Synopsis

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A parent company speaks for itself and not for the group it controls

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A parent company speaks for itself and not for the group it controls

A recent judgment from the Supreme Court of Appeal in the matter of *Anglovaal Mining Ltd v C:SARS* confirms the general principle that companies within a group should be treated as separate legal persons when considering their transactions.

Anglovaal Mining Ltd (Anglovaal) in the early 1990's held its mining interests directly and controlled its industrial interests through a 60% holding in Anglovaal Industries Limited (AVI).

In 1994, a subsidiary of AVI, National Brands Limited (NBL), required financing of R300 million to enable it to purchase a new business. Anglovaal determined that the necessary capital may best be raised in the international market. However, as it was unlikely that the international investors would have an appetite for a purely industrial investment in AVI, it was considered most appropriate that the investors be offered exposure to SA mining assets via a direct investment in Anglovaal, which would then utilise the funds to acquire a direct holding of approximately 15% in NBL.

The capital was duly subscribed, Anglovaal in turn subscribed for shares in NBL and the capital funded NBL's new acquisition. Anglovaal's interest in NBL therefore comprised of an indirect holding through its investment in AVI and a smaller direct holding as a result of the transaction described above.

At the time the funds were raised it was contemplated that NBL might be listed on the Johannesburg Stock Exchange, and, in the event of such a listing, the shares held by Anglovaal would be sold to provide the necessary public holding to provide marketability. In any event, it was felt that the shares would not be held for the long term by Anglovaal, and that they would likely be sold at a profit if the listing were not to materialise. Evidence to this effect was given by two former senior officers of the company.

It transpired that the listing of NBL was not effected as previously contemplated owing to a reversal in the fortunes of NBL. In 1999, on the advice of merchant bankers, Anglovaal separated its mining and industrial interests, disposing of AVI to another holding company and, at the same time, sold its direct holding in NBL to AVI for approximately R141 million, incurring a loss of some R159 million,

The distinction makes it plain that the intention of the group is not necessarily the same as the intention of the holding company, and highlights the danger of taking a broad view of a transaction in a group context.

which it claimed as a loss for tax purposes.

SARS disallowed the deduction of the loss and the matter went on appeal after an objection to the assessment had been disallowed.

The primary issue – capital or revenue?

In the Tax Court, it was held that Anglovaal's direct holding in NBL was a byproduct of the method of financing the acquisition of a new investment by that company, and that the acquisition had not been speculative. In so concluding, the Tax Court equated the intention with which AVI held its majority investment in NBL with the intention with which Anglovaal had acquired its direct holding.

The Tax Court had pointed out that, at the beginning of 1994, AVI held 98% of the shares in NBL, and that the effective interest of Anglovaal in NBL was then 59%. After the transaction entered into in 1994 the effective interest increased to more than 60%. It found that the fact that the acquisition of the new business would have a major strategic effect in NBL indicated that the NBL shares were acquired for a long-term strategic purpose.

The Supreme Court of Appeal was at pains to point out that the intention of AVI should not be confused with the intention of Anglovaal. There was nothing in the evidence to suggest that Anglovaal intended the direct investment in NBL to be a long-term investment. After all, it already had a significant investment in NBL via its 60% holding in AVI. It accordingly found that the shares had not been acquired as a long-term investment. Therefore the shares were held on revenue account and the loss was deductible.

This is an important distinction, in that it makes it plain that the intention of the group is not necessarily the same as the intention of the holding company, and highlights the danger of taking a broad view of a transaction in a group context.

The secondary issue – accounting for stock for tax purposes

Not to be outdone, SARS raised a second line of argument. Here it said that the expenditure of R300 million had been incurred in 1994 to acquire the NBL shares and that it had not then been claimed as a deduction. Anglovaal, it argued, had not taken the holding into account as closing and opening stock in the intervening years to 1999, and therefore a deduction could not be claimed in the 1999 year of assessment. This argument had also found favour earlier in the Tax Court.

The Supreme Court of Appeal, however, after examination of Anglovaal's published financial statements for the relevant years of assessment, found that these reflected the number and cost of investments held at the beginning of the year, all acquisitions and disposals during each such year and the number and cost of shares held at the end of each year. In addition, a schedule reflected the profit or losses on disposal specifying separately taxable and non-taxable disposals.

