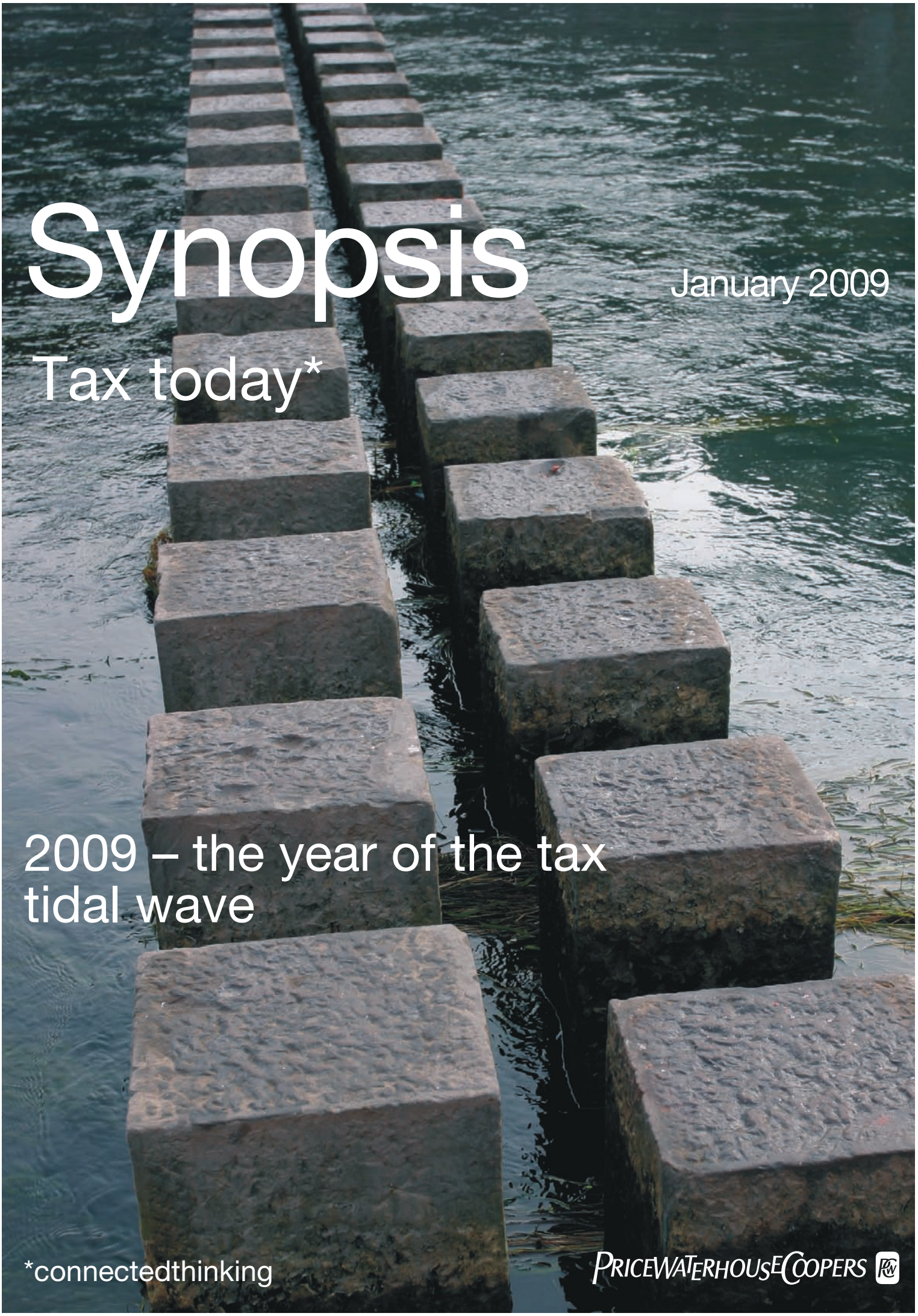

Synopsis

January 2009

Tax today*

2009 – the year of the tax tidal wave

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Tax tidal wave

Tax practitioners have resigned themselves to digesting hundreds of pages of new tax legislation every year. However, the wave of deferred 2008 legislation that is to take effect in 2009 is a veritable tsunami, which will heavily impact not only tax consultants, but corporate finance strategists and financial planners generally.

