Synopsis

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Tax today

Company distributions – new tax treatment

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In this issue

Company distributions - new tax treatment 2

Yet another preliminary skirmish in the King tax litigation 4

Binding Private Ruling 068. . . 7

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

Company distributions – new tax treatment

The Taxation Laws Amendment Bill currently before Parliament contains an unexpected revelation that certain changes to the taxation of dividends are imminent. These changes were originally intended as part of the change to a dividends tax regime at the time that STC will be replaced by a dividends tax, but their implementation has now been brought forward to 1 January 2011, ostensibly because of the expected implementation of the new Companies Act.

What is new?

The definition of what constitutes a dividend is currently governed by a definition that takes up more than four pages of legislation. This is to be replaced by a new definition, which includes the following:

"dividend" means any amount transferred or applied by a company for the benefit of any shareholder in relation to that company by virtue of any share held by that shareholder in that company, whether—

(a) by way of a distribution; or

(b) as consideration for the acquisition of any share in that company,

but does not include any amount so transferred or applied by the company to the extent that the amount so transferred or applied—

(i) results in a reduction of contributed tax capital…"

Contributed tax capital ("CTC") is an entirely new concept in South African Tax law. The following definition will also come into effect on 1 January 2011:

'contributed tax capital', in relation to a class of shares issued by a company, means—

(a) in the case of a company that is not a resident and that becomes a resident on or after 1 January 2011, an amount equal to the sum of—

(i) the market value of all shares in that company immediately before the date on which that company becomes a resident; and

(ii) the consideration received by or accrued to that company for the issue of shares on or after that date; or

(b) in the case of any other company, an amount equal to the sum of—

(i) the stated capital or share capital and share premium of that company immediately before 1 January 2011 in relation to shares issued by that company before that date, less so much of the stated capital or share capital and share premium as would have constituted a dividend, as defined before that date, had the stated capital or share capital and share premium been distributed by that company immediately before that date; and

(ii) the consideration received by or accrued to that company for the issue of shares on or after that date,

reduced by so much of that amount as the company has transferred on or after that date to shareholders in relation to those shares, and has by the date of the transfer been determined by the directors of the company or by some other person or body of persons with comparable authority to be an amount so transferred: Provided that the amount so transferred to a shareholder of any class of shares is deemed to be an amount that bears to the total of the amount of contributed tax capital attributable to that class of shares immediately before the distribution the same ratio as the number of shares of that class held by that shareholder bears to the total number of shares of that class."

Action needed

The crucial issue for all SA resident companies will initially be the determination of contributed tax capital (CTC) at 1 January 2011 as set out in paragraph (b)(i) of the definition.

It is not sufficient, particularly in the case of long-established companies, to assume that the stated capital or the issued share capital and share premium as reflected in the accounting records at 31 December 2010 will represent the company's CTC at 1 January 2011.

Consideration will need to be given to whether any portion of the share capital and share premium account represent amounts that would have constituted a dividend had they been distributed prior to that date. This would involve identifying whether any capitalisation issues have been made on or after 1 January 1974, in terms of which amounts were transferred from reserves to share capital or share premium (the so-called "tainted" capital), and whether these have since been distributed or not.

It may be necessary to examine the statutory records for all allotments of shares and share capital reductions since 1 January 1974 to establish with precision the tax circumstances of all share issues.

The ongoing requirements

After 1 January 2011, resident companies will need to record increases and reductions in the CTC.

On the face of it this appears a relatively straightforward task. Increase the CTC by the consideration received in respect of all future issues and reduce it by the amounts that are resolved to have been paid out of CTC as set out in the definition.

This somewhat simple description conceals potential issues that may give rise to error or distortion. In particular the determination of CTC may be affected by the group reorganisation relief rules, which may require that the CTC be determined by reference to the base cost of assets acquired in exchange for shares. There will therefore be a likelihood that companies engaging in transactions which qualify for any such relief may have a CTC that differs from the share capital reported in their statutory financial statements.

Similarly, it must be clearly recorded that repayments of share capital are to be regarded as payments out of CTC, otherwise the amounts so paid may be regarded as dividends. Companies need therefore to identify any CTC distributions in resolutions passed to return share capital to shareholders.

It is recommended that companies take early steps to identify and record the amount of CTC at 1 January 2011.

