

# Synopsis

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Exchange Control Voluntary  
Disclosure Programme  
released for public commentary

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# The Exchange Control Voluntary Disclosure Programme

As foreshadowed in an announcement by the Minister of Finance in his Budget Speech of 17 February 2010, the Exchange Control Department of the South African Reserve Bank has released for public comment (to be received by 2 August 2010) a draft Exchange Control Voluntary Disclosure Programme (VDP) as well as an amendment to the Exchange Control Regulations of 1961, to be included as Regulation 24.

The VDP deals with the way in which contraventions of the Regulations will be regularised, whilst Regulation 24 provides for the granting of administrative relief.

## Regulation 24

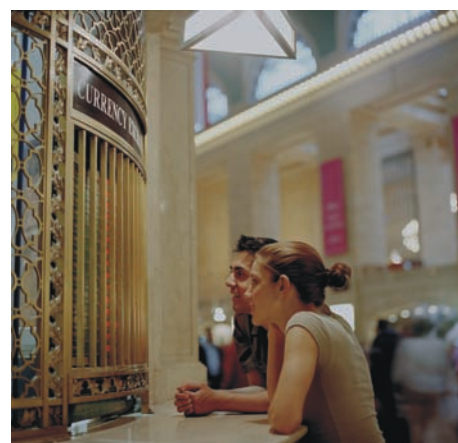
For the duration of the prescribed period, the proposed Regulation 24 will authorise the Treasury, or its delegate, to invite persons who have contravened the Regulations to apply to have the contraventions regularised. An affidavit or solemn declaration in regard to the contravention will be required.

## Purpose of the voluntary disclosure programme

The VDP is intended to encourage persons who are subject to the Regulations and who may have contravened them, to come forward, disclose and thereby regularise their contraventions, subject (where applicable) to the payment of a levy. The draft VDP makes provision for the following three categories of procedures.

## Disclosure and regularisation

In this category, natural persons and corporate entities who have contravened specified provisions of the Regulations will be entitled, by



declaration and disclosure to Exchange Control through an authorised dealer, to regularise the contraventions. Disclosures and declaration falling into this category will not attract a levy and relate to the following.

In respect of natural persons, declarations made by –

- (i) immigrants to disclose their foreign assets; and
- (ii) failure by residents to disclose –
  - (a) foreign inheritances and legacies received prior to 17 March 1998,
  - (b) foreign income earned prior to 1 July 1997;
  - (c) foreign loans (with recourse to the Republic of South Africa) raised to acquire a foreign asset prior to 28 February 2010 in contravention of the Regulations;

*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*

In respect of corporate entities, declarations by residents of –

(i) contraventions, prior to 28 February 2010, of the provisions of an approval relating to an approved foreign investment and which relate to the submission of financial statements and progress reports, the lodging of share certificates, the placing on record of the expansion of foreign investments, the declaration of dividends and their remittance to the Republic prior to 26 October 2004, and the disposal of all or part of a foreign investment;

(ii) unauthorised foreign loans (with recourse to the Republic) raised by them prior to 28 February 2010, provided such foreign loans accord with the applicable Exchange Control policy;

(iii) the acquisition of foreign investments prior to 28 February 2010 which are unauthorised and which accord with applicable Exchange Control policy. Where declaration and regularisation are not permitted in terms of this provision, applicants are entitled to apply for general administrative relief.

### Administrative relief for loop structures and donors to discretionary trusts

In terms of this category, applications are to be made pursuant to the provisions of Regulation 24, and in this regard –

(i) qualifying residents (both natural persons and corporate entities) who had, prior to 28 February 2010, entered into “loop structures” may regularise the transactions and will be required, as part of such regularisation, to dispose of the interest held via a non-resident entity to a resident within 180 days of submitting the application. This is to be disclosed to Exchange Control in an application through an Authorised Dealer and will attract a levy equal to 10% of the applicable funds;

(ii) a resident who is a donor (or the deceased estate of a donor) of a discretionary trust, which is not a resident, may elect that the foreign assets held by such a discretionary trust prior to 28 February 2010 be deemed to be held by such resident. This is to be disclosed to Exchange Control in an application through an Authorised Dealer and will attract a levy equal to 10% of the value of the foreign assets disclosed.

