

Synopsis

Tax today

Nov/Dec 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

- 2 *Tax law is certain only in so far as a court has ruled on the point in issue*
- 4 *Application of Exchange Control Amnesty and Amendment of Taxation Laws Act - A fortunate outcome*
- 6 *The pay-now-argue-later rule festers in our income tax system*

Tax law is certain only in so far as a court has ruled on the point in issue

One of the great difficulties facing tax consultants is that tax legislation, particularly the Income Tax Act, is complex and difficult to interpret. There is no certainty as to the proper interpretation of any provision in tax legislation until the High Court (or better still, the Supreme Court of Appeal or the Constitutional Court) has handed down a decision on the particular issue.

There are many issues of tax law which have never come before the courts and whose interpretation has therefore never been authoritatively determined.

Decisions of the Tax Board or the Tax Court on the interpretation of tax legislation have, strictly speaking, no authority as judicial precedents, for these are tribunals tasked solely with the review of assessments and they are not courts of law.

The problem is exacerbated by the fact that tax legislation is constantly being amended. A court may give judgment on a particular provision of tax legislation, bringing welcome certainty on its interpretation. That provision may thereafter be amended by parliament in a way that renders the judgment irrelevant, or at least of uncertain authority in relation to the interpretation of the amended provision.

The soon to be enacted Tax Administration Bill will have the effect of deleting many provisions of the Income Tax Act and relocating them in the Tax Administration Act. The statutory draftsman has taken the opportunity to change the wording of some of these provisions, with the result that new uncertainties in interpretation have been created.

All of this can cause great hardship for a taxpayer and his professional advisers.

In a vacuum of judicial authority on a particular point of interpretation, advisers must gaze into their crystal ball and try to predict how a court would rule on a particular issue. And if they get it wrong, there is nothing in the Income Tax Act to say that the taxpayer must be treated leniently.

The courts do not give opinions on abstract or hypothetical issues

Nor is it possible for a taxpayer to approach the court and ask it to give a ruling, in the absence of a disputed tax assessment, on what a particular provision of a tax act means.

As Kriegler J remarked in *Ferreira v Levin NO; Vryenhoek v Powell NO* 1996 (1) SA 984 (CC) –

the business of a court is generally retrospective; it deals with situations or problems that have already ripened or crystallized and not with prospective or hypothetical ones.

And as Innes CJ observed in *Geldenhuis & Neethling v Beuthin* 1918 AD 426 at 441:

Courts of Law exist for the settlement of concrete controversies and actual infringements of rights, not to pronounce upon abstract questions or

Written by: R C (Bob) Williams
Editor: Ian Wilson
Sub-editor and layout: Carol Penny
Tax Services Johannesburg
Distribution: Elizabeth Ndlangamandla
lizzy.ndlangamandla@za.pwc.com

to advise upon differing contentions, however important.

Indeed, section 21A(1) of the Supreme Court Act 59 of 1959 is explicit that the court will adjudicate only on an actual dispute, which its decision will resolve, and not on hypothetical issues or a matter where the point in question has become moot, that is to say, of no practical relevance. This provision reads:

When, at the hearing of any civil appeal to the Appellate Division or any Provincial or Local Division of the Supreme Court, the issues are of such a nature that the judgment or order sought will have no practical effect or result, the appeal may be dismissed on this ground alone.

In the recent decision of the Supreme Court of Appeal in *Clear Enterprises (Pty) Ltd v CSARS* [2011] ZASCA 164, in which judgment was given on 29 September 2011, the court invoked this provision of the Supreme Court Act, declined to give any decision on the case at hand, and struck the matter from the roll.

Advance tax rulings

It is, perhaps, a pity that there is no legislative provision for the High Court or the Supreme Court of Appeal to hear argument on a particularly important point of interpretation in relation to tax legislation, and give a ruling, for the guidance of taxpayers and SARS.

There is however provision in the legislation for SARS to give an advance ruling on a particular point of tax law, on application by a taxpayer and on payment of a fee. Such advance rulings will soon be governed, in relation to all types of tax except customs and excise duties, by chapter 7 of the Tax Administration Act.

SARS is permitted to decline giving an advance ruling on any of a number of grounds, now spelled out in section 80(1) of the Tax Administration Bill.



SARS is permitted to decline giving an advance ruling on any of a number of grounds, now spelled out in section 80(1) of the Tax Administration Bill.

The grounds on which SARS may decline are so wide-ranging – for example that giving an advance ruling would be *unduly time-consuming or resource intensive* – that, in effect, SARS can always opt out of giving a ruling if it feels disinclined to do so.