The far-reaching legislative changes to take effect in 2009 include –

the amendment to the definition of 'dividend' whose basis will be the new concept of 'contributed tax capital'. But, to add to the complexity, a 'foreign dividend' will continue to mean 'any dividend, as defined, prior to the coming into force of [the new dividends tax]'. Hence, the now-repealed (and complex) definition of 'dividend' will survive as a ghostly presence, emerging from the graveyard of repealed legislation only in respect of the tax aspects of a 'foreign dividend'.

The new definition of 'dividend' (at whose core will be the issue of whether the amount transferred by a company to a shareholder results in a reduction of the company's 'contributed tax capital') is to take effect when Part VIII of chapter II of the Act (the new dividends withholding tax) comes into operation, namely, on a date determined by the Minister by notice in the *Gazette*, which must be at least three months after that notice.

Section 9E introduces a tax regime for "passive holding companies". This is intended to eliminate the arbitrage opportunity for individuals of arranging their affairs so that their passive income (as distinct from income derived from their active trading activities) is derived by a company, rather than by themselves personally. The net effect of the legislation will be to impose a 40% charge on the "passive income" and a 10% charge on the dividend income of a passive holding company. The remaining income of such companies will be taxable at the ordinary corporate rate. Section 9E is to come into operation simultaneously with the introduction of the dividends tax.

Part VIII has been added to Chapter Two of the Income Tax Act to introduce a dividends tax that will come into operation simultaneously with the termination of Secondary Tax on Companies. This is to occur on a date determined by the Minister by notice in the *Gazette*, which must be at least three months after that notice. Few will mourn the passing of Secondary Tax on Companies and the international investing community will no longer be baffled by this strange creature and, hopefully, will be more inclined to invest in South Africa.

A new Part IV of the Income Tax Act introduces a presumptive turnover tax for micro-businesses.

In terms of s 12J(2) a deduction is to be available to a person who invests in the shares of a venture capital company ("VCC"); the deduction is equal to 100% of the amount invested in exchange for newly-issued shares, but limited to R750 000 during any given tax year where the investor is an individual. The R750 000 ceiling does not apply to listed companies and their group subsidiaries. The deduction is recouped (and must be added back into gross income) if the investor disposes of those shares.

The Companies Bill of 2008 is currently awaiting presidential signature, and will come into operation a year later. The new Act will impact on all aspects of a company's affairs.

Trading stock – time to draw a line in the sand

In articles over a number of years, we have tracked disputes relating to the sale of sand by farmers on whose land there are suitable deposits. In each of these cases, a contractor entered onto the land and extracted the sand, which was then removed. The Courts have in each instance held that the proceeds on disposal of the sand are of a revenue nature and subject to tax as ordinary income.

The taxpayers have contended that they are, however, entitled to a deduction for the cost or deemed cost of the trading stock. For this contention they have placed reliance on section 22(4) of the Income Tax Act:

"If any trading stock has been acquired by any person for no consideration or for a consideration which is not measurable in terms of money, such person shall for the purposes of subsection (3) be deemed to have acquired such trading stock at a cost equal to the current market price of such trading stock on the date on which it was acquired by such person …"

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Anomalies must be sorted out now

It must surely be time for the position to be regularised and clarified by legislation - the provisions should be simple to enact.

The Courts have rejected the contention of the taxpayers, holding that the provisions of section 22 are only of relevance if the item is held as trading stock at the end of a year of assessment, and that the provisions have no application where the sand is separated from the land and disposed of during the year.

Following the introduction of capital gains tax in 2001, section 22(3)(a)(ii) deals with items of trading stock which become so when they are converted from capital assets to trading stock The following statement in the SARS Comprehensive Guide to Capital Gains Tax indicates how the trading stock is to be treated:

"In terms of s 22(3)(a)(ii) the person will be treated as having acquired the trading stock at market value for ordinary income tax purposes. For CGT purposes the person is treated as having disposed of the asset at market value which brings symmetry to the transaction."

