

# *Synopsis*

## Tax today

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*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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# Contents

- 1 *Transfer pricing and thin capitalisation - new section 31*
- 4 *Legal professional privilege*
- 6 *SA tax consequences determined under foreign law subject*
- 8 *The abuse of trusts - a warning shot across the bows*

## ***Transfer pricing and thin capitalisation***

# **New section 31 of the Income Tax Act**

*The new section 31 will no longer apply only to the supply of goods or services, but to any cross-border “transaction, operation, scheme, agreement or understanding” between or for the benefit of connected persons.*

*The transfer pricing and thin capitalisation provisions of the Income Tax Act 58 of 1962 are currently contained in section 31 which must be read together with Practice Note 7. The section was enacted in 1995 and the practice note was released in 1999.*

A radical change to the transfer pricing and thin capitalisation provisions of the Act is now in the offing.

As from tax years commencing on or after 1 October 2011, the present section 31 is to be replaced by an entirely new section 31.

Consequently, taxpayers have twelve months before the new provision comes into force in which to consider whether any of their current arrangements may fall foul of the new section, and ought to be revised before the effective date.

The reason for the enactment of a new section 31 is that SARS was of the view that there are structural defects and uncertainties in the present section.

In particular, it was believed that the present section 31 adopts an inappropriately legalistic perspective, and that this allows taxpayers to mount arguments based on a literal interpretation of the section, whereas the focus should instead be on its economic and commercial purposes.

Moreover, in relation to transfer pricing, the present section 31 focuses on the “price” of the goods and services in question, while the real issue (in SARS’s view) is the impact of the

arrangement under scrutiny on the taxpayer’s “profit”.

A further weakness of the present section 31 in relation to thin capitalisation was perceived to be that it applies only to financial assistance that is granted by a foreign (non-resident) investor to certain residents, and that it does not apply to financial assistance given by a foreign resident to another foreign resident, even if the latter has a South African permanent establishment.

### ***The new section 31***

In relation to transfer pricing, the new section 31 will no longer apply only to the supply of goods or services, but to any cross-border “transaction, operation, scheme, agreement or understanding” between or for the benefit of connected persons.

If “any term or condition” in their contractual arrangement differs from what would have been agreed between independent persons dealing at arm’s length, and if it will result in a tax benefit to any party to the transaction, operation, scheme, etc, the consequence is that the “the taxable income of each person that is a party to that transaction ... that derives the tax

benefit” must be calculated on the basis of what would have been agreed between independent persons dealing at arm’s length. In relation to parties who did not derive a tax benefit, the terms actually agreed upon will (it seems) continue to apply.

In relation to thin capitalisation, the new section 31, like the old, regards “financial assistance” as including any loan, advance, debt, security or guarantee.

But the new section 31, unlike the old section 31(3), does not refer to the value of such financial assistance being excessive in relation to a company’s fixed capital, including its share capital. Instead, the new section 31(1)(b) applies a uniform criterion to

terms is the derivation of a tax benefit by a party to the arrangement.

In the new section it implicit, but not explicit, that the amount of deductible interest must be limited to that which would have been incurred in a transaction between independent parties dealing at arm’s length.

### ***Exemptions from the new section 31***

The new section 31 will not apply (and hence deductible interest will not be restricted to an arm’s length amount) where financial assistance is granted by a non-resident to a “headquarter company” (as defined in section 1) and where a headquarter company grants financial assistance to a foreign company in which it has a 20% interest. However, in these two situations, interest may be ring-fenced in terms of section 20C(2) – in other words, the narrowly-targeted anti-avoidance provisions of section 20C(2) which are confined to interest incurred by headquarter companies, will apply to the exclusion of the more general provisions of section 31(2).



both thin capitalisation and transfer pricing and to all other cross-border transactions between connected persons.

### ***New criterion***

The new criterion is whether the terms and conditions of a transaction, operation, scheme, etc, entered into between connected persons, are different from those that would have existed between independent persons dealing at arm’s length, and whether the result of these non-arm’s length

# Legal professional privilege

## *Does legal professional privilege extend to advice on tax law given by an accountant: the recent decision in the Regina Prudential case*

It is well-established that legal professional privilege applies to communications passing between a lawyer and his client.

