Synopsis

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Pay now argue later – back in the spotlight

Two recent decisions in the Western Cape have again thrust the "pay now argue later" issue into the public eye.

There is a conflict between the desire of SARS to collect the revenue that it assesses to tax and the reluctance of the taxpayer to make payment where the assessment is disputed. A distinction should also be drawn between the case where the taxpayer initiates a dispute in order to delay having to make payment and the situation in which the dispute is grounded on well-founded issues, where the taxpayer is concerned that amounts will be tied up over a lengthy period of time, but are likely to be found not to have been correctly assessed.

Prior to 1 February 2011 the position was that the obligation to pay was suspended until an objection had been determined – although this was not SARS' practice, it appears that the 'pay now argue later' principle only applied from the commencement of an appeal. However, once the objection was disallowed, the obligation to pay was not suspended and the taxpayer could only obtain suspension by making application for an extension of time within which to pay. Our courts have indicated that the power to grant an extension should be exercised reasonably having regard to the circumstances of the matter.

The Income Tax Act was amended from 1 February 2011 to deal with situations where a taxpayer may apply for the suspension of a demand for payment of tax pending the determination of a dispute.

The Income Tax Act was amended with effect from 1 February 2011 to deal with situations where a taxpayer may apply for the suspension of a demand for payment of tax pending the determination of a dispute. The position now is that the obligation to make payment of assessed taxes is not suspended by an objection or pending the decision on an appeal. However, the taxpayer may request SARS to suspend the payment of the tax or a portion of the tax where the amount is subject to dispute. In making a decision on a request, SARS is required to consider a number of prescribed factors, largely pertaining to the taxpayer's compliance record, financial position and the risk of non-recovery. Any decision may be revoked if the objection or appeal is vexatious or frivolous, if the taxpayer is dilatory in prosecuting the objection or appeal, if, on reconsideration, the suspension should not have been granted or if the circumstances which had warranted a suspension may have changed materially.

The promulgation of the new provisions also provided that any suspensions granted prior to 1 February 2011 would expire on 1 August 2011 unless renewed before that date.

In one of the matters that came before the High Court (*Kluh Investments (Pty) Ltd v C:SARS and The Minister of Finance* Case No. 8274/2011), a suspension had been granted under the old dispensation on 20 December 2010 pending the determination of a matter on appeal, provided that the appeal was lodged timeously and subject to the condition that it might be reviewed at any time. However, after 1 February 2011, the decision was withdrawn and payment of the tax was demanded.

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Tax residence – A court gives some guidance

One of the principal determinants of residence of a company or trust is the location of its place of effective management. For the first time in ten years, we have obtained some insight into the manner in which our courts may approach the interpretation of this term, which is so vital to certainty (*The Oceanic Trust Co. Ltd N.O. v C:SARS Western Cape High Court *Case No. 22556/09)

At issue was the operation of a trust established in Mauritius which owned substantial investments in South Africa. If the trust was found not to be a resident, then it could only be subject to tax in South Africa if the requirements of the double taxation agreement between South Africa and Mauritius so permitted. However, if it was found to be a resident of the Republic, its income would become taxable in South Africa.

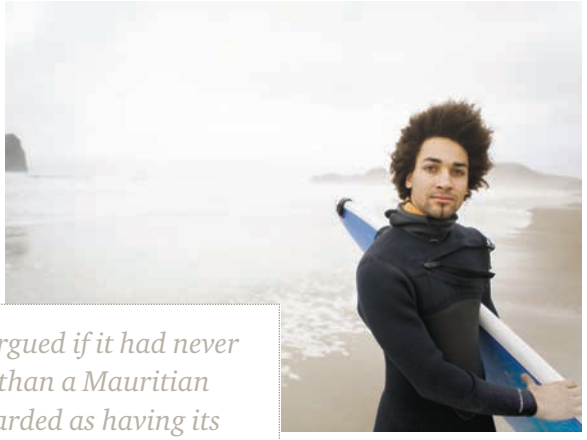
Investment portfolio

The trust was part of a listed group's structure and maintained its entire investment portfolio in South Africa. The investments were under the control of a local fund manager, and SARS asserted that the instructions regarding the transactions in relation to the portfolio were issued by South African group companies. SARS asserted that the Trust was a resident of the Republic, having regard to the facts that numerous decisions appeared to have been taken in the Republic and that they had not been furnished with minutes or trustees resolutions that substantiated the Trusts assertions.

Key place of effective management

The trust's argument was simple, it relied on a recent United Kingdom decision that had laid down as a principle that the location of the place of effective management of a trust is the place where the real top level management of the trust occurs and not merely its day to day management. It relied in this instance on the matter of Commissioner for *Her Majesty's Revenue and Customs v Smallwood & Anor* [2010] EWCA Civ 778.

In that case, a trust which had been established in the United Kingdom and controlled by United Kingdom trustees had, for a short period, been managed by a single trustee in Mauritius for purposes of effecting a particular transaction, after which the trustee resigned and was replaced by the original United Kingdom trustees. The Court in that matter had found that the trust had never ceased to be effectively managed from the United Kingdom. Nevertheless, the key principle is that the place of effective management is the place where the trustees exercise control.



The Mauritian trust argued if it had never had any trustee other than a Mauritian trustee, it must be regarded as having its place of effective management there.

