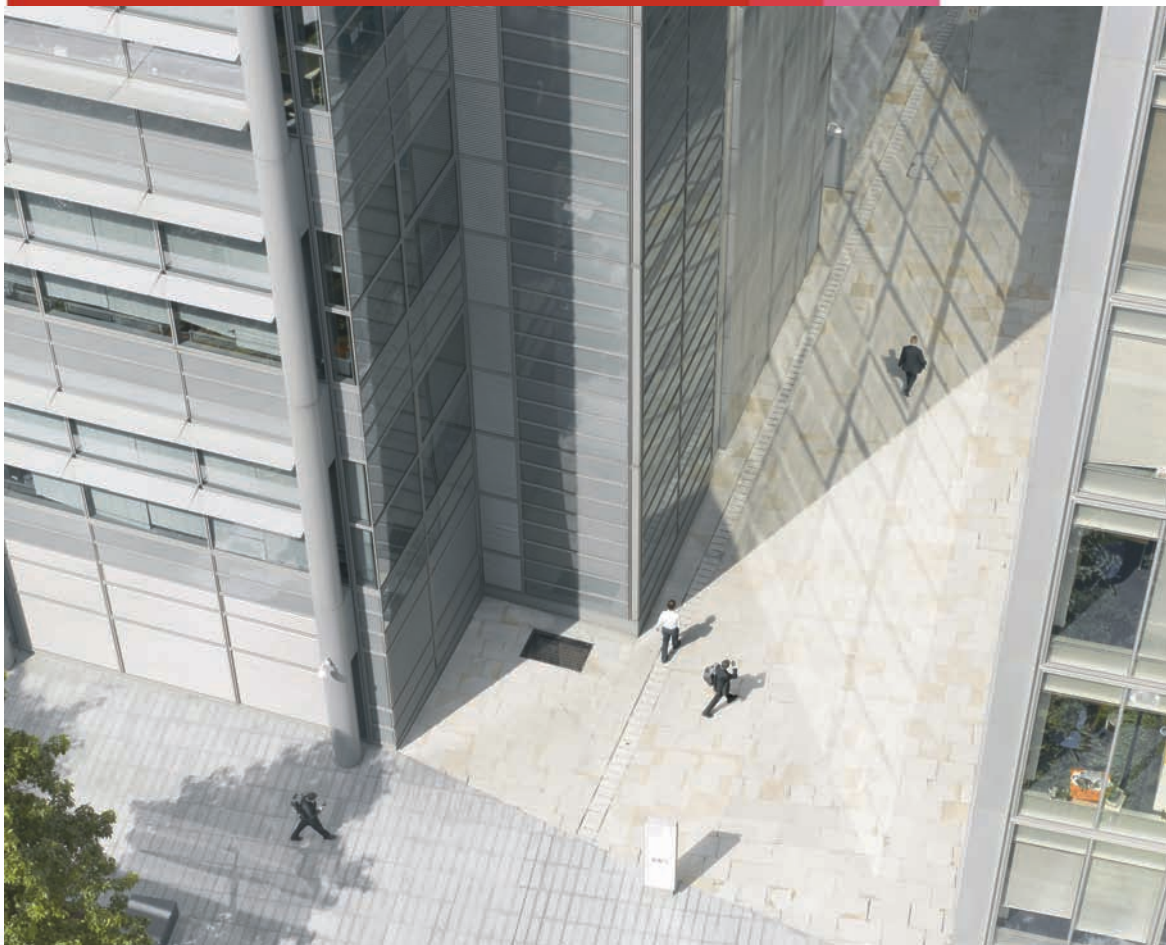


Synopsis

Tax today

May 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.



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“Realisation company” not a magical act to ensure favourable taxation

On 10 May 2011 the Supreme Court of Appeal handed down judgment in *CSARS v Founders Hill (Pty) Ltd* [2011] ZASCA 66.

This decision will send shock waves through the property development industry, scarcely less seismic than those which followed the Appellate Division decision thirty-six years ago in *Natal Estates (Pty) Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A). This decision will have tax-planning implications for institutions with property portfolios.

The *Natal Estates* decision involved farmland that had been held for many years in a company which was subdivided and sold in a vast orchestrated scheme involving the provision of services, the employment of national marketing agents and the imposition of standards of construction for purchasers to ensure optimization of prices. The Appellate Division held that the nature and scale of activities of the company were such that it had embarked on a scheme of profit-making using the land as its stock-in-trade, and found the profits derived from the sales of land to be taxable.

