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

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Carrying on business through an agent – adding to the confusion

A recent decision in the Tax Court in the Western Cape (Case No. 13002) related to the question whether a company was carrying on farming.

The company (Company A) had acquired a piece of land on which there were substantial plantations. Company A itself did not wish to exploit the plantations commercially, but wished to ensure their preservation. It therefore entered into an arrangement with a second company (Company B), in terms of which Company B had the right to exploit the timber, but was obliged to maintain the rotation by planting trees to replace those that were cut. Company B was entitled to all proceeds from the exploitation and was obliged to meet its own costs and to keep the plantations insured against fire.

Subsequently Company A reached an agreement with Company B that it would sell the land together with the plantations to Company B. As part of the negotiation, the amount payable by Company B was effectively reduced by what was referred to as a "bonus management fee" for its management of the plantation.

Company A declared a capital gain in respect of the sale of the land. SARS, however, relying on a provision of the First Schedule to the Income Tax Act, included the proceeds from the disposal of the plantation in gross income, alleging that Company A was carrying on farming operations.

The Tax Court held that Company A was indeed carrying on farming operations. Davis J, delivering the judgment of the Court, relied heavily on references in the agreements to a "forestry business", to the payment of a management fee and to the references in the annual financial statements of Company A reflecting the plantations as inventory and the growing of timber as a main objective of the company. Thus he concluded:

"When the objective evidence, particularly the range of documents to which I have references, including contracts and financial statements are considered. They all indicate in the direction that appellant was conducting a business of plantation farming."

Recent decisions in the Supreme Court of Appeal

The decision should be considered critically in light of two judgments of the Supreme Court of Appeal delivered in 2010 and 2011.

The miner

In *C:SARS v Foskor (Pty) Ltd 72 SATC* 174 (SCA), the taxpayer owned rights to mine for a particular mineral (foskorite) on a specified property. Another company had rights to mine for copper on the same property, and it was agreed that the other company would conduct the excavation and, in the course of such excavation would excavate and deliver the foskorite to the taxpayer, and be compensated for the cost of excavation and delivery. This agreement bore the marks of a contract mining arrange- ment. In short, the other company extracted foskorite (to which the taxpayer alone was entitled) from the soil, delivered it to the taxpayer and was reimbursed for the costs that it incurred in so doing.

The Supreme Court of Appeal found that the taxpayer was not carrying on mining operations. It held that the arrangement was for the delivery of the foskorite as a by-product of the mining operations of the other company.

The construction company

A similar result emerged in the case of *C:SARS v SA Custodial Serviuces (Pty) Ltd* 74 SATC 61 (SCA). The taxpayer company entered into an agreement with the government to erect a prison and operate the prison for a period of years as agent for the government, for which it received a fee. It was obliged to deliver occupation of the prison to the government at the end of the management contract. In law, the prison became the property of the state when it was constructed. The taxpayer engaged a sub-contractor who was required, as its agent, to erect the structure and to comply with the requirements of the main contract as to quality, materials, etc. The taxpayer claimed that, as the principal contractor, it was carrying on a trade; that the expenditure that it incurred in remunerating the sub-contractor was deductible expenditure and the prison building was trading stock until it was finally delivered to the government.

In the court below, the issue had been dealt with in the following terms:

"The second question is the submission by the Respondent that because it operated through sub-contractors it was itself not really trading *as such and therefore could not become a* trader *as per the definition thereof in the Act. There is no merit in this argument either:* "Qui facit per alium, facit per se." *This principle is part of our law. It simply means that he who acts through agents, acts himself. It is thus clear that whatever the Applicant really is and however it might have operated whatever it did, it did by and through itself. Therefore all the definitions regarding trader and trading stock, etc. must be viewed in the light that they apply to the Appellant directly and not to any of its sub-contractors."*

The Supreme Court of Appeal, however, found that there was no sub-contract, and that the arrangement between the taxpayer and the sub-contractor was not a sub-contract, but a principal contract. Therefore the sub-contractor provided all the materials that were used in construction and did not do so as agent of the taxpayer. It followed that the taxpayer was not carrying on the construction activity and could not claim the necessary deductions.

Thus, the SCA has held in two separate judgments that unless a person carries on the activities relating to a trade personally and directly, that person is not carrying on that trade.

Can these decisions be reconciled with Case No. 13002?