Yet another preliminary skirmish in the King tax litigation

Most taxpayers who have the misfortune to confront SARS in a court of law, do so in the context of civil litigation in the Tax Court or the High Court involving a disputed assessment to income tax or some other tax.

If the judgment goes against the taxpayer, the result could be financially draining for the latter; indeed, it may tip the taxpayer into bankruptcy.

Some taxpayers who incur the wrath of SARS, find themselves in court facing criminal charges in terms of the Income Tax Act or other tax legislation. Here the stakes are even higher.

Where a court orders the taxpayer to pay tax over to SARS, that money can (at least in principle) be recouped over time by hard work and good fortune.

By contrast, a criminal conviction is a permanent stain on a person's character and reputation. It may render the person unemployable. Banks may refuse to accept such a person as a client, or may terminate his banking facilities. Visas may be refused for international travel. Many countries block immigration by persons with a criminal record.

A conviction can also of course have financial consequences by way of a fine and – in the most serious cases a conviction may result in a prison sentence.

SARS's case against Dave King

SARS has for the last decade been pursuing the well-known businessman, Dave King, claiming some R3 billion in arrear taxes.

The present matter concerned the parallel criminal prosecution of King, following a complaint by SARS to the National Directorate of Public Prosecutions.

It seems that SARS took over financial responsibility for the prosecution. The judgment notes that (as is common overseas) private practitioners had been briefed by the state to conduct the investigation and prosecution.

The judgment of the Supreme Court of Appeal in the latest preliminary skirmish before the criminal trial itself, will be of interest to tax consultants, who need to be *au fait* with the rights of their clients when faced with the prospect of a criminal prosecution at the instance of SARS.

The judgment contains important dicta on fundamental aspects of the general constitutional right of access to information held by SARS.

The constitutional right to a fair trial

The South African Constitution guarantees the right to a fair trial in a court of law. This is a multi-faceted right, and the Constitution provides inter alia in section 35(3) that –

"Every accused person has a right to a fair trial, which includes the right :
a) to be informed of the charge with sufficient detail to answer it;
b) to have adequate time and facilities to prepare a defence …"

The constitutional right to information held by the state

The constitutional right to information held by the state (which, as was noted above, includes SARS) is of great importance to taxpayers and their advisers. This is a general right, and is not limited to the context of a criminal investigation.

Section 32 of the Constitution provides that –

(1) Everyone has the right of access to :

a) any information held by the state; and

b) any information that is held by another person and that is required for the exercise or protection of any rights.

(2) National legislation must be enacted to give effect to this right, and may provide for reasonable measures to alleviate the administrative and financial burden on the state.

The national legislation referred to in section 32(2) is the Promotion of Access to Information Act 2 of 2000.

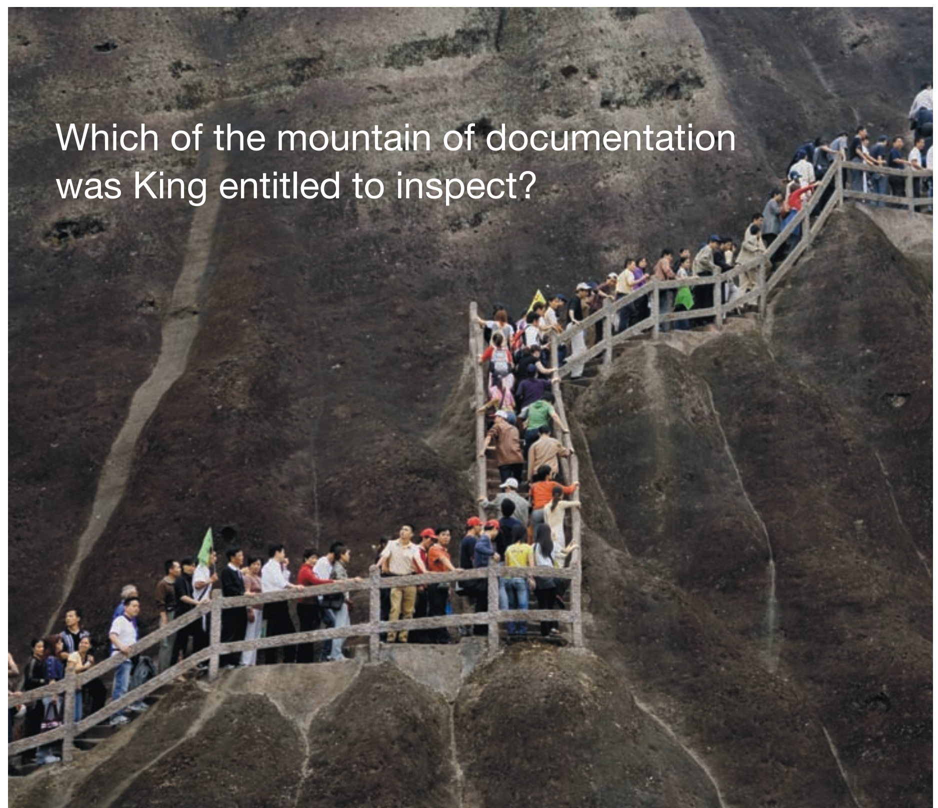
The scope of the constitutional right to be informed of the charge in sufficient detail