In evidence, it was deposed that no account was taken of the investment in the computation of taxable income during the relevant years of assessment, as the cost of the investment was equal to the value of the closing stock art the end of 1994, and the value of opening and closing stock in the subsequent years was equal.

SARS's submission was that:

> "although the legal basis for adding back closing stock and carrying forward opening stock as a deduction is uncertain, one thing which is certain is that one commences the process by claiming a deduction in the year of assessment when the expenditure is actually incurred."

In this respect the Supreme Court of Appeal found no merit in SARS submission. It found that the witness's evidence that the investment was not taken into account in the computation of taxable income:

> "could have meant only that the expenditure had no effect on such computation as it was cancelled out by the book value of the shares at the end of the particular year as required by s 22."

It was accordingly held that, for purposes of recording the investment for tax purposes, Anglovaal had acted within the requirements of section 22 of the Income Tax Act.

Taxability of SA resident partner on his share of the profits of a foreign partnership

The decision of the Tax Court in ITC 1819 (2007) SATC 159 has now been upheld by the Free State High Court on 17 September 2009 in *Grundlingh v CSARS* [2009] SAFSHC 88.

Grundlingh, an attorney, was a resident of South Africa. He was admitted to practise as an attorney in both South Africa and Lesotho.

He was a partner in the firm known as Webbers in Bloemfontein, and was also a partner in the separate Lesotho-based partnership, known as Webber Newdigate, which had a fixed place of business in Lesotho.

Grundlingh's share in the profits of Webber Newdigate was taxed by the Lesotho fiscal authorities.

SARS included those self-same profits in Grundlingh's taxable income for the tax years in question, and credited him (in terms of section 22(1) of the South Africa – Lesotho Double Tax Agreement) ("the DTA") with the amount of tax he had paid to the Lesotho revenue authorities on those profits.

Grundlingh objected to the assessment and contended that, in terms of the DTA, his share in the profits of Webber Newdigate was taxable only in Lesotho, and were not taxable in South Africa.

It is clear (see the judgment at para [10.1]) that, in terms of South Africa's residence-based tax system, a resident of the Republic is taxable on his world-wide income, save for such income as falls within one of the exclusions in a DTA.

Grundlingh argued that article 7.1 of the DTA provided such an exception and was applicable in the present case. Article 7(1) of the DTA provides that –

> The profits of an enterprise of a Contracting State, shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

The court rejected Grundlingh's argument, holding (at para [10.8]) that article 7(1) was inapplicable because the partnership, Webber Newdigate, was not an "enterprise" that was taxable in Lesotho.

The court reached this conclusion (see para [10.3]) on the basis that, in Lesotho, as in South Africa, a partnership is not a separate taxable entity. In terms of Lesotho's income tax system, a partnership is taxed on the same basis as in South Africa, namely (see the judgment at para [10.5]) that the partners are taxable as individuals, and the partnership is not liable to tax in its own right.

Thus, as a partner in Webber Newdigate, it was Grundlingh who was liable to tax, and not the partnership.

The court pointed out that, in terms of s 24H(2) of our Income Tax Act 58 of 1962, each partner in a partnership is deemed to be carrying on the business of the partnership.

For tax purposes, therefore (see the judgment at para [10.8]) Grundlingh was deemed to be carrying on the business of Webber Newdigate, and any portion of the profits of the partnership that were received by Grundlingh, was deemed, in terms of s 24H(2), to be generated by him.

Consequently, relief from double taxation in the present case was provided by article 22(2) of the DTA which provided that –

> In South Africa, taxes paid by South African residents in respect of income taxable in Lesotho, in accordance with the provisions of this Agreement, shall be deducted from the taxes due according to the South African fiscal law. Such deduction shall not, however, exceed that part of the income tax, as computed before the deduction is given, which is attributable to the income which may be taxed in Lesotho.

In the result, SARS's assessment of Grundlingh, in terms of which his share in the profits of Webber Newdigate was included in his taxable income and he was credited with the tax he had paid to the Lesotho revenue authorities (see para [2]) was held to be correct.

Grundlingh's appeal against the assessment was therefore dismissed and the assessment confirmed.