By a strange coincidence, the very next year, another case involving the sub-division and sale of property came before the Appellate Division in *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue* 1976 (2) SA 614 (A).

In this case, ownership in a tract of land was held in undivided shares by a trust (50%) with the remaining undivided half being held by 13 individuals (who were also the beneficiaries of the trust) in equal shares. The land was not capable of

sale as a single unit but only by piecemeal sale over a protracted period of time. A scheme was devised for the transfer of the land to a company and for the individuals to acquire shares and debentures in the company, whose purpose was to realize the land to best advantage.

The company did not acquire any further land, and from 1950 to 1970 it spent some R95 000 in developing the land by way of expenditure on roads, water supply and surveys.

In an appeal against an assessment to tax on the proceeds of the sale of the land, the Appellate Division held that the company was a *realisation company* and that the proceeds of the sale of the land were capital, not income.

In other words the company, unlike *Natal Estates Ltd*, had not “crossed the Rubicon” and embarked on a business of selling land for profit, but had merely realised to best advantage, a capital asset that had retained its character as such when acquired and sold by the company.

With the decision in *Berea West*, the concept of a “realisation company” was authoritatively accepted into our law.

The concept is an exception to the general principle that, where an asset is acquired for the purpose of resale at a profit, the proceeds of the sale are income, not capital, being derived from a trade or scheme of profit-making.



Founders Hill incurred expenditure of some R11 million in ensuring that each sub-divided stand was sold with services provided by the local authority, and in developing and marketing the properties.

The decision in Founders Hill

The taxpayer, Founders Hill (Pty) Ltd, was indicative of a “realisation company”, as envisaged in the decision in *Berea West*, having been formed for the avowed purpose of taking over and realizing land that was formerly owned and held as a capital asset by its holding company, AECI Ltd.

The latter company had been formed in 1924, following a merger of two other companies, and had acquired “vast tracts of land” in the process. SARS argued that Founders Hill had indeed crossed the Rubicon when it sold the land in question. Founders Hill, for its part, maintained that it had done no more than realize a capital asset to best advantage, and that the proceeds of the realization were capital, not income.

As the judgment notes, a so-called “realisation company” is one which is – formed for the purpose of facilitating the realization of property and the company does no more than act as the means by which the interests of its shareholders in the property may be properly realized.

Is property acquired by a realization company or trust a capital asset in its hands?

The interest of the judgment lies in the fact that Lewis JA, giving the

judgment of the court, made the point – perhaps not sufficiently recognised hitherto in judgments and commentaries and certainly not considered by the Tax Court in this matter – that SARS’ argument and the counter-argument begs the question of whether the property, on acquisition by Founders Hill, was ever a capital asset in its hands.

Clearly, this is the first issue to be determined. For, if the answer is in the negative, the question of whether the Rubicon has been crossed will not arise.

The circumstances of the acquisition by and sale of the land by Founders Hill

The stated main business and main object of Founders Hill (Pty) Ltd was (emphasis added)

To acquire from AECI Limited certain properties situate at Modderfontein, Johannesburg which are held by AECI Limited as a capital asset and which have become surplus to its needs, for the sole purpose of realising same to best advantage and within a period of one year of completion of such realisation to be voluntarily wound up.

On 24 June 1994, AECI duly sold certain erven to Founders Hill for a total price of some R14 million, including VAT, and other sales (some

preceded by sub-division) followed. Certain of the properties were rezoned and sub-divided by AECI prior to transfer to Founders Hill, and the latter engaged professionals to develop and market some of the erven.

Founders Hill incurred expenditure of some R11 million in ensuring that each sub-divided stand was sold with services provided by the local authority, and also in developing and marketing the properties.

Founders Hill had no employees and its sole shareholders and directors were those of its holding company, AECI.

A mere realization as contrasted with a sale in the course of a trade or scheme of profit-making

In her judgment, Lewis JA acknowledges the well-established principle that a taxpayer is entitled to realize a capital asset to best advantage. However, as she goes on to say (at para [42])

Calling an entity a ‘realization company’ (and limiting its objects and restricting its selling activities in respect of the assets transferred to it), is not itself a magical act that inevitably makes the profits derived from the sale of the assets of a capital nature.

As Lewis JA then goes on to say, it is equally established that, to quote from the decision in *Californian Copper Syndicate v Internal Revenue* (1904) Sc (Court of Session) LR 691 at 694, a profit on the realization of property will be assessable to income tax where –

what is done is not merely a realization ... but an act done in what is truly the carrying on, or carrying out of a business.