Consequently, neither the revenue authorities nor anyone else can compel those communications to be disclosed in any legal proceedings, such as in litigation with the revenue authorities involving a disputed tax assessment.

Thus, for example, where legal advice is given by a lawyer as to whether a transaction or a proposed transaction would fall foul of an anti-avoidance provision in tax legislation, the client is not obliged to make disclosure of that advice when called upon to make discovery of relevant documents in subsequent legal proceedings.

Nor is the client obliged to make discovery of the documents that he prepared for the lawyer for the purpose of obtaining that advice.

The documentation prepared by the client for the lawyer may, for example, include admissions or revelations by the client as to whether he had entered into the transaction with a tax-avoiding intention, and whether the particular transaction was linked to or formed part of a series of transactions.

These are considerations that may be of great importance in determining whether the transaction falls foul of anti-avoidance provisions in tax legislation but, if they are privileged, these documents are not disclosed to the opposing litigant nor to the presiding judge.

### ***LPP allows a client to make full and frank disclosure to a legal adviser***

In tax matters, legal professional privilege allows the client to make full and frank disclosure to the legal adviser,

which may include documentation, prepared for the lawyer, that exposes the client to civil or criminal liability.

If there were no such privilege, a client would not feel free to make full disclosure to a legal adviser. Any resultant legal advice may consequently be based on faulty premises.

But does the privilege apply to written communications between an accountant and a client where the former gives advice on tax law?

This is an issue that has been debated in the UK for some 40 years. The decision of the English Court of Appeal in the *Regina Prudential* case, handed down on 13 October 2010, is of great significance.

*In tax matters, legal professional privilege allows the client to make full and frank disclosure to the legal adviser, which may expose the client to civil or criminal liability.*



### ***The decision of the English Court of Appeal in the Regina Prudential case***

In *Regina (Prudential plc and another) v Special Commissioner of Income Tax (Institute of Chartered Accountants in England and Wales and others intervening)* [2010] WLR (D) 252, the legal proceedings took the form of an application for the judicial review of notices served by the revenue authorities on certain taxpayers in terms of the

applicable tax legislation, which required the taxpayers to deliver to the revenue authorities certain documents which contained information relevant to their tax liability, including communications which had passed between the taxpayers and their accountants when the latter were giving advice on the tax law aspects of a proposed transaction.

In his judgment, Lloyd LJ remarked that the question of whether legal professional privilege (“LPP”) should, by statute, be extended to accountants, had been considered on a number of occasions in the past 40 or so years. However, Parliament had not legislated for any statutory extension of LPP to cover legal advice sought from and given by accountants on tax matters. Parliament’s failure to change the law in this regard, he said, was not an oversight.

In particular, while article 8 of the Convention for the Protection of Human Rights and Fundamental Freedoms, which was a schedule to the Human Rights Act of 1998, guaranteed protection for correspondence with a lawyer, it did not extend that privilege to communications with any other person who might be asked to give legal advice.

Lloyd LJ pointed out that LPP represents a significant restriction on considerations of public interest in ensuring that all relevant evidence is made available in legal proceedings, and the proper boundaries of LPP were consequently a matter of public policy.

Lloyd LJ said that it was clear that a rule which limited LPP to communications with a member of the legal profession was in accordance with law and could properly be regarded as necessary in a democratic society, particularly for the protection of rights and freedoms.

The scope of LPP, he said, varied between member states of the European Union, with some according the privilege to employee-lawyers, whilst others did

not. It was not arguable, he said, that there was a breach of article 8, with or without reference to article 14, where LPP was limited to advice given by members of the legal profession to the exclusion of accountants.

Consequently, said Lloyd LJ, the Court of Appeal was obliged to rule that LPP does not apply, at common law, in relation to any professional other than a qualified lawyer, that is to say, a solicitor or barrister, or an appropriately qualified foreign lawyer. It had been so held in *Wilden Pump Engineering Co v Fufeld* [1985] FSR 159, a decision binding on the Court of Appeal, despite the arguments that had been put forward on the basis of human rights law, or the argument that the case was distinguishable.