Submissions influence SA tax law

The process through which fiscal legislation is introduced has become far more transparent in recent years with Treasury circulating proposed legislation for comment and consulting widely with interested persons before submitting drafts of proposed legislation to Parliament. In turn, the Parliamentary Select Committee on Finance examines the draft legislation and receives comment from interested persons and groups, as well as briefings and responses to comment from SARS and Treasury. This inclusive process provides business with a forum to engage with government on important issues of tax practice and policy.

PricewaterhouseCoopers (PwC) has been instrumental in this process for a number of years, analysing the impact of proposed new legislation, pointing out anomalies and inconsistencies and recommending revisions to the draft legislation to modify or clarify the new law.

PwC's legislative monitoring and lobbying efforts remain at the forefront of the ongoing engagement with government, i.e. National Treasury, SARS and Parliament's Select Committee on Finance. And these efforts continue to bear fruit for SA taxpayers.

The 2009 Taxation Laws Amendment Acts (promulgated 30 September 2009) contain many amendments which have been modified as a result of submissions made by PwC and others. Some examples are listed below.

Provisional Tax 2nd Estimate

The very fact that the draft Amendment Bill attempted to soften the (arguably harsh) 2008 changes was a testament to the sustained engagement with government since October 2008. However, whilst the initial 2009 proposals sought to solve the problem by granting SARS vague and broad discretionary powers, ongoing lobbying efforts resulted in the clearer two-tier rules that are now contained in the final Act.

Retrenchment withdrawals from retirement funds

Not only did the submissions raise with Treasury the need for a slightly more concessionary treatment (in the current economic climate) of pre-retirement withdrawals precipitated by retrenchments, but they also assisted Treasury in finding the appropriate parameters that would minimise the risk of abuse whilst still allowing the concession.

Mining stockpiles

Notwithstanding SARS's determination to include mining stockpiles into "trading stock", the submissions were successful in ensuring that the closing stock inclusion would effectively be dependent upon the accounting recognition of inventory.

Deemed expenditure on issue of shares

The rules that deal with paying for asset acquisitions through an issue of shares (in s24B ITA) have been criticised for obstructing – rather than facilitating – many acquisition deals. It is as a result of lobbying that Treasury agreed to return to the pre-2008 rules, temporarily, in order to draft more precise anti-avoidance provisions to counter perceived possible abuse.

Transfer of Estate Duty abatement to spouses

Whereas the original proposals would only have allowed the 'unused' portion of deceased taxpayers' R3.5m abatement to be transferred to surviving spouses if 100% of the estate was bequeathed to the spouses, the submissions process was successful in relaxing the requirements, i.e. ensuring that the unused abatement could be transferred irrespective of how much of the estate was actually bequeathed to the surviving spouses.

CFC exemptions

The streamlining of exemptions for CFCs (controlled foreign companies) was also substantially shaped by ongoing engagement with Treasury.

The lobbying process is ongoing and Treasury has again called for comments on existing law that may require amendment owing to practical, technical or interpretation anomalies. PwC will again be availing itself of this opportunity and encourages commerce and industry to join the process.

Rectification of a contract in a manner that varies its tax consequences

Two cases, two outcomes

Where a person applies to court to "rectify" a contract that he has entered into, he is asserting that the written contract, as it stands, does not accurately reflect the true intention of the parties, and he is asking the court to order that the contract be rephrased so as to accurately reflect the true mutual agreement of the parties at the time they entered into their agreement.

It is thus a remedy that is available only where all the parties to the contract were in fact of one mind, but the written contract failed to accurately express their consensus.

Rectification is therefore not a remedy that is available where only one or some of the parties were under a misapprehension or mistaken impression.

Rectification does not create a new contract, nor does it amend an existing contract; it merely serves to correct the written memorial of the agreement so as to accurately express the true intention of the parties (*Boundary Financing Ltd v Protea Property Holdings (Pty) Ltd 2009 (3) SA 447 (SCA)*).

One of the reasons why a party may seek rectification of a contract is that, in its inaccurate and unrectified form, it has disagreeable tax consequences that would be removed if it were to be rectified.

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(1) To qualify as a zero-rated going-concern sale

In order to qualify as a zero-rated sale of a business as a going concern, the contract must contain the provisions mandated by section 11(1)(e) of the Value-Added Tax Act 89 of 1991.