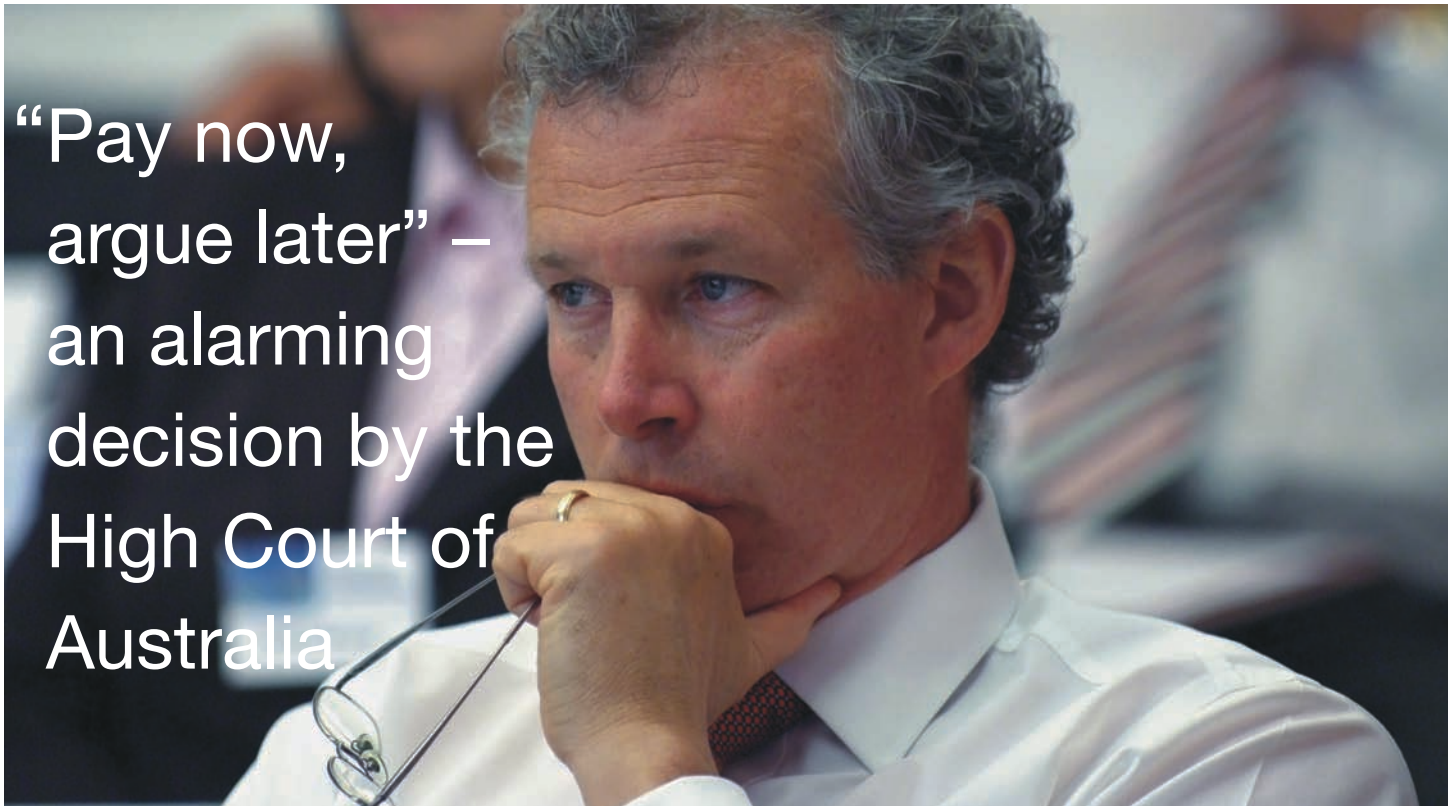
The SARS statement implies that the owner of the asset should be entitled to a deduction in respect of the market value of the asset on conversion. However, the Income Tax Act does not expressly so allow.

Therefore, looking at the wording of the law, and applying the principle that section 22 has application only to determine the value of trading stock on hand at the end of the year the anomalous situation arises where an asset is converted to trading stock. First there is a disposal for capital gains tax purposes, which is deemed to be for proceeds equal to the market value of the asset. Then, this same value must be included in income as trading stock held at the end of the year. But, there is no provision allowing a deduction for the amount taxed under the capital gains rules. Therefore, applying the strict wording tax is payable twice on the same amount. Exactly the same result would arise if the asset were converted and sold in the same year – capital gains tax on conversion and ordinary tax on the proceeds of sale with no deduction for the deemed cost of acquisition.