Lewis JA also acknowledged that the concept of a “realization company” (or realization trust) is well recognized in our law.

The leading decision in this regard is that of *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue* 1976 (2) SA 614 (A) where it was held that the taxpayer company was a realization company, and that when it sold the land in question, the proceeds of the sale were capital, not income.

In his judgment in *Berea West Estates*, Holmes JA had explained the concept of a realisation company as follows:

in general the authorities sanction a proposition which may be illustrated along the following lines: Suppose, for example, A and B and C own a tract of land, *not having acquired it with a view to sale*, and they wish to realise this capital asset; and they promote a company and become the exclusive shareholders; and they transfer the land to the company for the purpose of realising the asset; and, when it has been sold, the company is to be wound up and its assets distributed among the shareholders. The company would be regarded as a realisation company, and not a company trading for profits, and the surplus would be regarded as a capital receipt; unless, of course, the company conducted itself as a business trading for profits, using the land as its stock-in-trade.

Lewis JA distinguished between a company formed for the sole purpose of realizing property to best advantage and a realization company, by stating (at para [44]) that (emphasis added) –

A “realisation company” (that is to say, a company which acquires property, previously held by its shareholders, for the purpose of sale on their behalf) will be subject to income tax on the proceeds of such sale, except in “special circumstances”.

In my view an interposed realization company (or other entity) will stand in the shoes of the entity that has transferred assets to it, and hold them in turn as capital assets, *only in special circumstances*, exemplified in Holmes JA’s judgment in *Berea West* (where A, B and C hold shares in property and require a vehicle to sell them as advantageously as possible, as was the case in *Berea West*), or where there is a need to protect the assets from the original holder. *Malone Trust v Secretary for Inland Revenue* is an illustration of the latter situation.

In the present case, said Lewis JA (at para [53]):

Counsel for Founders Hill could not explain why [the company] was formed, and AECI assets sold to it, other than on the basis that AECI had taken legal advice to this end. That is not an explanation. And the case does not fall within the exception recognised on the special facts of *Berea West* where the realization of the property was not the main purpose of the interposition of the trust but a subsidiary one, or where, in the example of *Holmes JA*, three parties form a company to enable them to realize their properties to their best advantage. Special cases do not create general rules.

In essence, therefore, the Supreme Court of Appeal has held in *Founders*



Hill that a “realisation company” (that is to say, a company which acquires property, previously held by its shareholders, for the purpose of sale on their behalf) will be subject to income tax on the proceeds

of such sale, except in “special circumstances”, which are exemplified in the facts of *Berea West* and *Malone Trust v Secretary for Inland Revenue* 1977 (2) SA 819 (A).

Conclusion

It is thus no longer the law in South Africa – if ever it was – that there is a general principle whereby a person or entity who holds a capital asset, can form a realisation company or trust for the specific and limited purpose of realising that asset, secure in the knowledge that the proceeds of the disposal will be capital and not income in the hands of that entity.

In terms of the decision in *Founders Hill*, that proposition will hold true only where there are “special circumstances”, and in all other cases, the proceeds of such a sale will be income and taxable as such in the hands of the realisation company or trust.

Are you ready for the new dividends tax?

STC will be replaced by a dividend withholding tax with effect from 1 April 2012. To an extent, this is old news, but don't stop reading, because the new tax will create a huge administrative burden which many companies appear to be unaware of or have not yet started any preparatory work.

The basic issue

The dividends tax will be levied at a rate of 10% on dividends paid by South African resident companies or foreign companies listed on the JSE. The tax is levied on the shareholder but must be withheld by either the company paying the dividend or a so called "regulated intermediary". Conceptually there is nothing complicated about the new form of tax. As always, though, various exemptions and variations apply, and that is where the complications arise. In essence, detailed information will be required about shareholders, to a level that was not needed up till now. Taking into consideration the way in which the investment industry is structured, obtaining and maintaining such information and, accordingly, withholding the correct amount of tax, may be no easy task.