It is noteworthy that, in the two matters determined in the SCA, the taxpayer engaged the services of another person to perform certain operations on its behalf. The benefit of the exertions of the agent in each case accrued to the taxpayer. Notwithstanding that the benefit accrued to the taxpayer and the sub-contractor was merely an agency to enable that benefit to be derived, the Court held that the taxpayer was not carrying on the trade that it claimed to be carrying on and that the trade was being carried on instead by the sub-contractor.

In Case No. 13002, the Court appears to have adopted a view that is diametrically opposed to that in the SCA decisions. Here, the benefit of the farming operations, namely the revenue from the harvesting of the timber was not derived by the taxpayer, but by Company B. It had the right to use the land and exploit the timber for the duration of the agreement with Company A, subject to returning the plantations to Company A in like condition on termination of the agreement. Yet, Company A was found in this instance to be carrying on farming operations.

It is disturbing that these decisions cannot be reconciled. Stripped down to their bare essentials, all three cases go to the question of identifying the person who was carrying on the specified trade.

In the SCA cases, all benefit and profit went to the principal, yet the principal was found not to be conducting the relevant activity, because it did not directly carry on the physical activity.

In Case No.13002, the owner did not derive the benefit of the farming activities and did not directly conduct the physical activity, and yet was found to be carrying on farming operations. Even if it can be accepted that benefit was derived by the owner by reason that the value of the plantations was not diminished, the owner did not directly carry on the physical activity.

It is to be hoped that some consistency will be applied if this matter should be referred to the Supreme Court of Appeal.

Interpretation Note 74: the deductibility of expenditure on repairs

Interpretation Note 74, issued by SARS on 6 August 2013, is a collation of fundamental principles regarding the deductibility of expenditure on* repairs *(and the recoupment of such expenditure) in terms of section 11(d) of the Income Tax Act 58 of 1962 and the principles, as laid down in case law, regarding the distinctive features of a* repair *as contrasted with other categories of expenditure.

The Note commences with the general observation that –

'expenditure on repairs to an asset not comprising trading stock is likely to be of a capital nature, particularly when it is not incurred at regular intervals'.

This is a puzzling proposition on several grounds.

Firstly, in the context of income tax, a *repair* is usually regarded as being, by definition, expenditure that is not of a capital nature, as distinct from expenditure on an *improvement* or *reconstruction*, which is capital in nature. Implicitly, however, this dictum seems to countenance that certain expenditure, though involving a *repair* will nonetheless be of a capital nature and – on that ground – non-deductible.

The rationale for the deductibility of expenditure on repairs

The Interpretation Note goes on to defend the proposition, quoted above, that expenditure on an improvement or reconstruction is not deductible by saying that expenditure on repairs is of a capital nature where –

'the expenditure relates to the protection of a capital asset'.

Although the Interpretation Note cites a Tax Court decision as authority for this proposition, its validity in this form is doubtful. A *repair* does not 'protect' a capital asset in the usual sense of that word – it restores the asset to its prior condition.

Nor is it true, as a general proposition, that expenditure that 'protects' a capital asset is necessarily of a capital nature. For example, there seems little doubt – although there has not been a specific reported decision to this effect – that where a business employs a watchman or security guard to protect its capital assets, the wages paid to that person are not of a capital nature and are deductible under section 11(a) of the Income Tax Act.

The distinctive characteristics of a 'repair'

The Interpretation Note goes on to affirm, in principle, the distinction between deductible expenditure on a *repair* and non-deductible expenditure on an *improvement*. The Interpretation Note, however, concedes that a repair inevitably effects a measure of improvement, in that the asset is in a better condition after the repair than before it. This paradox is a source of uncertainty in tax law.

The Note goes on to quote a dictionary definition to the effect that to *repair* means –

"to restore (something damaged or broken) to good condition or working order".

The Interpretation Note says in this regard that –

'In order to determine whether an expense will constitute a repair it is necessary to establish the meaning of the word "repairs" as used in section 11(d). The Act does not contain a definition of the word "repairs" and it must, therefore, be given its ordinary grammatical meaning.'

While not wholly incorrect, this unqualified assertion of the predominance accorded to dictionary definitions is somewhat surprising in the light of the recent, seminal decision of the Supreme Court of Appeal on the principles governing the interpretation of statutes, in which the court unequivocally signalled a movement away from looking at the meaning of words, shorn of their context – which is of course precisely what a focus on the grammatical meaning of a word entails.

Thus, in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) the Supreme Court of Appeal said that –

'Over the last century there have been significant developments in the law relating to the interpretation of documents, both in this country and in others that follow similar rules to our own'.