### General administrative relief

Applications in this category are to be made pursuant to Regulation 24.

Residents (both natural persons and corporate entities) who have contravened any of the provisions of the Regulations at any time prior to 28 February 2010, including contraventions involving the ownership of an unauthorised foreign asset (excluding bearer instruments) will be entitled, by providing the required

information, to apply to have such contraventions regularised.

Applications under this category may be made directly to Exchange Control or through an Authorised Dealer for onward submission to Exchange Control.

The levy payable by qualifying residents, which must be remitted from funds held abroad, is an amount equal to 10% of the market value of the unauthorised foreign asset, disclosed as at 28 February 2010. Where the qualifying resident has no offshore funds available to pay the levy, a local payment will be permitted subject to an additional levy of 2%.

Where a qualifying resident has exited funds in contravention of the Regulations and has no foreign assets, a levy of 12% on the amount exited in contravention will be payable.

All disclosures and applications made in terms of the draft VDP are to be made before 31 October 2011.

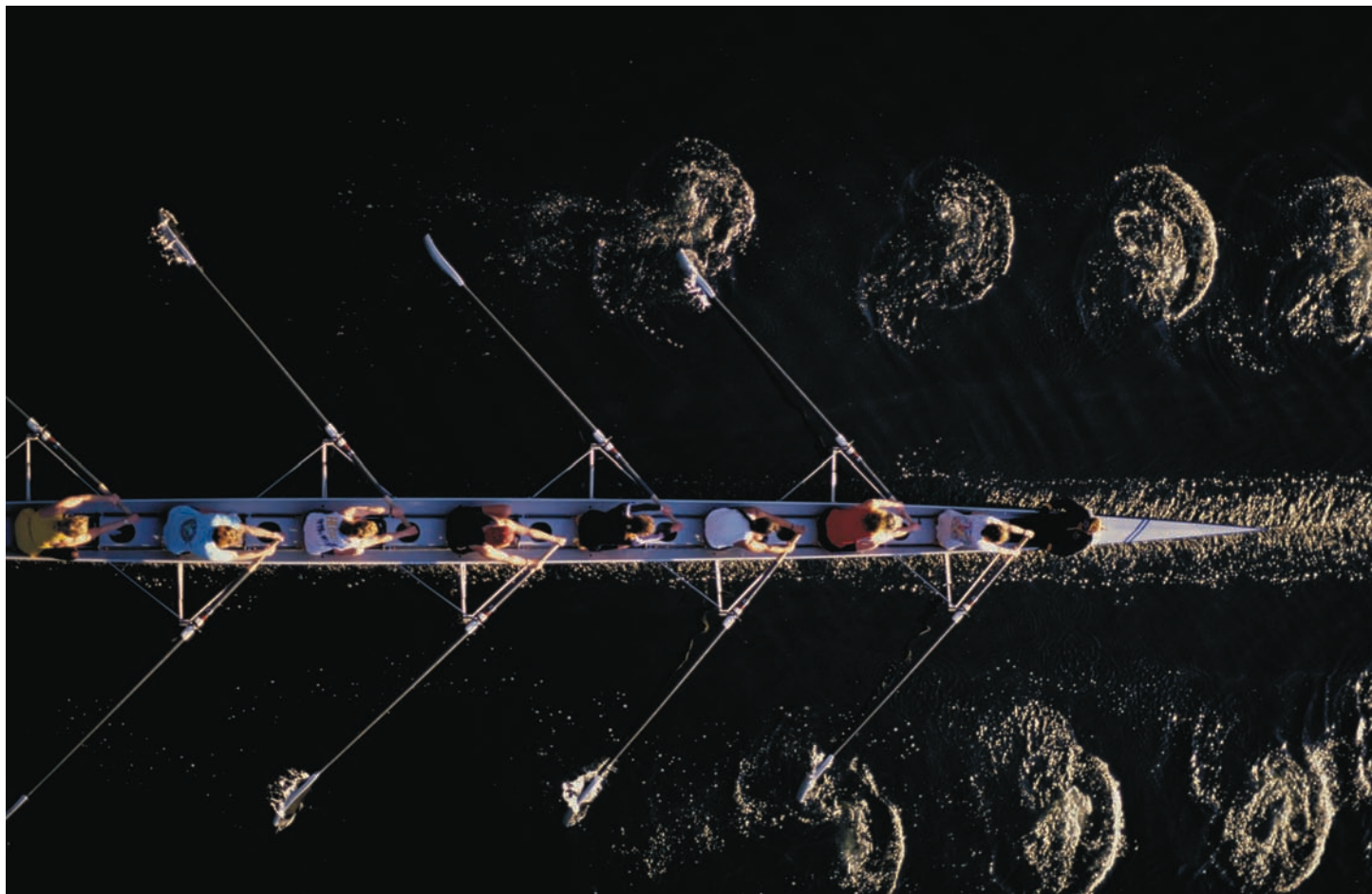
## Overview

The VDP for taxes is not an amnesty. However, the VDP for exchange control would appear to be so, as valuable concessions are being offered. Applicants will not be prosecuted, assets will not be forfeitable and a nominal levy will be exacted.

The scope of the relief offered under the VDP is more extensive than applied in earlier amnesties in that companies are permitted to apply. It seems also that the VDP will apply to the full range of taxes and not just income tax or capital gains tax.

# Bombay High Court CGT decision creates ripple effect

A common structure for inbound investment into a country (the operating country) is to hold shares in the domestic company through an offshore holding company. This affords the opportunity of disposing of the investment offshore by selling the shares in the offshore company and effectively avoiding liability to tax on capital gains in the operating country. A recent decision of the Bombay High Court has created uncertainty around this strategy and has apparently spawned “copycat” action by other revenue authorities.