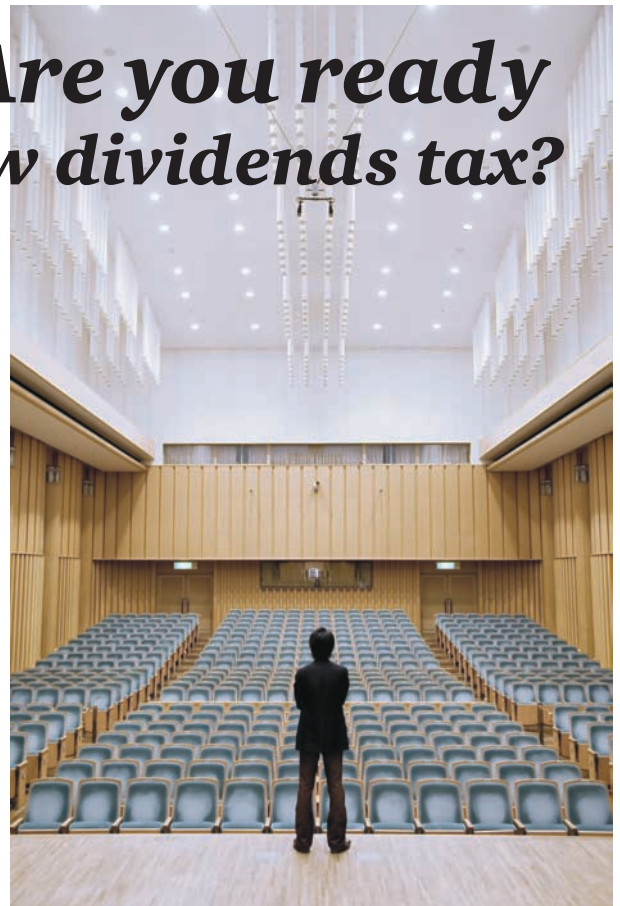
The OECD published a report in 2009 dealing with the problems of applying withholding taxes to cross border investors in collective investments vehicles. Certain of the comments from this report equally apply to the situation of the dividends tax in South Africa: "The international financial system is built around financial intermediaries..."; "In all of these intermediate structures, there may be a number of layers between the issuer of a security and the beneficial owner..."; "[it] effectively requires the information to be passed through multiple layers of financial intermediaries..."; "In addition to the administrative burdens involved in

processing large amounts of paper, a more fundamental problem with any such requirement is that it is inconsistent with the intermediary's business goal of protecting its proprietary customer information...".

In the case of private companies with only a few shareholders, or within a group of companies, obtaining such information should be easy. Although there are still certain procedures to be followed by companies within this category, the focus of this article is on listed companies with a large (and diverse) number of shareholders.

Investment structure in South Africa

Uncertificated or dematerialized listed investments in South Africa are regulated by the central security depository, known under its abbreviated name of STRATE. Linked to STRATE are six central securities depository participants (CSD Participants), mainly the large banks and Computershare, the only non-banking entity. The next level of role players, who are in most cases the entities with direct contact with investors, are brokers. STRATE compiles shareholders information from the CSD Participants, which are then made available to companies via their appointed transfer secretaries.



Therefore, the typical chain of information flow is from shareholder to broker to a CSD Participant to STRATE. The flow of dividends from a listed company to its dematerialized shareholders would be a payment to STRATE, who would in turn pay onwards to the CSD Participants, who would pay on to the broker, who would pay on further down the chain.

The aforementioned system is in respect of uncertificated shares. Companies must run separate systems for certificated shares because these are not administered by STRATE, but by the companies' appointed share transfer secretary.

Both CSD Participants and brokers keep so-called nominee accounts. Shares may therefore be registered in the name of say "ABC Bank Nominees", which would then be the shareholder reflected on the companies' sub registers in STRATE, and CSD Participants records. ABC Bank Nominees will presumably have the details of the shareholder, but such information might not be sufficient for purposes of administering the dividends tax. For example the shareholder on record

Nominees might not be the beneficial holder of the dividend because it is a trust with vested beneficiaries or the dividends could be the subject of a cession in favour of a third party. It might also not be clear from the records whether the beneficial holder of the share falls into the category of exempt persons (see below) in respect of the dividends tax.

Exemptions and variations

Beneficial owners exempt from the dividends tax include resident companies, certain public benefit organisations, pension, provident and benefit funds and various other organisations which are normally exempt from income tax. Although it should be clear in the majority of cases whether a beneficial owner falls within any of these categories, there will be cases which are border-line and where further enquiry would be necessary.

If the beneficial owner is a non-resident then no exemption applies. However, the 10% rate might be reduced in terms of a double tax agreement between South Africa and the country of the non-resident person. In addition (this rule applies to the so-called dual listed companies), if the dividend has been subject to withholding tax in a foreign country such withholding tax can be set-off as a credit against the South African dividends tax.