The court then went on to say (at para [25]) that –

'Most words can bear several different meanings or shades of meaning and to try to ascertain their meaning in the abstract, divorced from the broad context of their use, is an unhelpful exercise.'

The Interpretation Note makes no attempt to follow the approach favoured by the Supreme Court of Appeal in this case which acknowledges –

'The stress placed in modern statutory construction on the purpose of the statute and identifying the mischief at which it is aimed …'

The Interpretation Note cites the decision in ITC 617 (1946) 14 SATC 474 which distilled the following principles from prior case law –

- *'Repair is restoration by renewal or replacement of subsidiary parts of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.*

- *In the case of repairs effected by renewal, it is not necessary that the materials used should be identical with the materials replaced.*

• *Repairs are to be distinguished from improvements. The test for this purpose is – has a new asset been created resulting in an increase in the income-earning capacity or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?'*

There is established authority for all of these propositions, and they have indeed become a mantra in tax literature.

However, the Interpretation Note throws no new light on the difficulties inherent in the first and third of these propositions.

The Interpretation Note cites and quotes from decisions in this regard, but without venturing a view on the criteria that characterise an *entirety*. This question is particularly important in the current era where, particularly in the field of computers and other electronic equipment, faulty components are seldom repaired and are merely replaced.

Thus, the Note quotes from the decision in ITC 617 (1946) 14 SATC 474 in which the court considered the deductibility of various expenses incurred on a racecourse, comprising a number of buildings and a race track. In this case, the Tax Court merely asserted and concluded, without advancing reasons, that the track as a whole was the entirety and the court did not lay down any governing principles, saying merely that –

"[A]s far as the buildings are concerned the general principles applicable to the repair of each building as constituting a separate and distinct subject matter, are applicable to that particular building, whether used for one purpose, or conjointly for several purposes. In the case of the race-track or course itself the whole subject matter is to be regarded as comprising the track itself, the rails along it and the starting gates, discs indicating distances and so on."

Maintenance as distinct from repair

The Interpretation Note goes on to discuss whether *repair* includes *maintenance*. Again, the Note takes as its starting point a dictionary definition and quotes *The Concise Oxford English Dictionary* to the effect that maintenance is –

'the process or state of maintaining or being maintained',

and that *maintain* means to –

"cause or enable (a condition or state of affairs) to continue, keep at the same level or rate; keep (a building, machine, etc.) in good condition by checking or repairing it regularly".

The court cites the decision in *Heerman's Supermarket (Pty) Ltd v Mona Road Investments (Pty) Ltd* 1975 (4) SA 391 (D) at 396 where van Heerden J considered the meaning of the words *repair* and *maintenance* in the context of a lease agreement and the question whether the wide dictionary meaning of the word *repair* was wide enough to cover *maintenance*.

In that case, a lessor had claimed that it was liable for repairs but not for maintenance under the provisions of the lease agreement. The court held that the word *repairs* was capable of covering *maintenance*.

In *Clanwilliam Municipality v Braude* 1954 (3) SA 657 (C) the court expressed the view that –

'the words "maintenance" and "repair" have "connotations which differ in accordance with the objects and circumstances to which they are applied'.

Regrettably, the Interpretation Note does not explicitly make the important point that context is vital in determining meaning and that an expression, such as *repair*, may mean one thing in the context of tax legislation and another in the context of a contract.

Nor does the Note discuss the respective spheres of application of the general deduction provisions in section 11(a) and the specific provisions of section 11(d) in relation to expenditure on *repairs*. Thus, in the context of *repairs*, does section 11(d) merely cover expenditure that would have been encompassed by section 11(a) in any event?

The Note is undoubtedly correct where it says that –

'Expenditure incurred on maintenance will be deductible under section 11(d) provided it complies with the essential elements of a repair and the other requirements of that section.'

The distinction between repairs and improvements

The Interpretation Note distils the following principles, as emerging from case law, in regard to the fundamental distinction between deductible expenditure on a *repair* and non-deductible expenditure on an *improvement*:

• *Has a new asset been created, resulting in an increase in the income-earning capacity, or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?*

• *Unless the structure or article on which repairs are deemed to have been done was damaged or had deteriorated, and replacement was required, no repair for the purposes of section 11(d) has taken place and no further inquiry need be made.*

• *Materials used for the repair need not be identical to the original materials that are being replaced. As long as the purpose of the work is to restore the asset to its original condition, as distinct from creating an improvement, the work constitutes a repair. The fact that new materials are substituted for the old at a greater cost than would have been incurred had the same materials been used is not relevant. Each situation must be decided on its own merits in order to determine whether the use of new*

An artless taxpayer finds a short-lived solution to his tax problems

The judgment reported as A v CSARS (IT Case No 12524) in which judgment was given on 20 November 2012 is a curiosity.