The problem is compounded by amendments to section 22 in the Revenue Laws Amendment Act (Act 60 of 2008). These provide for additional circumstances in which the cost of trading stock will be increased by certain amounts, where no expenditure has actually been incurred and where the amounts in question have been taxed. This applies to shares in a controlled foreign company whose cost price is deemed to include previously imputed income to the extent that it has not been distributed as a dividend. Unless a deduction is allowed in respect of the amounts concerned, there is effective double taxation of an imputed amount when the stock is valued at the end of the year – first by imputation and then by inclusion in income as closing stock.

It must surely be time for the position to be regularised and clarified by legislation. The provisions should be simple to enact. What is required is the symmetry to which the Comprehensive Guide to Capital Gains Tax (erroneously, it is submitted) refers. This can only be achieved with certainty if a specific deduction is enacted in section 11 to cover the circumstances where taxed amounts are required to be included in the cost of trading stock at year end or where the event that gives rise to the deemed cost and the disposal arise in the same year.

This debate has been in progress for years and the lack of clarity has typically redounded to the benefit of SARS. This an unsatisfactory state of affairs that requires urgent correction to bring symmetry.



"Pay now, argue later" – an alarming decision by the High Court of Australia

Usually, when a creditor sues a debtor for money allegedly owing, and obtains judgment against that debtor, the execution (enforcement) of that judgment is suspended if the debtor lodges an appeal. The creditor can then only enforce the judgment if and when the appeal court upholds it.

One of the most draconian powers vested in SARS is that it is not subject to this principle, and can instead insist that a taxpayer, who has been assessed to tax and disputes the assessment, must "pay now and argue later" (see the Income Tax Act 58 of 1962, sections 88 and 92). In other words, the taxpayer's obligation to pay is not suspended by the fact that he has lodged an objection to the assessment, and intends to take the matter on appeal to the courts.

But what if "paying now" would push the taxpayer over the financial brink into insolvency? In such circumstances, even if his appeal against the assessment were later successful, it would be a hollow victory. Although SARS would reimburse him for the tax, his assets, including his business, would in the interim have been sold off at bargain-basement prices, at a judicial sale in execution by the deputy-sheriff.

If, in a particular case, these would be the consequences of having to pay now and argue later, would a court intervene and order that execution of the judgment be postponed until the appeal had been finally determined?

One's instincts suggest that a court would indeed intervene to prevent an irremediable injustice of this kind. Sadly, instinct is not always a reliable guide to the law, and certainly not to tax law.

In a judgment handed down a few months ago, involving precisely this scenario, the High Court of Australia refused to intervene, and reversed the contrary decision of the Supreme Court of Queensland the Court of Appeal.

The decision in question has been reported as *Deputy Commissioner of Taxation v Broadbeach Properties Pty Ltd* [2008] HCA 41.

The court conceded that this might be harsh, but said that it was the inevitable consequence of a long-standing policy designed to protect the interests of the fiscus.

The revenue authorities had served a statutory demand for payment of the disputed tax

As in South Africa, (see section 345(1) of our Companies Act, 1973, read with section 344(f)), Australia's companies legislation provides that a creditor of a company may serve on the company a statutory demand for payment of a debt, and that failure to comply with such a demand constitutes grounds on which the creditor is entitled to apply for the winding-up of the company, as though it were insolvent.

In the *Broadbeach* case, the revenue authorities had issued assessments against the company in question for outstanding general sales tax, interest and penalties. The company objected to the assessments, but the Australian Tax Office proceeded to serve a statutory demand on the company for payment for some millions of dollars in tax in terms of the assessments.

Usually, the making of a statutory demand is resorted to where the debtor company does not dispute the debt. The process of a statutory demand then provides the creditor with a fast-track procedure to have the company wound up, without having to first obtain a judgment and attempt to recover payment by executing that judgment.

In the *Broadbeach* case, the company disputed that it owed the tax for which it had been assessed, and had lodged an objection.

Will a court set aside a statutory demand where the taxpayer disputes the tax?

The question before the High Court of Australia was whether, given that objection had been lodged against the assessments, the company was entitled to have the revenue authorities' statutory demand set aside, so that the company could avoid being wound up until the tax dispute was decided in the courts.

The interest of the decision is that the High Court held that the taxpayer's objections to the assessments in question did not constitute grounds on which the court would set aside the statutory demand made against the company.