And if SARS gives a ruling as to the way in which a particular provision of the Act will be interpreted in

relation to a particular factual scenario, and the taxpayer thinks that SARS has got it wrong, he cannot take the ruling on appeal to the courts. The taxpayer will then have to decide whether to go ahead with his plans anyway, resign himself to the fact that SARS will probably assess him on the basis of the advance ruling, and that he will then have to argue for his interpretation of the Act in the Tax Court and (if the matter goes on appeal) in the High Court.

Application of Exchange Control Amnesty and Amendment of Taxation Laws Act

A fortunate outcome

There is a saying that hard cases make bad law. A recent decision in the South Gauteng Tax Court (reported as Income Tax Case No 1844 73 SATC 45) appears to be such a case.

The matter concerned the application of the Exchange Control Amnesty and Amendment of Taxation Laws Act, 2003. An employee of a South African subsidiary of a US parent company, working in South Africa, had over a number of years been awarded options to acquire shares in the US parent in terms of a group share incentive scheme. In contravention of the exchange control regulation, he had, on exercise of the incentive options, arranged for the relevant securities to be sold and for payment of the proceeds into an offshore account. The income derived in these transactions was taxable in terms of section 8A of the Income Tax Act. He had omitted to report this income in his returns of income for the relevant years. He had therefore made application for and was granted tax and exchange control amnesty in respect of these infractions.

Amnesty

The legislation provided for amnesty under two specific sections, namely, section 15 in respect of “receipts or accruals from a source outside the Republic” (foreign source income) or section 17, which dealt with “amounts accumulated as or converted to foreign assets” (domestic source income).

The taxpayer had applied for and been granted amnesty in terms of section 15. SARS subsequently determined that the amnesty was inapplicable, as the declaration by the taxpayer that the amounts were derived from a foreign source was

incorrect, and amnesty should have been sought under section 17. SARS raised an assessment for the employee share option benefit derived in the 2002 year of assessment, to which the taxpayer objected, stating that the amnesty prevented SARS from assessing him to tax. After denial of the objection, the matter came before the Tax Court on appeal.

One’s sympathies lie with the taxpayer in this matter. He had taken up the invitation to “clear the slate”, as it were, and had disclosed all the information that had previously been withheld. In the circumstances, he felt that he was fully protected by the amnesty.

In the judgment of the Court (CJ Claassen J), the crucial issue was identified in paragraph [18] (at page 52):

“What is important for this case, is whether or not the income received by the appellant fell within the four corners of s 15 or s 17 of the Amnesty Act. Section 15 clearly refers to undeclared foreign income from a source outside the Republic, whereas as s 17 refers to income of undeclared amounts which have arisen within the Republic.”

SARS’ argument was that the benefit from an employee share incentive scheme is a benefit of employment. The taxpayer had become entitled to the benefits in respect of services rendered in the Republic. Therefore, the income was derived from a source within the Republic. The taxpayer should have applied for amnesty in terms of section 17 and not section 15. In

short the application was defective and the amnesty ineffective.

To most observers, SARS’ logic is straight out of Tax 101 – the source of income is not the location from which it is paid, but the *quid pro quo* given in return for the income received, and the location of the source is the place where the services were performed. An employee stock option is a benefit of employment and the source is therefore located at the place where the services were rendered.

The Court was not persuaded by this approach, and ruled that the evidence overwhelmingly indicated that the amounts were from a source outside the Republic. This was concluded because all of the activities in the operation of the share option scheme took place in the USA, with the funds then being deposited in the Isle of Man, and that the option contract was concluded in the USA, in terms of the principles for establishing the place of contract.

Wrong approach

It is submitted, with respect, that the approach taken by the Court to establish the source of the income was wrong. The question was not where the relevant amounts had arisen, but the source of such amounts – a very different issue.

An employee share option provides the opportunity to the employee to profit from appreciation in the value of the underlying shares between grant (the date he accepts the option) and vesting (the date



The taxpayer had taken up the invitation to “clear the slate”, as it were, and had disclosed all the information that had previously been withheld - he felt that he was fully protected by the amnesty.

when the option may be freely exercised). Employee share incentive schemes typically require that the employee should remain in the service of the employer until the benefit vests, with penal forfeiture provisions if the services of the employee should terminate prior to the vesting date. This leads to an inescapable conclusion that the benefit afforded by such an option represents remuneration for services rendered or to be rendered.