It was therefore not open to the present court, said Lloyd LJ, to hold that LPP applied outside the legal profession, except where this was so under statute.

### ***Implications for LPP in South Africa***

The decision of the English Court of Appeal in the *Regina (Prudential plc)* case, discussed above, is of course not binding on South African courts, though it will have strong persuasive value.

However, a South African court, adjudicating on the same issue, would have to take into account the provisions of our constitutional Bill of Rights, including the right to information and the right to have disputes decided in a fair public hearing before a court, and such considerations may impel a South African court to a different conclusion.

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# SA tax consequences determined under foreign law

*One of the characteristics of a sovereign state is that it makes and administers its own laws. Seldom will a state apply the law of another state as part of its own law.*

*It is therefore a matter of some concern to find that the Taxation Laws Amendment Bill 2010 introduces a proposed new definition of “foreign dividend” which is entirely dependent on foreign law.*

It is proposed that, with effect from 1 January 2011, the following definition shall apply:

“**foreign dividend**’ means any amount that is paid or payable by a foreign company where that amount is treated as a dividend or similar payment by that foreign company for the purposes of the laws relating to—

(a) tax on income of the country in which that foreign company is incorporated, formed or established; or

(b) companies of the country in which that foreign company is incorporated, formed or established, where that country does not have any applicable laws relating to tax on income.”

The term “dividend” is defined in international tax law in the model tax conventions developed by agencies like the OECD and the United Nations. The OECD model, for example, in Article 10 defines dividends as “income from shares ... not being debt claims, participating in profits ...” The introduction of a novel unique definition is therefore questionable.

It appears that Treasury wished to introduce a definition similar in intent to the OECD definition, and sought a means to identify whether the

instrument by which the right to receive the dividend is treated in substance as a “debt claim”. Dividends on preference shares in certain jurisdictions (for example, Australia) may be taxed as if they are interest on fixed interest instruments. The decision to impose tax in this manner is a matter of tax policy in the country concerned – it does not change the juridical nature of the preference share.

Alternatively, in a particular country distributions from certain companies may be taxed whereas distributions by other companies are not taxed. On the basis that the proposed definition does not impose a “subject to tax” condition, it is considered that, provided it can be shown that the nature of a non-taxable distribution is identical to the nature of other (taxable) distributions, it will meet the requirements of the new definition.

There may also be no connection between the tax treatment to which the dividends are subject in the source country and the treatment in the country in which the company is incorporated. Modern concepts of corporate residence make it possible for a company to be incorporated in a country which has no tax laws but resident in a country that recognises residence by reference to the location of central management and control. By this means the new definition can be circumvented with relative ease.

*Evidence will have to be led establishing what the law of the foreign country states, and how the law is applied in that country. Where the language of the foreign country is not English, certified translation will have to be made of the relevant law of the country concerned.*



It is also clear that the tax laws of many other countries do not use terms such as “dividend”, but refer to income or benefits from shares. In some countries the term “dividend” may also not be in use in the corporate law (the term is not defined in the South African Companies Act for example). How then does one establish what constitutes a dividend under the corporate laws?

These issues result in considerable uncertainty over the application of the proposed new definition.

***There are important practical considerations as well.***

If a dispute should arise between a taxpayer and SARS concerning whether a distribution from a foreign company is or is not a “foreign dividend” in terms of the proposed definition, then a taxpayer must deal with the question of adducing evidence concerning the law of

another country (the onus of proof in matters of tax being on the taxpayer).

This becomes a matter of the law of evidence and the rules concerning the proof of foreign law. In essence, evidence will have to be led establishing what the law of the foreign country states, and how the law is applied in that country. Where the language of the foreign country is not English, certified translation will have to be made of the relevant law of the country concerned, and evidence will have to be led from an expert witness learned in the relevant country’s laws (possibly necessitating the services of court certified interpreters) to establish the treatment of distributions in the country concerned under either the tax laws or the corporate laws.

It is to be hoped that the wisdom of using a definition dependent on foreign law is reexamined and that a definition with more universal certainty is enacted.