In 2007, Vodafone International Holdings BV (“Vodafone”), a Netherlands company acquired an interest in CGP Investments Holdings Limited (“CGP”), a Cayman Islands company, from Hutchison Telecommunications International Limited (“HTI”), a Hong Kong company in a transaction that was concluded outside India. CGP controlled an interest in an Indian mobile communications company, Hutchison Essar Limited (“HE”) indirectly through a wholly-owned Mauritian subsidiary. HE was a joint venture company

between the Hutchison Group and the Indian-based Essar Group.

The Indian Foreign Investment Council approved the transaction subject to the condition that Vodafone should comply with Indian domestic laws. As a result of the transaction, the name of HE was changed to Vodafone Essar Limited.

Section 9 of the Indian Income Tax Act treats any income derived, inter alia, from the transfer of a capital asset in India as income arising in India. The Indian tax authorities (ITA) took the view that the disposal by HTI was a

transfer of an interest in Indian assets. They then contended that, in terms of section 195 of the Income Tax Act, a purchaser is required to withhold and pay over capital gains tax arising on the disposal and issued a notice to Vodafone to show cause why it should not be regarded as an “assessee-in-default” for failing to withhold Indian tax on the capital gain from the purchase consideration paid to HTI. Interestingly, the ITA did not seek to recover tax from the seller, but targeted the purchaser, presumably because they could exert pressure on

the Indian interests indirectly controlled by the purchaser to exact payment.

The ITA's case was that the sale consideration derived by HTI was in respect of the transfer of its economic interests in India and that the subject matter of the transaction was the transfer of tangible and intangible interests of HTI in the Indian company and not an innocuous acquisition of shares in CGP.