In its judgment, the court acknowledged that, as a general rule –

> the court may set aside a statutory demand where there is a 'genuine dispute' regarding the existence or amount of the debt.

However, the court held that legislative policy in Australia authorises the recovery of tax debts, regardless of a pending objection against the assessment to tax, and operates on the presumption that such assessments are valid.

The court conceded that this might be harsh, but said that it was the inevitable consequence of a long-standing policy designed to protect the interests of the fiscus.

The court pointed out that, if this robust approach were not adopted, a taxpayer who had been assessed to tax might dissipate the amount of the contested tax in legal expenses, to the detriment of the fiscus.

Importantly, the court conceded that, in the separate judicial proceedings (following a statutory demand) in which the creditor applied to court for an order that the company be wound up, the company would be entitled to argue afresh that the company should not be wound up until the disputed tax debt had been adjudicated in the courts.

In Australia, a tax assessment is conclusive proof that the assessed tax is legally due

The Australian tax legislation provides that a notice of assessment is "conclusive evidence" that the tax is due. (The South African Income Tax Act achieves a similar result by empowering SARS to file a statement with the clerk of the court, setting out the amount of the assessment, and by providing that such a statement has the effect of a civil judgment; see the Income Tax Act, section 91 read with section 92.)

In this artificial sense, therefore, an assessment to tax, even if an objection has been lodged, is not a "disputed" debt for the purpose of deciding whether a statutory demand for payment should be allowed to stand or should be set aside.

In the earlier Australian case, *Clyne v Deputy Commissioner of Taxation (*1982) 43 ALR 342, Mason ACJ said at 344 that –

> it is a somewhat unusual course for the Deputy Commissioner [of Taxation] to commence proceedings for recovery in a court

relying on a notice of assessment which is under challenge … It is to be hoped that this is so. The institution of proceedings for recovery on a notice of assessment which is challenged in proceedings under [the Assembly Act] may operate oppressively and unfairly to a taxpayer

In the *Broadbeach* case, the court commented that, although the operation of these statutory provisions may be harsh, "they implement a long-standing legislative policy to protect the interests of the revenue". The court quoted from the judgment In *Deputy Commissioner of Taxation v Niblett* (1965) 83 WN (Pt1) (NSW) 405 at 411where Asprey J observed –

It may be thought to be a hardship that a taxpayer should have to pay the tax assessed when an objection to the assessment has not been decided upon but there are obvious financial considerations of high policy that must be weighed in the balance against cases of individual hardship with which the Commissioner through the appropriate use of his powers under [the Assessment Act] can cope ... Where the meaning of the words of a statute is clear 'it is not open to the Court to narrow or whittle down the operation of the Act by seeming considerations of hardship or of business convenience or the like.

In other words, this (in the view of the Australian courts) is a situation where possible injustice and hardship to the individual are outweighed by "financial considerations of high policy", in other words, by the interests of the state in protecting its coffers.

In the earlier Australian decision in *F J Bloemen Pty Ltd v Federal Commissioner of Taxation* (1981) 147 CLR 360 at 375, Mason and Wilson JJ had remarked –

"[The appellants] point to the fact that notwithstanding that the assessment may be under review or appeal ... the tax assessed is payable and the Commissioner has access to the extensive powers prescribed in [the taxing legislation which] contains large powers to enable the recovery of tax; powers the exercise of which may make life uncomfortable both for the taxpayer and perhaps others who owe money to the taxpayer. So much may be conceded, but [the Assessment Act] does not proceed upon the hypothesis that the Commissioner will be motivated in the exercise of his powers by improper or collateral purposes."

On the basis of this reasoning, the High Court of Australia refused to order that the statutory demands served on the Broadbeach company by the revenue authorities be set aside.

Implications for South Africa

The Australian income tax system, and its corporate law, are broadly similar to those of South Africa. As was noted above, our Companies Act also makes provision for a "statutory demand" and our Income Tax Act also sanctions the "pay now, argue later" approach to tax collection.

Consequently, South African taxpayers may – given the assertive (some would say aggressive) attitude to tax collection by SARS – fear that SARS will follow the precedent set in the Broadbeach decision and start using the stratagem of a statutory demand to enforce payment of disputed tax debts.