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## The abuse of trusts

# A warning shot across the bows

*Although it did not involve a tax issue, the recent decision of the Cape High Court in van der Merwe NO v Hydraberg Hydraulics; van der Merwe NO v Bosman CC 2010 (5) SA 555 is a warning shot across the bows of all trustees, trust beneficiaries and professional advisers that the courts may, in circumstances where the trust form is abused, pierce the “veneer” of a trust.*

### **Treating a legal entity as non-existent where its identity is abused**

The notion that, where the legal identity of a juristic entity is abused, the law can disregard its existence is not novel.

Section 65 of the Close Corporations Act 69 of 1984 provides that in circumstances where the incorporation of a close corporation, or any act by it, or any use made of the corporation, constitutes a “gross abuse of the juristic personality of the corporation as a separate entity”, a court can deem it not to be a juristic person.

Section 163(4) of the Companies Act of 2008 has a similar provision.

### **Separation of control and enjoyment**

Ownership and control of trust assets is vested in the trustees, in their capacity as such, whilst the benefits of those assets are made available to the trust beneficiaries.

However, where (as occurs in many family trusts) the same persons are both trustees and beneficiaries, such a separation does not exist. The persons who control the trust assets as trustees are then the same persons who enjoy the benefits of those assets as trust beneficiaries.

In *Land and Agricultural Bank of South Africa v Parker* 2005 (2) SA 77 (SCA), Cameron JA said that, in such circumstances –

The core idea of the trust is debased ... because the trust form is employed not to separate beneficial interest from control, but to permit everything to remain “as before”.

Cameron JA went on to say that –

The courts will themselves in appropriate cases ensure that the trust form is not abused. The courts have the power and the duty to evolve the law of trusts by adapting the trust idea to the principles of our law (*Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (O) at 859F - G). This power may have to be invoked to ensure that trusts function in accordance with principles of business efficacy, sound commercial accountability and the reasonable expectations of outsiders who deal with them ... Where trustees of a family trust, including the founder, act in breach of the duties imposed by the trust deed, and purport on their sole authority to enter into contracts binding the trust, that may provide evidence that the trust form is a veneer that in justice should be pierced in the interests of creditors.

In van der Merwe’s case (in which judgment was given in the Cape High Court on 17 June 2010) Binns-Ward J said –

The abuse of the trust form is something that should not lightly be countenanced by the courts in cases in which the veneer of a trust is used to protect the trustees against fraud and dishonesty and to raise unscrupulous defences against bona fide third parties seeking to enforce the performance of contractual obligations purportedly entered into by such trustees ostensibly in that capacity.

van der Merwe’s case concerned a situation where a trust had sold certain immovable property and had then repudiated liability under the contract on the grounds that the signatories to the contract had not been properly authorised by the trust, and that the contracts did not comply with the formalities required by the Alienation of Land Act.

It was clear from evidence placed before the court that the trustees of the trust had conducted the affairs of the trust with complete disregard for the principles of trust law, in particular, the need for all the trustees to act jointly in making decisions.

Moreover, the court observed that the trust bore “the unwholesome hallmarks” of the kind of trust in which, as regards both structure and management, there was no proper separation between those persons who controlled the trust, and those persons who benefited from the trust.

These factors led Binns-Ward J to say that –

If it had been legally possible, this matter would be an appropriate case, in my judgment, to have disregarded the veneer of the trust form. This might have been done in one of two ways: By holding the delinquent trustees personally liable for performance, or by directing the trust to perform as if the obligation had been properly incurred by the trustees acting in the capacity that they purported to act.

This is, it would appear, the first time that our courts have identified a situation in which they would, in principle, have treated a trust as non-existent (at least for certain limited purposes) and would have handed down an order that achieved that result.

Binns-Ward J, with undisguised reluctance, concluded that he could not make such an order in the particular circumstances of this case because he could not ignore the peremptory requirements of the Alienation of Land Act 68 of 1981 in regard to the formalities with which the contracts in issue had to comply. In other words, he could not make an order that the trustees were personally bound to the contracts in question, since the statutory formalities had not been complied with.