Tax professionals develop standard-form agreements in this regard, in which the master version has been carefully drafted to contain the requisite provisions.

Nonetheless, slip-ups can occur.

In *Milner Street Properties (Pty) Ltd v Eckstein Properties (Pty) Ltd* 2001 (4) SA 1315 (SCA) the facts were that the VAT Act had been amended in 1994 to substitute a new section 11(1)(e) so as to add a new requirement. The amendment required that the purchaser and seller must have –

> at the time of the conclusion of the agreement for the disposal of the enterprise or part, as the case may be, agreed in writing that such enterprise or part, as the case may be, will be an income-earning activity on the date of transfer thereof

The respective professional advisers for the purchaser and seller were unaware of this amendment to the VAT Act, and the contract drawn up by them failed to state, as required by the amendment, that the enterprise was "an income-earning activity on the date of transfer".

The seller's advisers, it seems, also failed to include in the agreement a provision to the effect that if, for whatever reason, the sale did not qualify for zero-rating, VAT at the standard rate would be added to the purchase price and would be payable by the purchaser.

SARS ruled that, since the contract did not comply with the amended section

11(1)(e) of the VAT Act, the sale was not zero-rated, and VAT must be paid at the standard rate.

Two consequences ensued. Firstly, the seller would now have to pay over a slice of the the selling price (in excess of R400 000) to SARS by way of VAT.

Secondly, as the court remarked, the purchaser, as a registered VAT vendor, could now –

“lay claim [to the VAT] as a refund from the Commissioner for Revenue Services”.

In effect, therefore, the purchaser would get an unexpected and unbudgeted windfall by way of this refund.

There was only one way in which the seller could try to get the contract re-categorised as a going-concern sale that complied with section 11(1)(e) of the VAT Act and was therefore zero-rated for VAT, namely to apply to court for rectification of the contract so as to add the words mandated by the amendment to section 11(1)(e).

At first blush, it might appear that SARS would be unenthusiastic at the rectification of a contract for this purpose, and might oppose the application to court for rectification.

However, the reality was, as the parties agreed in this matter, and as SARS itself conceded –

the fiscus has no financial interest in the outcome of the action because, whatever the facts thereof, no nett tax accrues to the Receiver of Revenue. The matter is one dealing with the legal effect of the Value-Added Tax Act as between the plaintiff and the defendant.

It was clear from the correspondence between the parties in the lead-up to the signature of this particular agreement that it was their intention that the business in question was to be sold as a going concern.

However, the purchaser (reluctant to give up its prospective windfall gain in the form of a refund of the VAT payable by the seller) argued that, as a matter of law, rectification of a contract could not be used as a stratagem to circumvent statutorily prescribed formalities for the zero-rating of the sale of a business.

The court did not agree with this argument.

The court ruled that the requirement imposed by the amended section 11(1)(e), namely that the parties must agree in writing that the business would be an income-earning activity on the date of transfer, was not a requirement that went to the formal validity of the contract.

In other words, it was not a provision similar to section 2(1) of the Alienation of Land Act 68 of 1981 which states that –

No alienation of land …shall ... be of any force or effect unless it is contained in a deed of alienation signed by the parties thereto or by their agents acting on their written authority

The effect of the latter provision is that a contract for the sale of land that is not in writing is void. Hence, there is no contract at all, and therefore nothing capable of being rectified. (See Magwaza v Heenan 1979 (2) SA 1019 (A) at 1029B-C.) The same barrier to rectification applies to an unwritten contract of suretyship, since the law requires such contracts to be in writing. (*Intercontinental Exports (Pty) Ltd v Fowles* 1999 (2) SA 1045 (SCA).)

In the present case, said the court (at para [26]) –

non-compliance with the formalities prescribed by section 11(1)(e) concerns not the conclusion and hence the formal validity of the contract but a fiscal consequence thereof

Moreover, said the court, the purpose of the legislature in requiring contracts for the sale of land and contracts of suretyship to be in writing was to prevent uncertainty and disputation and remove a temptation for perjury and fraud.