The source of income taxable in terms of section 8A of the Income Tax Act was considered by the High Court in 1978 in *SIR v Kirsch* 40 SATC 95. In that matter an SA company had allotted shares at a bargain price to service directors of a subsidiary who were employed in Israel. Inland Revenue sought to tax one of these persons, who was also a director of the SA company, arguing that the benefit was remuneration from a source within the Republic arising from

his services as director and not as employee. The Court rejected this argument, stating (at 100):

“During argument it became clear that the appellant had lost sight of the fact that these allottees, referred to as ‘service directors of the Company in Israel’ at the directors’ meeting, were not the only directors of International... It seems to me that this fact utterly contradicts the suggestion that respondent received the shares qua director and indeed it establishes that the causa was his work as a ‘service director’ in Israel. Once that is so there is no basis for saying that the income was ‘from a source within or deemed to be within the Republic’...”

This was a unanimous decision of the Full Bench of the Transvaal Provincial Division. It was almost the exact reverse of the matter that was being adjudicated in *ITC 1844* – involving acquisition of shares in an SA company by a foreign based employee of a foreign subsidiary. The principle is crystal clear though – the services are the source (*causa*) of the income. One would have thought

that the Tax Court of South Gauteng was bound by the doctrine of *stare decisis* to apply the principles from this judgment.

Silke on South African Income Tax (at 5.8) states the law on source of remuneration to be the following: *“While the Supreme Court has yet to consider the point, the Special Court for Hearing Income Tax Appeals (now the Tax Court) has consistently laid down that the source or originating cause of income from employment and other services rendered is the services, irrespective of the place where the contract is made or the remuneration is paid.”* (Emphasis added)

That said, serious doubts remain as to the correctness of this decision, and, if the matter has been taken on appeal to a higher court, the Supreme Court may yet have an opportunity to consider the point.

The pay-now-argue-later rule festers in our income tax system

It is not surprising that the draconian “pay-now-argue-later” rule continues to feature in High Court decisions on income tax, most recently in Mobibane v CSARS [2011] ZAGPJHC where judgment was handed down on 20 October 2011.

The pay-now-argue-later rule is probably the most invasive of a taxpayer’s rights. After all, the notion that a person should be obliged to pay a debt that he disputes, and which has not been adjudicated by a court, is fundamentally offensive to ordinary conceptions of justice.

When we scrutinise the recent decision in *Mokoena v CSARS* 2011 (2) SA 556 (C) what we see, in essence, is the presiding judge, Spilg J, rebelling and recoiling against the very notion of a taxpayer’s having to pay now and argue later. As he said in this judgment, where a taxpayer’s objection to and appeal against an assessment is still pending –

It is self-evidently incompetent, having regard to the rights of objection and appeal, to obtain judgment in the interim.

It may well be that Spilg J was wrong in his interpretation of the language of the Income Tax Act, but his instinctive recognition of injustice was impeccable.

Of course, the counter-argument to the proposition that it is *inherently incompetent* for SARS, having issued an assessment, to file a statement under section 91(1)(b) of the Income Tax Act, which then has the “effect” of a civil judgment, is that in *Metcash Trading Ltd v C:SARS and Another* 2001 (1) SA 1109 (CC), the Constitutional Court affirmed the constitutionality of having to pay tax now and argue later.

Indeed, the Supreme Court of Appeal in *CSARS v Hawker Air Services (Pty) Ltd* 2006 (4) SA 292 seemed to take this view where the court refers to –

the pay now argue later rule, the constitutionality of which was established by [the decision of the Constitutional Court in] Metcash Trading Ltd v Commissioner, South African Revenue Services...

But is this correct? Did the Constitutional Court approve a “rule” that statutory provisions requiring a taxpayer to pay now and argue later are constitutional? Is it not more correct to say that the Court merely affirmed the constitutionality of the pay-now-argue-later provisions of the *Value-added Tax Act* without expressing any view, even *obiter*, as to whether that “rule” is constitutional in the context of the *Income Tax Act*?

It is all too easily forgotten that *Metcash* was concerned only with whether the pay-now-argue later principle of tax collection offends against constitutional norms in the context of the *Value-Added Tax Act*. The decision of the Constitutional Court that the pay-now-argue-later provisions of that Act are not unconstitutional is by no means decisive of the constitutionality of the similar provisions in the context of the *Income Tax Act*.

This is because there are fundamental differences between VAT and income tax. In the VAT system, a person who registers as a VAT vendor is declaring out of his

own mouth that he is engaging in a trade of providing particular goods or services, and there is no scope for a later denial. In the context of income tax, however, determining whether a the taxpayer was trading in a particular commodity, or was engaged in a scheme of profit-making (or is entitled to a section 11(a) deduction for expenditure or whether a particular receipt or accrual was of a capital nature) may involve complex issues of law and fact, the resolution of which may require a lengthy trial, with many witnesses and much documentary evidence and argument by opposing counsel on points of law that are strongly arguable both ways.