A police docket, which is made available to the prosecution, usually consists of three sections: section A contains statements of witnesses, expert reports and documentary evidence. section B contains internal reports and memoranda, and section C contains the investigation diary of the particular matter.

The documents in sections B and C of the police docket are normally not disclosed to the legal team for the defence.

In the King matter, section A of the police docket consisted of some 200 000 pages, and part B included about 21 000 e-mails plus about 270 lever-arch files of documents.

This mountain of documents (and the indictment itself, which ran to 800 pages) gives some indication of the complexity of the case against King, and of the resources that SARS had invested to collate evidence that would secure a conviction.


Which of the mountain of documentation was King entitled to inspect?

The prosecution made the documents in Section A of the docket available to King's legal team, but not the documents in Sections B and C.

The question was – and this will, of course, be an issue in many or most prosecutions for tax offences and other offences – which of this mass of documentation was the accused, King, entitled (in terms of his constitutional rights) to inspect in order to establish what case he had to meet, and to prepare his defence accordingly?

And was the prosecution within its rights in denying the defence access to the documents in sections B and C of the docket?

King's argument was simple and extreme – his constitutional right to information held by the state was unlimited; the police docket consisted of information held by the state; ergo, he was entitled to have sight of all the documents in the docket.

Indeed, King's legal team pressed the argument even further, contending that (in order to give effect to King's constitutional right to information and a fair trial) the prosecution must also supply a "motivated index" of all the documents in the police docket, setting out a full description of each and every document in the B and C sections of the docket, plus a statement, in relation to each document to which access was being denied, of the precise basis on which such access was denied.

In effect, said the court, King was demanding that the prosecution satisfy him, in advance and as a pre-condition to being tried, that his trial would be fair.

SARS estimated that, to provide such an index, would cost in excess of R1.5 million.

SARS argued that King and his legal team were not entitled to view the documents in section B and section C of the docket, inter alia because these documents were protected from disclosure by legal "privilege" and that it would be against public policy to disclose these documents to the defence.

The decision of the High Court

King's legal team managed to persuade the High Court that their client was entitled to the order that he claimed – namely that he be furnished with a full description of every document in sections B and C of the police docket, plus a full description of each and every document to which he had been denied access together with a statement (a "motivated index") of the precise basis on which he had been denied access to each such document.

In fact, as the Supreme Court of Appeal pointed out, the order granted by the High Court went beyond what King had asked for.

SARS – or to be more precise the National Directorate of Public prosecutions – took the decision of the High Court on appeal to the Supreme Court of Appeal.

The decision of the Supreme Court of Appeal

The interest of the Supreme Court of Appeal judgment lies in its forthright delineation of the rights of an accused – in a tax matter or otherwise – to access to documents in the police docket, and the court's far stricter view in this regard than that adopted by the High Court.

The Supreme Court pointed out (at para 1 of the judgment) that, in our law, the general rule is that a person is not entitled to see his adversary's brief, and that this is referred to as *litigation privilege,* which is something different from *attorney and client privilege*.

However, said the court, in a criminal matter, litigation privilege does not apply to documents in the police docket that are incriminating, exculpatory or likely to be helpful to the defence.