The court endorsed the words of the court below where it was held as follows:

Now, it would appear to me that the object of the requirement regarding writing in the amended s 11(1)(e) is to obtain certainty that the parties to a supply of an enterprise as a going concern, were *ad idem* when they concluded this agreement, that the enterprise was disposed of as a going concern and that they contemplated at that stage that the enterprise would be an income earning activity on the date of transfer thereof. Having these matters stated in writing would tend to eliminate disputes and uncertainty occurring afterwards as to the nature of what was disposed of in the agreement and as to what was in the contemplation of the parties when they concluded their agreement. I would think that the requirement that these matters be stated in writing was inserted in the section largely for the benefit of the Commissioner to enable him to determine whether what was supplied was indeed an enterprise which was supplied as a going concern and to satisfy him that the parties, when they concluded the agreement, did indeed contemplate that the enterprise would be an income earning activity at the date of its transfer.

Consequently, said the court, there was no reason why rectification in this kind of case should not be permitted.

The court also pointed out that SARS did not regard non-compliance with section 11(1)(e) as precluding rectification, since VAT Practice Note 14 said that –

‘Where an agreement for the sale of an enterprise as a going concern was concluded before, on or after 25 November 1994, but the parties did not agree in writing that the enterprise is disposed of as a going concern (as they were unaware of the amendment to

s11(1)(e)) they may enter into a separate agreement – based on the original contract - regarding this aspect.'

The court made the further important point that –

the purpose of rectification in circumstances such as the present is not to avoid the payment of a tax which would otherwise be due to the Commissioner. Nothing would prevent the Commissioner, even if the document should be rectified, from going behind its terms to determine for himself whether the supply of the goods was to be charged with VAT at zero per cent.

Since it was common cause between the parties that they had all along been *ad idem* that the sale in question was to be a going-concern sale and zero-rated for VAT purposes, the court held that there was no barrier, legal or factual, to rectification.

(2) To correct a fraudulent understatement of the purchase price to reduce transfer duty

In *Brits v van Heerden 2001 (3) SA 257 (C)* the parties to a sale of immovable property had deliberately recorded an incorrect amount in the written agreement as the purchase price in order to avoid paying transfer duty.

The facts were that the plaintiff had agreed to purchase the defendant's house. The purchase price was to comprise a cash payment of R160 000 and the defendant was also to cede to the plaintiff an insurance policy worth R33 000.

The agreement was reduced to writing in which the purchase price reflected only the cash consideration of R160 000, in order to avoid paying transfer duty on the further R33 000, which also formed part of the consideration for the sale.

When the defendant paid the R160 000 but failed to cede the insurance policy, the plaintiff was in a fix. On the face of the written contract, the defendant had fully performed his obligations.

The only way in which the plaintiff could enforce cession of the insurance policy was to apply to court to rectify the contract in order to reflect the defendant's obligation to do so.

With breathtaking chutzpah, the defendant opposed the application for rectification on the grounds that the court should not come to the plaintiff's assistance as the omission of the provision relating to the cession of the insurance policy had not been a mistake, but had been done deliberately for the purpose of evading transfer duty and thereby committing a fraud on the fiscus. (The defendant, no less than the plaintiff, was of course a party to the fraud.)

The court was now in a dilemma.

The legal maxim *ex turpi causa non oritur actio* expresses the principle that a person cannot base a legal claim on his own dishonourable (in the sense of illegal and immoral) act.

If the court were to grant an application for rectification of the contract on the facts of this particular case, it would be coming to the aid of a party who was just as much a party to the fraud as his opponent.

On the other hand, if the court refused to order rectification, the court would indirectly be assisting the purchaser to consummate the fraud and, moreover, the fiscus would lose the transfer duty that ought to have been paid on the R30 000 policy that formed part of the purchase price.

In the result, the court held that, in these circumstances, the plaintiff's claim for rectification was not defeated by his admission of criminal conduct on his part, that the court could not allow itself to be party to a fraud on the fiscus, and that rectification should therefore be granted.

The plaintiff's joy at securing judgment in his favour would have been shortlived.

With astonishing naiveté and short-sightedness, his attorney had apparently failed to forewarn him that, even if he were to succeed in court, the judge was hardly likely to let the matter rest, and would inevitably order – as indeed transpired – that the record be handed over to the Director of Public Prosecutions and the Receiver of Revenue with a view to the criminal prosecution of both the purchaser and the seller for fraud.

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