Special rules apply where the shareholders are insurers or collective investment schemes, or where the dividend consists of a distribution of an asset in specie. To further complicate matters the withholding tax must be reduced by STC credits available in the company. In addition, following the recent amendment to the definition of “dividend” for tax purposes and the introduction of the concept of

“contributed tax capital” a payment regarded as a dividend for company law or accounting purposes might not be a dividend for tax purposes, or vice versa.

Administration

It is clear, therefore, that a comprehensive process of information gathering is needed. In addition there must be a clear line of communication between the company, regulated intermediary and shareholder on the matters mentioned above. Special attention must be paid to the structure in respect of certificated shares. The standardisation of forms, procedures and communication lines will be important to an efficient system. Shareholders are notorious for not opening large envelopes entitled “important shareholder information inside” – they therefore need to be “incentivised” in this regard by stating clearly that, unless full information is received in time, a 10% tax will be withheld.

The Income Tax Act prescribes certain procedures and places reporting obligations on different persons. The Act also allows for SARS to prescribe certain formalities, which may include the use of prescribed forms and procedures. None of these have been released yet by SARS.

Process going forward

The Act places the obligation to withhold and pay over the tax to SARS on the company declaring the dividend unless the dividend is paid by the company to a regulated intermediary. If paid by the company to a regulated intermediary, the withholding obligation then shifts to such person, unless it is paid on in turn to another regulated

Unhappy shareholders do not complain to the regulated intermediaries – rather, they phone the company secretary or the chairperson of the Board. To avoid a potentially chaotic situation and to maintain a happy shareholders corps, companies need to take action early.

intermediary. CSD Participants, brokers and nominees as described above all fall within the definition of a regulated intermediary. Other persons falling within the definition are certain transfer secretaries.

It is clear that in most instances the withholding tax and information gathering function will be on a regulated intermediary, probably the one closest to the shareholder. But companies cannot simply sit back and shift the responsibility. They need to take an active interest in the process and ensure that each party in the structure has the required infrastructure and competence to perform the information gathering and administration process. The difficulty for companies in this regard is that a number of regulated intermediaries might be involved in the administration of their shares and it may therefore be difficult for companies to control the process.

Unhappy shareholders do not complain to the regulated intermediaries – rather, they phone the company secretary or, the more popular option, the chairperson of the Board. In order to avoid a potentially chaotic situation, which could include endless reconciliations and refunds, and to maintain a happy shareholders corps, companies need to take action early.

PwC is closely involved in discussing the introduction of the dividends tax with National Treasury, SARS and role players in the Investment Industry. For more information contact: Charl du Toit 021 529 2367.

The VAT lottery

In last month's edition of *Synopsis* we reported on a recent decision in the Tax Court in the Western Cape concerning a payment of R67 million received by a company (Limited) for the cancellation of an exclusive right to distribute certain brands of Scotch whisky in South Africa and certain neighbouring territories (The capital - revenue lottery). This saga had a second instalment, namely, whether Limited was liable for the payment of VAT on the transaction (VAT Case No. 179, judgment handed down on 14 March 2011).

SARS had assessed Limited to VAT on the payment, to which Limited had objected on a number of grounds. The objection was disallowed and the matter proceeded to trial.

There had been a taxable supply and the critical issue was whether tax was payable at the standard rate of 14% or at the zero rate of tax.



The issues before the Court could be summarised as being the following:

Had there been a taxable supply; and

If there had, was the supply subject to VAT at the standard rate or the zero rate?

The Court commenced from the basis that a vendor is liable to account for VAT on a supply of goods or services made in the course or furtherance of an enterprise.

There was no apparent dispute that Limited was a vendor and that Limited carried on an enterprise.

The first issue centred on whether there had been a supply of a service. SARS contended that the definition of service is extremely wide and includes the "surrender of a right". Limited argued that the right was a time-limited right that would have expired in any event and that it had not surrendered the right, merely anticipated its termination date. The Court rejected this argument. Limited had an exclusive right that would have entitled it to distribute the

whiskies for a further 41 months, and concluded:

"The surrender of the right constituted 'services' as defined in section 1 of the Act and by concluding the termination agreement, the appellant voluntarily 'supplied' as defined in section 1 the services (being the surrender of the right)."

Secondly, the Court found that the value of the supply in respect of which tax should be payable is the amount of the consideration less so much of such amount as represents tax. After stating the definition of "consideration" as provided in the Value-added Tax Act, the Court then held that:

"The value of the services supplied was consequently the R67 million."

This is an unusual conclusion as the *consideration* and not the value was clearly R67 million.