Consequently, an accused is entitled to view such of the content of the police docket as is relevant for the exercise or protection of his constitutional right to a fair trial. Such entitlement is not restricted to statements of witnesses or exhibits, but extends to all documents which may be important for an accused to properly adduce and challenge evidence and thereby ensure a fair trial.

However, said the court, there is no blanket right to every item of information in the hands of the prosecution.

Litigation privilege, said the court, still exists in criminal proceedings, though in an attenuated form as a result of the constitutional right to a fair trial.

The constitutional right to information

One of the most important rulings of the Supreme Court of Appeal in this matter was in regard to the legal consequences of the fact that the constitutional right to information has been given effect by the enactment of the Promotion of Access to Information Act 2 of 2000.

The court said that, once this Act came into force, an applicant for access to information has to base his claim on the Act, and – unless he challenges the adequacy of that Act to protect his rights in terms of section 32 of the Constitution – he cannot claim that he has a "free-standing" or "residual" constitutional right to information in terms of section 32(1) of the Constitution itself.

King had made no challenge to the constitutionality of the Promotion of Access to Information Act.

In the present case, said the Supreme Court of Appeal, King was in effect demanding a pre-trial right to audit the disclosure that had been made by the prosecution so as to determine whether the prosecution had fulfilled its duty of disclosure.

In effect, said the court, King was demanding that the prosecution satisfy him, *in advance and as a pre-condition to being tried*, that his trial would be fair.

The Bill of Rights, said the court, did not go as far as this. Moreover, the order being sought by King was "a most novel order", that had never been even asked for in any court in the English-speaking world.

The court held that the accused in this case did not reasonably require a motivated index of part B and C of the police docket in order to conduct his defence, and upheld the appeal against the judgment of the High Court.

Binding Private Ruling 068

The “contributed capital” of a foreign co-operative is synonymous with “equity share capital”

Binding Private Ruling is concerned with whether the contributed capital of a foreign limited liability co-operative constitutes “equity share capital” as defined in section 1 of the Income Tax Act 58 of 1962.

The applicant for the ruling was a resident company that was the holding company in a group of companies through which it held its local and foreign investments.

In order to restructure the holding of its foreign investments, the applicant intended to interpose a particular Entity between the foreign holding company and the foreign operating companies.

This Entity was to reside in a country which had an appropriate tax treaty network with the territory in which the foreign operating companies were resident.

The Entity would have legal personality under the company law of its country of residence, such that it could own assets and conclude agreements in its own right.

In terms of the Entity’s proposed deed of incorporation, each of its members would make a contribution in cash or in kind as determined by the general meeting. The deed of incorporation would also provide that the participating members were to have an unlimited right to dividends, when declared, and to a return of capital when the Entity was wound up.

The issue that was the subject of this Ruling was whether the “contributed capital” of the foreign limited liability co-operative would constitute “equity share capital” as defined in section 1 of South Africa’s Income Tax Act.

That definition reads as follows –

“equity share capital” eans, in relation to any company, its issued share capital and in relation to a close corporation, its members’ interest, excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution, and the expression “equity shares” shall be construed accordingly;

Although the Binding Private Ruling does not say so, the difficulty in applying this definition in this matter was that the law of the country in which the Entity was resident was not on all fours with the corporate law of South Africa.

In South Africa, shareholders in a company do not make a “contribution”, as such, to the capital of the company, but instead “subscribe” for shares in the company, and the amount so subscribed then becomes share capital.

However, terminology aside, it seems – from the very limited information provided in the Ruling – that a “contribution” in terms of the law of the country where the Entity was to be resident approximated to the subscription for shares in terms of South African law – at least insofar as, in return for such a contribution, the contributors would be entitled to dividends, and that on the winding up of the entity, the amounts contributed would be returned to the contributors.

Whether the law of the country where the Entity was resident prohibited or restricted a return of capital to the subscribers while the Entity was a going concern, we do not know, as the Ruling does not go into this important aspect. Nor does the Ruling make clear whether this “contribution” gave the contributors any rights akin to those of a lender if the company went into liquidation, which would allow them to claim for repayment in competition with the Entity’s creditors.

The Ruling was content to equate the “contributed capital” of the Entity with “equity share capital” in terms of the Income Tax Act simply on the basis of two (fundamental but limited) points of similarity, namely, the right to dividends whilst the Entity was a going concern, and the right to a return of the contribution when it was wound up.

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