The taxpayer, Mr A, an instrument technician who had previously rendered services to various companies via a labour broker, and been paid by that labour broker, received some encouraging tax advice from an unnamed source.

A magical solution to Mr A's tax situation

The advice, in a nutshell, seems to have been – why render your services via a labour broker and be heavily taxed on your earnings from that entity? Why not instead form an inter vivos trust, with yourself as the sole trustee and yourself, your spouse and your children as beneficiaries? You can then continue rendering the same services to the same companies and have the trust invoice those companies for those services so that the funds are paid to the trust and not to you. In this way, you can reduce your personal income (and your personal income tax) to zero, and at the same time you can pay all your personal and domestic expenses from the trust's bank account.

This breathtaking counsel seems not to have strained Mr A's credulity, and for the next three years he implemented the advice wholeheartedly, registering a trust, and having the remuneration for his services (based on his hourly charge-out rate) paid into the trust's bank account by his client companies, which he then used to pay his personal living expenses including the rental for his residence, groceries, doctors' bills, school fees, electricity, municipal rates and domestic gardening services.

The assessments in question related to the tax years 1998 to 2001, and thus pre-dated the statutory amendments that include a personal service company (later renamed a personal service provider) in the definition of employee in the Fourth Schedule to the Income Tax Act.

SARS spoils the party

Not unexpectedly, SARS's suspicions were soon aroused by the decline in Mr A's personal income to virtually zero and the coincidental formation of a family trust with a substantial gross income but expenses that reduced its taxable income to an overall loss. A SARS audit revealed the facts.

Interpretation Note 74: deductibility of expenditure on repairs (cont)

materials is for the purpose of improvement or merely for the purpose of restoring the asset to its original condition.

- *Repairs undertaken at the same time as improvements may qualify for deduction under section 11(d) if they can be clearly and separately identified from the improvements. Much will depend on the facts of the specific case and the taxpayer will bear the onus of showing that what was undertaken was a repair. In ITC 1457 (1989) 51 SATC 131 (T) the taxpayer had converted residential flats on the upper floor of a two-storey building into offices after the flats had fallen into disrepair. A quantity surveyor could identify certain of the work as repairs.*

While there can be no arguing with the accuracy of this summary, it adds no new insights.

Conclusion

This Interpretation Note is a useful collation of long-established principles in regard to nature of a *repair*, but it sheds no new light on the unsettled questions in this area of tax law.

The most striking omission from the Note is the failure to consider whether the principles of statutory interpretation, recently laid down by the Supreme Court of Appeal in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) necessitate a reconsideration of the way in which the courts have hitherto interpreted the expression repair in the context of section 11(d) of the Income Tax Act.

If the principles of interpretation, laid down in that decision were to be applied in the debate as to what constitutes a *repair*, account would have to be taken of the internal logic of the Income Tax Act, and the underlying purpose of the distinction between expenditure that qualifies for outright deduction and that which qualifies for deduction in instalments, spread over the productive life of an asset.

SARS proceeded to issue assessments for the tax years in question in which all income of the trust that was derived from the rendering of Mr A's services was now attributed to him personally.

The bases of the revised assessments

The revised assessments seem to have had three bases.

Firstly, that the income from the rendering of Mr A's services to the companies in question, though invoiced and received by the trust was in *reality* his income.

Secondly, that the income accrued to Mr A personally by virtue of paragraph (c)(ii) of the definition of gross income in section 1 of the Income Tax Act 58 of 1962 which provides that –

"any amount received by or accrued to or for the benefit of any person in respect of services rendered or to be rendered by any other person, shall for the purposes of this definition be deemed to have been received by or to have accrued to the said other person."

Thirdly, that section 103(1) was applicable and the Commissioner had the power under that provision to regard the income in question as accruing to Mr A personally.

The Tax Court therefore dismissed Mr A's appeal against the assessments in question.

There can be no quibble with the end result, namely, that Mr A was liable, in his personal capacity, for the income from his services that had been derived by the trust.

However, the reasoning process by which the Tax Court arrived at this conclusion is somewhat shaky.

The underlying reasons for the judgment

It was certainly arguable that the income in question, derived from the services rendered by Mr A to the companies in question, was indeed in reality that of Mr A in his personal capacity. However, that conclusion was not established by the court's bald assertion to that effect.