In the VAT system there is a very narrow range of possible disputation between a vendor and SARS and it is far more likely that a VAT vendor who denies liability vis-à-vis SARS is engaging in what the Constitutional Court in *Metcash* called “frivolous objections”. In income tax, on the other hand, there is a very wide range of issues of law and fact on which a taxpayer can, in good faith and on reasonable grounds, contest liability.

As the Constitutional Court pointed out in *Metcash* –

‘having regard to the fundamental nature of VAT and the painstakingly detailed mechanism provided by the Act for calculating, collecting, recording and regularly transmitting VAT by vendors, an amount assessed by the Commissioner ... is in the nature of a liquidated debt.’

For all these reasons, therefore, a pay-now-argue-later rule is far more defensible, constitutionally, in the context of VAT than it is in the context of income tax.

The protection afforded by the Promotion of Administrative Justice Act

However, in practical terms, rather than incur the high costs and long delays of a constitutional challenge, it makes more sense for a taxpayer faced with an income tax assessment that he disputes, not to challenge the constitutionality of the pay-now-argue-later provisions of the Income Tax Act, but rather to apply in terms of the current section 88(2) of the Income Tax Act (soon to be repealed and replaced by section 164 of the Tax Administration Act) for the obligation to pay the disputed tax to be suspended “pending a decision of a court of law” pursuant to an appeal against the assessment.

The reference in this provision to a “court of law” is significant, for the Tax Court is not a court of law, and what the Act envisages in this provision is a suspension of the obligation until the High Court has given judgment on the disputed assessment.

It is also noteworthy that section 164(6) of the Tax Administration Bill provides that –

During the period commencing on the day that—

(a) SARS receives a request for suspension [of the payment of assessed amount of tax pending a decision of the High Court on the appeal against the assessment]; or

(b) a suspension is revoked [by SARS], and ending 10 business days after notice of SARS’ decision or revocation has been issued to the taxpayer, no recovery proceedings may be taken unless SARS has a reasonable belief

The pay-now-argue-later rule is probably the most invasive of a taxpayer’s rights. After all, the notion that a person should be obliged to pay a debt that he disputes, and which has not been adjudicated by a court, is fundamentally offensive to ordinary conceptions of justice.



that there is a risk of dissipation of assets by the person concerned.

This provision thus gives the taxpayer a ten day breathing space, if SARS gives a negative decision on the request for suspension, to prepare an urgent application to the High Court to interdict the enforcement of the assessment pending a challenge to that decision in terms of the Promotion of Administrative Justice Act.

The Tax Administration Act now spells out in section 164(3)(a) – (h) the considerations that SARS must take into account in determining whether to accede to a request for such suspension. These include whether payment of the disputed tax would result in *irreparable financial hardship* to the taxpayer.

A striking omission from the list of considerations to be taken into account is whether the taxpayer is disputing the assessment on *prima*

The pay-now-argue-later rule festers in our income tax system

facie reasonable grounds.

Considerable doubt exists over the correct interpretation of provisions in the tax law for the simple reason that there have been wholesale amendments to the law over a number of years and many of the disputes have not yet come before the Courts. The legislature in this context, it is submitted, should have recognized that the lodging of an objection on reasonable grounds is a relevant consideration.

It is likely that the issue of whether payment, up-front, of the disputed amount of tax would result in *irreparable financial hardship* to the taxpayer (as envisaged in section 164(3)(e)) will be the focus of an application for suspension of payment.

This phrase – particularly the word *irreparable* – sets a very high threshold, but on closer scrutiny, the entire expression makes little sense. One may speak of an irreparable financial loss (hardly appropriate in this context, since SARS will always have funds to fully recompense the taxpayer for a loss), but in what sense is *hardship* “irreparable”? The more suitable

word was surely *severe* financial hardship and the courts will probably interpret the phrase in this way.

But even so the yardstick is very imprecise. How is hardship to be measured? Is the critical threshold not having money to put food on the table? Having no choice but to sell the family home so as to pay the tax? Foregoing a holiday? Having to take a child out of private school?

Until the High Court speaks on the interpretation of section 164(3)(a) – (h) it is difficult to predict how these eight statutory criteria will be interpreted and in particular, the relative weight to be attached to each. Thus, for example, if the taxpayer has an impeccable *compliance history* as envisaged in sub-section (a), will this prevail over all the other considerations? If the taxpayer is able to provide *adequate security for payment* as envisaged in (d) will this factor, in and of itself, always be decisive?

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.