Limited contended that the compensation that it had received was not received in the course or furtherance of its enterprise. The Court rejected this hypothesis and found that the decision to seek compensation was "integral to the furtherance of the enterprise".

There had therefore been a taxable supply and the critical issue was thus whether tax was payable at the standard rate of 14% or at the zero rate of tax.

Section 11(2)(l) of the VAT Act provides for the imposition of tax at the rate of zero per cent where:

"the services are supplied to a person who is not a resident of the Republic, not being services which are supplied directly

(i) . . .

(ii) in connection with movable property (excluding debt securities, equity securities or participatory securities) situated inside the Republic at the time the services are rendered, except . . .

(iii) . . .

and not being services which are the acceptance by any person of an obligation to refrain from carrying on any enterprise, to the extent that the carrying on of that enterprise would have occurred in the Republic."

There was no dispute that the services were supplied to the distiller who was not a resident and that the payment was not in respect of a restraint of trade. The question that required decision was therefore whether the services were supplied in connection with movable property situated in the Republic at the time that the services were supplied.

SARS contended in its papers that the services had indeed been supplied in connection with movable property situated in the Republic, without specifying the property to which it referred. The Court first excluded the stock of whisky, by noting that Limited had sold its entire stock to the new distributor and had levied VAT in respect of that supply.

The response of SARS was that it was not referring to the stock of whisky, but to the right that had been cancelled. This, they contended, was an incorporeal thing under the law of property and therefore classified as movable property. Further it was situated in the Republic because it was predominantly exercisable in the Republic.

The response of the Court was to first point to the illogicality of the SARS argument. How could one agreement be a service and goods at the same time?

“These services must be supplied *directly in connection with movable property situated inside the Republic* at the time the services are rendered. Logically there must be two separate entities: the services being supplied and the moveable property which stands in direct connection with the services being supplied. I fail so see how the right which is being surrendered, the surrender of which constitutes the supply of the services, and is thus a constituent part of the services being supplied, can at the same time constitute the moveable property which is required by the provisions of section 11(2)(l) to be in direct connection with the very services being supplied.”

If it were wrong, the Court went on, it is not clear that the property was situated in the Republic. The Court questioned the appropriateness of precedents relied upon by SARS, and found that they did not support SARS’ contention that the location of a right is where it is exercisable. Instead, the Court referred to the decision of the Supreme Court of Appeal in *MV Snow Delta: Serva Ship Ltd v Discount Tonnage Ltd* 200(4) SA 746 (SCA), in which the SCA had noted a conflict of view between the Roman-Dutch commentators, Voet and Grotius, and had found that:

“Our Courts have adopted the view of Grotius. The first reported judgment is *Union Government v Fishers’ Executrix* 1921 TPD 328 (Wessels JP, De Waal J concurring). This judgment was approved and followed by this Court in *Randfontein Estates Gold Mining Co Ltd v Custodian of Enemy Property* 1923 AD 576. Innes CJ (at 581) pertinently held that the only attribute of locality that personal actions possess must relate to the locality where the debtor resides: it is only there that the incorporeal rights can be regarded as localised.”

The distiller had an obligation to permit enjoyment of the right that it had granted to Limited, and therefore, the grantor of the right was the distiller, who was not resident in the Republic at the time the services were supplied.

The Court therefore determined, correctly it is submitted:

“...that the supply of services is subject to VAT at the rate of zero per cent in terms of the provisions of section 11(2)(l) of the Act.”

International Tax - a rare opportunity

The South African Fiscal Association has been fortunate in engaging the services of Jonathan Schwarz, a leading UK barrister, and renowned author of a number of international tax publications, to come to South Africa and deliver a seminar on aspects of international tax planning.

The one day seminar is divided in four independent presentations of 90 minutes each on the following topics:

Tax treaties and domestic anti-avoidance rules;

International tax language and treaty interpretation;

Current Permanent Establishment issues; and

Practical effect of the 2010 changes to the OECD Transfer Pricing Guidelines.

The cost for attendance for SAFA members is R750 per delegate (to a maximum of four delegates for corporate members). For non-members and for corporate members from the fifth participant the cost is R1 000.

Cape Town

Date: 13 June 2011

Venue: Crystal Towers Hotel and Spa
Century City

Time: 09:00 – 16:30

Johannesburg

Date: 14 June 2011

Venue: Southern Sun Grayston
Sandton

Time: 09:00 – 16:30

For reservations, please contact Jolandie James on 021 529 2368 or email jolandie.james@za.pwc.com

For more information go to www.ifa.org/ - see Newsletter 2/2011.

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