If the court were minded to reach such a conclusion, then it ought to have explicitly found that the trust (or at least the modus operandi of the trust) was a sham in that Mr A, as its founder, did not have the bona fide intention that it was to function as a genuine trust, with the legal and fiscal consequences that this entailed. On the facts of this matter, such an argument was clearly tenable, given that Mr A apparently regarded the moneys paid to the trust for his services as his to do with as he pleased, and available to be freely spent by him without regard for the stated objectives of the trust.

If this was, in essence, the conclusion of the court, then the judgment need have gone no further, and the second and third grounds for the revised assessment, discussed below, were superfluous.

In the second ground for the dismissal of the appeal, namely that the income in question accrued to Mr A by virtue of paragraph (c)(iii) of the definition of 'gross income', the court reached its conclusion on the basis of a single sentence in the judgment, namely that this provision empowers SARS –

'to tax the person rendering the service, irrespective of who actually derives the remuneration for such service'.

This may, indeed, appear to be the meaning of this statutory provision. However, if this provision were to mean literally what it says in the stark terms articulated by the court, it would mean that no juristic person could ever derive income from services, for a juristic person, being a legal fiction devoid of a physical existence, can never render services in its own right.

This would come as a cruel surprise to companies countrywide, who make up their returns on the basis that their employees render services on behalf of the company and that the resultant income accrues to the company.

As for the applicability of section 103(1), the court quotes from this section and states that SARS –

'is accordingly empowered in terms of section 103(1) of the Act, to determine the tax liability of transactions, operations or schemes which have the effect of avoiding or reducing the liability for income tax'.

There can be no quibble with the end result, namely, that Mr A was liable, in his personal capacity, for the income from his services that had been derived by the trust. However, the reasoning process by which the Tax Court arrived at this conclusion is somewhat shaky.

This applicability of section 103(1) in the circumstances of this case rested heavily on the finding by the court that there was no agreement between Mr A and the trust and that –

' the salary, which [Mr A] had previously received for services rendered by him … was effectively still in place after the conclusion of the agreements between the trust and The Companies relating to the appellant's services as an instrument technician'.

In other words, despite the fact that it was common cause that the trust had entered into a series of agreements with the companies in question in terms of which the trust would henceforth invoice them for Mr A's services, the latter's omission to cancel his prior arrangement meant that 'the salary which [he] had previously received for his services … was effectively still in place' [sic].

The astonishing corollary of the latter proposition seems to be that the Tax Court believed that, although the trust had received payment from the companies into its own bank account, Mr A would be entitled to sue the companies (or perhaps his erstwhile labour broker) for payment all over again on the basis that the amounts paid into the trust's bank account did not discharge their continuing and unextinguished obligation to pay him the salary that 'was effectively still in place'.

Interpretation		
6 August	Interpretation Note No. 74: Deduction and recoupment of expenditure incurred on repairs	This interpretation note provides guidance to identify whether expenditure qualifies for deduction and SARS view that repairs effected close to the date of disposal may result in a recoupment.
Binding rulings		
27 July	Binding Private Ruling 149 Disposal of an asset that constitutes an equity share in a foreign company	This BPR recognises a Netherlands Co-op as a company for tax purposes and the interest of a member as an equity share, and rules that a transfer of an equity share in exchange for an interest in the co-op qualifies as an asset-for-share transaction'.
24 July	Binding Private Ruling 150 Tax treatment related to a credit linked deposit	The BPR rules that a bank advance to finance sales on credit which will be serviced purely from customer receipts will be an instrument on which interest will accrue on a yield to maturity basis. A fee payable to the customer for collection activities will be subject to VAT
13 August	Binding Private Ruling 151 renunciation of an inheritance	The BPR states that a renunciation of bequests by residual heirs in an estate will not expose them to donations tax or a tax on capital gains, and that the accrual to the surviving spouse as a result will be subject to rollover relief.
13 August	Binding Private Ruling 152 Capital Gains tax: Cancellation and extinguishment of a right to interest	Here it has been ruled that the waiver of a right to receive future payments of interest on the discounted portion of a purchased loan will not expose the creditor to capital gains tax.
Case law		
19 August	Case 13002 (Western Cape Tax Court)	The case holds that the proceeds of the disposal of land on which a plantation was established are gross income, by reason that the seller was conducting farming operations.
PwC publications		
12 August	*VAT Alert* Electronic record-keeping	The Tax Administration Act contains provisions regarding the maintenance of electronic records. These include new requirements not previously dealt with in the VAT Act which are discussed in the VAT Alert.