Vodafone, naturally, opposed the notice and instituted action to set it aside, on the ground that the transaction was between two non-resident parties and that the subject matter was the transfer of shares in a non-resident company that took place in the Cayman Islands, which was not within the jurisdiction of the ITA. It contended that the acquisition of shares in CGP was a transaction separate and distinct from the acquisition of a controlling interest in HE, which was an incidental result of the transaction. It therefore argued that, by acquiring a controlling interest indirectly it had not acquired an Indian asset for the purposes of section 9 of the Income Tax Act.

The Bombay High Court (*Vodafone International Holdings BV v Union of India* judgment on 3 December 2008) rejected Vodafone's submissions. In so doing, it cast aside the legal form and substance of the transaction and disregarded the separate legal personality of both CGP and the intermediate Mauritian company. Instead it placed reliance on the economic effect of the transaction.

The Court held that the transaction could not be viewed as a simple transfer of shares in CGP. It stated that the shares could be seen in two different perspectives, namely, as an asset in themselves or as a means of obtaining access to the tangible and

intangible interests in India. It found that HTI could not have disposed of the shares without extinguishing its rights in HE and the result of the transaction was that Vodafone acquired an interest in a joint venture in India and this fell within the ambit of section 9 of the Income Tax Act. Further, the purpose of the transaction was to give Vodafone access to the Indian mobile communications market, and, as a result Vodafone became a co-licensee to operate a mobile telephone network in India.

**The decision is creating ripple effects outside India and recent reports reveal that the decision has been relied upon in China and Uganda in imposing tax on capital gains accruing to non-resident sellers of shares in non-resident companies that control substantial assets within their jurisdictions.**

The Court held that it was entitled to apply the American "effects doctrine" which permits a state to apply its laws to impose liabilities on persons who are outside its jurisdiction in respect of acts which have consequences within its jurisdiction. Thus, it held, the disposal of a controlling interest in HE by HTI could be found certainly to have consequences within India and therefore be subject to the domestic laws of India.

This decision strikes at the very heart of legal principles relating to the separate legal personality of companies and the recognition of the form and substance of transactions. It is submitted that the Bombay High Court, in dismissing the petition of Vodafone, erred in both respects.

It is well known that a company is an entity that is regarded in law as distinct from its members, with legal capacity to acquire property and to sue and be sued in its own name. It is also well established that the courts will only cast aside this separate personality and look to the persons behind the company in exceptional circumstances. Here the Bombay High Court saw fit to cast aside the separate legal personality of not one, but two companies, in finding that a capital gain derived by a third company was subject to tax in India.

It is also open to courts of law, where the intention of the parties in entering into an agreement is other than or different to the contract between them purports, to disregard the form of the actual contract and to give effect to the real intention of the parties. It appears that the Bombay High Court was mesmerised by the fact that the assets controlled by HTI indirectly enabled it to participate in the economic benefits of participation in a lucrative Indian market. It therefore found that the intention of the parties was to transfer an interest in the Indian joint venture to Vodafone. It is submitted that this is flawed reasoning and disregards the fundamental principles of form and substance. While the economic effect of the transaction was that Vodafone acquired an indirect interest in HE, HTI and Vodafone at all relevant times intended that Vodafone should acquire the shares in CGP. This was what was agreed and implemented.

## Would a South African court have found for the tax authorities?

Our law does permit SARS to seek to tax a capital gain made by a non-resident on the sale of shares outside the Republic to another non-resident, but only where the shares constitute a direct or indirect interest in fixed property situated in the Republic.

Assuming, for the moment, that the Income Tax Act in South Africa does not have a limited scope in relation to the taxation of capital gains made by non-residents, it is interesting to note that the tax authorities' case had no merit. Our Courts are astute in recognising the separate legal personality of companies and will look beyond this to the shareholders only in the most exceptional cases, typically involving fraud or criminal behaviour, in which the corporate form is used as a disguise. They would certainly not look behind the corporate veil to invade a legitimate commercial transaction. Further, our Courts are quick to differentiate between the economic substance of transactions and their legal substance, and will disregard the legal form in which a contract is cloaked only where there is clear evidence that the intention of the parties was to effect a transaction that is other than or different to the form of their contract would suggest.