South African taxpayers may, however, take heart from an important aspect of the decision in Broadbeach and from differences between Australian law and South African law, as follows –

In the *Broadbeach* case, the High Court of Australia acknowledged that, when the revenue authorities made the necessary separate application to court for a winding-up order vis-à-vis the Broadbeach company on the grounds of its failure to pay the disputed tax in response to a statutory demand, the company would be entitled to argue afresh that such an order should not be granted. This is of equal application in South Africa.

In terms of Australian tax legislation, an assessment is "conclusive proof" that the assessed tax is owing. In South Africa, our Income Tax Act provides in section 91 that a statement of the amount of tax that is due, filed by SARS with the clerk of the court, has the effect of a civil judgment. Arguably, this falls significantly short of the Australian rule that an assessment is "conclusive proof" that the tax is owing.

In South Africa, where a tax assessment is bona fide disputed on reasonable grounds, and where immediate enforcement of that assessment could result in irremediable financial prejudice, a court might hold that SARS's invocation of the "pay now, argue later" principle is an infringement of the taxpayer's rights under our Bill of Rights, and on that ground it should not be permitted.

Taxpayer held criminally liable for incorrect professional advice?

Le Roux and his accountant sentenced to imprisonment

The *Synopsis* of November/December 2008 commented on the much-publicised trial of Garth Le Roux, the former Springbok cricketer turned businessman, on charges of tax fraud, involving some R633 000 in disputed tax.

At issue was whether it was lawful for one of Le Roux's companies to "sacrifice" commissions given in return for discounts on the purchase price of a Fancourt property by another company in his stable without declaring those sacrifices to SARS for VAT and income tax purposes.

Conviction and sentence

Both men have now been convicted, Le Roux on three tax fraud counts, and his accountant, van Heerden, on seven.

In her submission as to an appropriate sentence, the prosecutor is reported to have said that –

According to press reports, the prosecution is also considering appealing against the sentence, from which one may infer that SARS believes it ought to have been heavier.

"the court should not send out the message that people with a 'big cheque-book' could buy their way out of prison".

The prosecutor contested the defence's argument that the two accused were well-respected men in their communities, successful, family-orientated, first-time offenders, who did not deserve prison terms.

If the court was to show leniency, the prosecutor argued, it should reflected in the length of the jail term, not in handing down a non-custodial sentence.

In passing sentence, the magistrate echoed the words of the prosecutor, saying that the accused had to be sentenced to imprisonment, without the option of a fine, so as to ensure that the public did not get the impression that people with big cheque-books can buy their way out of prison.

The court sentenced Le Roux and his accountant to an effective four years in jail. Both intend to appeal.

According to press reports, the prosecution is also considering appealing against the sentence, from which one may infer that SARS believes it ought to have been heavier.

Financial statements audited and professional advice relied upon

It seems strange that, in neither the prosecution's argument on sentence, nor in the defence's submissions, nor in the magistrate's reasons as to an appropriate sentence was detailed consideration given to what was surely an important consideration, namely that the offending tax returns, submitted by Le Roux and his companies, were based on audited financial statements, and that Le Roux had received professional advice that the tax treatment of the contentious commissions in those financial statements was appropriate.

Principles undergone significant changes

And, further, that, between the occurrence of the events in question, and the criminal case, the principles of tax law in regard to the accrual of income had undergone significant changes as result of the Supreme Court of Appeal decision in the case of Brummeria Renaissance.

The magistrate is reported to have said in this regard that, "

"Le Roux was clearly a very successful businessman, who clearly had a much greater knowledge of tax issues than he had shared with the court during his testimony. It is not possible that he honestly believed that he... did not have to pay income tax on amounts in excess of half a million rand earned at each of these occasions."

In other words, the view taken by the court was that a businessman is not justified in relying on the advice he is given by his professional advisers in regard to what must be disclosed in his tax return and supporting documentation, and can be held criminally liable where that advice turns out to be wrong.

That, with respect, is a far-reaching proposition, and it is to be hoped that the Supreme Court of Appeal will express a view on it.

Apart from the technical issues of tax law at stake in the case, it is to be hoped that the Supreme Court of Appeal will speak its mind on the important issue of whether this was an appropriate case for SARS to institute criminal proceedings at all.

Mining industry subject to a further tax

After more than five years of negotiation between Treasury and the mining industry, a mineral and petroleum resources royalty will become payable from 1 May 2009. The enabling legislation has been promulgated. The Department of Minerals and Energy is at pains to point out that this is not a tax, but a charge for the depletion of national resources. The royalty bears all the hallmarks of a tax.