## The “copycat” cases

Reports in 2009 estimated that the Indian tax authorities had issued similar “show cause” notices to more than 400 non-resident sellers of shares, on the strength of the *Vodafone* decision. It transpires that this decision is creating ripple effects outside India too. Recent reports reveal that the decision has been relied upon by the tax authorities in China and Uganda in imposing tax on capital gains accruing to non-resident sellers of shares in non-resident companies that control substantial assets within their jurisdictions. It is further reported that the Chinese tax authorities recovered significant tax on a particular transaction by this means and *The Economic Times* reported on 30 June 2010:

*Recovery of tax has been considered a major victory by China’s State Administration for Taxation. The SAT had last year introduced circular 698 which empowers it to tax capital gains if Chinese companies are sold through sale of shares outside China between two non-resident parties.*

It is possible that this practice will spread to more jurisdictions unless a superior court in India finds against the Indian Tax Authorities in the ongoing *Vodafone* dispute.

## Be afraid!

The message appears to be that in some jurisdictions non-resident investors are being targeted more aggressively than ever before. Potential investors in foreign jurisdictions would be well advised to seek comprehensive local guidance before committing to investment holding structures that might carry significant risk.

# What determines tax liability – the law or the trust deed?

A trust deed is a contractual arrangement that regulates the right of persons (beneficiaries) to participate in the income and capital administered by trustees for their benefit.

It is not uncommon for a trust deed to say, for example, that the trustees can determine which trust incomings and outgoings will be treated as capital, and which will be treated as revenue.

The trust deed may also say, for example, that the trust's revenue or capital losses of prior years are to be recouped before any income or capital distribution can be made to beneficiaries in the current year.

Where a trust deed contains such provisions, what account, if any, must SARS take of them in determining the taxable income of the trust and the trust beneficiaries?

No reported decision of the South African courts has yet addressed these issues, but some guidance can be derived from the decision of Australia's Full Federal Court in the case of *Cajkusic v Commissioner of Taxation* [2006] 64 ATR 676.

Of course, decisions of foreign courts must be treated with caution because of differences in statutory and non-statutory tax principles between various jurisdictions.

The Australian law of trusts is based on English law. So too, to a considerable extent is South Africa's law of trusts, but our trust law has gone through a process of evolution and is now a South African institution that has drawn on the jurisprudence of several countries, but has also developed distinct and unique home-grown features.

In both Australia and South Africa, trust income is taxed either in the trust itself, or in the hands of the trust beneficiaries, but the same income is not taxed in the hands of both. Thus, if it is not taxable in the hands of the beneficiaries, the trust



income is necessarily taxable in the hands of the trust.

The decision in *Cajkusic v Commissioner of Taxation* concerned a family trust. Its income tax return for the 1998 tax year reflected nil net income. However the Australian tax authorities disallowed certain deductions claimed by the trust and certain prior year losses claimed by the trust, with the result that the trust had a net income of some \$225 000 for the year.

The trust deed provided that the trust beneficiaries were "default income beneficiaries", meaning that if the trustees passed no contrary resolution, the beneficiaries would be entitled to the trust's net income for the year. No such contrary resolution was in fact passed for the year in issue in this case.

The Australian tax authorities therefore included the \$225 000 income of the trust in the assessable income of the trust beneficiaries. The latter objected to the assessment.

The question before the court was whether, on the facts as outlined above, there was any trust income to which the trust beneficiaries were entitled in the 1998 tax year, given the lack of any contrary resolution by the trustees and the default rights of the beneficiaries. in terms of the trust deed.

If effect were to be given to the decision of the trustees, taken in terms of their powers under the trust deed, to regard certain expenditure as deductible and to recoup prior years' losses, then the trust would have no income in the tax year that was distributable to beneficiaries. It followed that, if any tax was payable on trust income, it would be payable by the trust, not by the beneficiaries.

On the other hand, if effect were to be given to the tax legislation in terms of which the trust did indeed have a taxable income because the expenditure claimed as a deduction was not deductible, and in terms of which the trust's prior losses could not be carried forward, and if effect were also given to the provision in the trust deed that, in default of any contrary resolution by the trustees, the trust beneficiaries were entitled to the trust's net income for the year, then the trust's income for the year would be taxable in the hands of the beneficiaries.

The Full Federal Court ruled that the trust did not have any distributable net income in the 1998 tax year. This was because the trustees, in accordance with their powers under the trust deed, had treated certain outgoings as being deductible for income tax purposes and (again in accordance with the requirements of the trust deed) had set off certain prior year losses against the trust's current year income.

Consequently, said the court, there was – in terms of the trust deed – no trust income to which the trust beneficiaries were entitled in the 1998 tax year. The trust's taxable income (determined in accordance with tax legislation, as distinct from the provisions of the trust deed) must therefore necessarily be taxable in the trust.

# The deemed source of pensions and annuities in respect of non-governmental service

The Income Tax Act 58 of 1962 provides in section 9(1)(g)(ii) that an amount is deemed to have been derived from a source in the Republic if it was received by or if it accrued to the taxpayer by virtue of any pension or annuity granted to him, and that such deeming prevails irrespective of where payment was made or where the source of the funds was situated – but only if the services in respect of which that pension or annuity was granted were performed in the Republic for at least two years during the ten years immediately preceding the date on which the pension or annuity first became due.

It is implicit that this rule applies whether or not the taxpayer resides or carries on business in the Republic.

What section 9(1)(g)(ii) does is give South Africa the right to tax a pension in circumstances where the above 2/10 rule applies (that is to say, where the services in question were rendered wholly within the Republic for at least two out of those ten years). This would apply regardless of whether the pensioner is a resident of the Republic at the time that the amount accrues or whether the person paying the pension is or is not a resident.

This statutory rule is immediately followed by a proviso that says that

only a portion of such a pension or an annuity is deemed to be from a South African source if the pension or annuity was granted in respect of services that were rendered partly within and partly outside the Republic. In that event, such portion of the pension or annuity must bear to the total pension or annuity the same ratio as the period during which the services were rendered in the Republic bears to the total period during which the services were rendered.

In effect, where the proviso applies, the deemed source provision in the opening phrases of section 9(1)(g)(ii) falls away, and the actual source of

the income is determined on a pro-rata basis.

It needs to be borne in mind that the portion of a pension that is received by or accrued to a resident for services rendered outside the Republic, that is not deemed to be from a source within the Republic, qualifies (anomalously, given South Africa's residence-based tax system) for exemption from tax in South Africa in terms of section 10(1)(gC).

The above provisions also do not apply to pensions or annuities payable by the government or a provincial administration or municipality in the Republic. Such pensions and annuities, are, in terms of s 9(1)(g)(i), deemed to be from a source within the Republic.

## What determines tax liability – the law or the trust deed?

The Australian Tax Office (the counterpart to SARS) has since indicated that it accepts the correctness of the decision of the Full Federal Court in this case, and the correctness of the principles applied by the court in determining whether a trust beneficiary was entitled to trust income in a given tax year.

The Australian Tax Office has pointed out that this decision of the Full Federal

Court did not hold that the terms of a trust deed can determine whether a particular trust receipt is income or capital in the hands of the trust. It is safe to say that SARS would endorse this view.

The decision highlights the distinction between the concept of income in everyday usage and the concept of taxable income. The law will have regard to the trust deed to determine

whether and to what extent income is derived by a beneficiary of a trust or retained by the trust. The taxing statute will then be applied to quantify the amount that is taxable in the beneficiary's or trust's hands.