Persons affected

This legislation applies to persons who hold a prospecting right, retention permit, exploration right, mining right, mining permit or production right granted pursuant to the Mineral and Petroleum Resources Development Act or a lease or sublease in respect of such a production right, or to any person who wins or recovers a mineral resource within the Republic. It comes into effect on 1 May 2008 and all qualifying persons are required to register by 30 June 2009.

Persons who are residents of the Republic (as defined in the Income Tax Act) are exempt in respect of any year of assessment if their gross sales do not exceed R10 million during the year of assessment and the amount of the royalty would be less than R100 000.

Calculation of the royalty

The royalty is a percentage of gross sales of mineral resources. Different rates apply depending on whether the mineral resources are unrefined, or refined to a state specified in the legislation. The minimum percentage is 0.5%, and this may increase to a maximum of 7% (unrefined) or 5% (refined) by the ratio of 9 times the percentage of earnings before interest and tax (EBIT) divided by gross sales in respect of unrefined mineral resources and 12,5 times the ratio in respect of refined products.

The two critical determinants are therefore gross sales and EBIT.

Gross sales are the amount received or accrued in respect of the disposal of the

mineral resources or that would have been received if the disposal had been at arm's length, excluding any amounts in respect of insurance, handling or transport after the mineral resource has achieved a minimum condition specified in either Schedule 2 or Schedule 3.

EBIT represents gross sales to which are added:

any amount included in taxable income relating to the use of assets or expenditure incurred in production of the mineral resource to the required condition, other than amounts relating to the disposal of assets that form part of capital expenditure,

and from which are deducted:

all amounts allowed to be deducted in terms of the Income Tax Act from income earned during the year of assessment relating to assets used or expenditure actually incurred directly in the production of the mineral resource to the required condition, excluding the a number of prohibited deductions. These are:

- Deductions for financial instruments;
- The royalty itself;
- Expenditure in respect of insurance, handling or transport after the mineral resource has achieved a minimum condition;
- Deductions relating to accruals or receipts connected to effecting disposal of the mineral resources;
- Assessed losses from the prior year;
- Foreign exchange losses in terms of section 24I of the Income Tax Act;
- Deductions relating to an impermissible tax avoidance arrangement; and
- Capital expenditure for operators in the oil and gas industry.

Where persons dispose of both unrefined and refined mineral resources, apportionment of expenses on a consistent, acceptable basis is permitted.

Payment

The royalty is payable semi-annually, by way of estimated payments, on a basis similar to provisional tax for income tax purposes. If the estimated payments are less than the actual royalty that is finally calculated, there is a six-month period after the end of the year of assessment within which an additional payment may be made to avoid the payment of interest. Penalties may be incurred if the aggregate of the first and second estimated payments are less than 80 per cent of the final liability. Overpayments are refundable with interest running from a date six months after the end of the year of assessment.

Administration

The law is administered by SARS, and returns must be submitted annually within six months after the end of the year of assessment.

The returns are assessed. A notice of assessment may not be issued more than five years after the date of submission of the return unless he is satisfied that the registered person failed to make payment due to fraud, misrepresentation or non-disclosure of material facts. Assessments are subject to objection.

There is also a right of objection against certain of the Commissioner's discretionary administrative decisions relating to registration of qualifying persons, substituted estimates, refunds and imposition of penalties and interest.

Unsurprisingly a number of the provisions of the Income Tax Act are incorporated by reference in this Act. These include secrecy, power to obtain information (including search and seizure), objection and appeal, dispute resolution, payment and recovery of tax, offences, reporting unprofessional conduct and jurisdiction of the courts.

The compliance burden and risks

These new laws place yet another compliance burden on the mining and oil and gas industry. Not only are they required to estimate taxable income and pay provisional taxes for income tax purposes; they are required to compute and make payment in respect of the estimate of royalty liability on the same dates.

The principles that apply in respect of income tax and mineral royalties are not identical and certain amounts of income and expenditure that may be taken into account for income tax purposes must be excluded from the royalty calculation. This requires well organised financial reporting systems, or interrogation procedures that can assemble the relevant information accurately and consistently. Failure to plan and adapt early could prove costly.