Thus, the Mauritian trust argued in the Western Cape High Court, if it had never had any trustee other than a Mauritian trustee, it must be regarded as having its place of effective management in Mauritius.

The Court was not persuaded by this argument. It found that the decision in the United Kingdom matter was based on the interpretation of a particular section of the United Kingdom law that determined the status of trustees as a single continuing body. In addition, there was insufficient factual information at its disposal to determine where the trust was resident and this was an issue that would need to be determined by the Tax Court in due course on the basis of evidence that should be led in this regard.

In passing, the Court pointed to the importance of the evidence in this determination. What must be established is the place where the key management and commercial decisions are taken. While the place of effective management will ordinarily be the place where the most senior body of persons (e.g. board of directors, trustees) makes its decisions, no definite rule can be given and the location of the place of effective management must be determined on the basis of the relevant facts and circumstances.

Formulaic approach unlikely here

It is clear from this decision that a formulaic approach to the location of the place of effective management is unlikely to be applied in South Africa. Merely holding board meetings in a particular location is not likely to prove conclusive. It will be necessary to establish that the decisions that are key to the operation were in substance taken at those directors' meetings. The production of relevant minutes of meetings and discussion records will be a vital part of this trail of evidence.

The complexities of the new transfer pricing provision of the Income Tax Act

An illuminating judgment from Australia

As from years of assessment commencing on or after 1 October 2011, the present section 31 of the Income Tax Act will be deleted in its entirety and replaced with a new, redrafted provision.

This radical step has been claimed by SARS to be necessary to overcome the structural problems and uncertainties associated with the present section 31.

In particular, the present section 31 is said to have a narrow focus on the legal aspects of the specific transaction, and this (it is said) allows taxpayers to mount legalistic arguments. SARS believes that the issues should turn on the total arrangement and on its economic substance and commercial objectives.

The new section 31 is aligned with OECD guidelines.

Where transfer pricing is concerned, the focus of the new section 31 will no longer be the supply of goods or services, but any cross-border "transaction, operation, scheme, agreement or understanding" between or for the benefit of connected persons (see section 31(2)(a)).

If "any term or condition" in that transaction differs from that which would have existed between independent persons dealing at arm's length and which results in a tax benefit to any party to the transaction, then section 31 requires that "the taxable income of each person who is a party that transaction ... that derives the tax benefit" must be recalculated to reflect the terms that would have been agreed between independent persons dealing at arm's length (see section 31(2)(b)).

Tax practitioners in South Africa are having to confront the complexities of the imminent new section 31 and the challenging task of advising their clients on its implications and plan how an assessment to additional tax in terms of section 31 could be challenged.

Coincidentally, a decision of the Australian Full Federal Court, handed down on 1 June 2011, will light the way.

In *FCT of T v SNF (Australia) Pty Ltd* 2011 ATC 20-265; [2011] FAFC 74 the facts, in brief, were that from1998 to 2004 the SNF Group of companies was a French-based multinational conglomerate manufacturing and distributing industrial chemicals known as polyacrylamides. The principal use of this substance was the cleansing of water in an industrial setting.

The global capacity for polyacrylamides in 2004 stood at the substantial volume of 910,000 tonne/year with the SNF Group being the main player in the global market.

The activities of and corporate entities comprising the SNF Group were divided between those which manufactured the chemicals (the suppliers) and those who were its distributors. Amongst the distributors was SNF (Australia) Pty Ltd, the taxpayer in this particular matter.

Pay now, argue later *(from page 2)*

The taxpayer sought an order in the High Court declaring that the provisions of the Income Tax Act prior to its amendment effectively on 1 February 2011 did not give SARS the right to review and withdraw a suspension of its right to demand payment until the appeal had been finally determined. Therefore, it argued, the suspension would only expire on 1 August 2011 or on the earlier determination of the appeal. The argument relied on the fact that the new provisions specifically included a power of revocation, whereas the old provisions did not.

The Court determined that the grant of a suspension under the old provisions was at the direction of the Commissioner. The obligation to pay was enforceable "unless the Commissioner otherwise directs". The Court pointed out:

"It is clear in my view that the power to direct necessarily includes the power to formulate the content of the relevant order or instruction. I can think of no reason why the content of the direction should not include a reservation of the right to revisit its terms; particularly having regard to the factors that would have to weigh with the Commissioner in determining it."

It was therefore found that the decision to withdraw the suspension was permitted under the previous legislation notwithstanding that no specific provision to this effect was contained in the law.

Taxpayers who have agreements for a suspension of payment of assessed income tax that were issued prior to 1 February 2011 should ensure that they submit applications for extension no later than 31 July 2011.

The internal architecture of the group was such that the distributors purchased the chemicals from the suppliers at prices which were determined by those working at the helm of the group within SNF France.

In short, the scenario was that of a multinational supply and distribution business involving the worldwide manufacture and distribution of a specialized product. There were disparate corporate entities in multiple tax jurisdictions, each with a distinct function, whose negotiations with outside parties were restrained by the overriding will of the parent company.

As the court observed (at para [2] of the judgment –

A multinational group of that kind has the capacity to move income from one country to another by controlling the prices at which intra-group sales occur. By increasing the sale prices at which members of the group sell to each other, the income of the selling subsidiaries may be augmented and the expenses of the buying subsidiaries correspondingly increased. Through that device an arbitrary amount of income may be transferred within the group. Also, income may just as readily be moved in the opposite direction by the concomitant practice of reducing the prices at which sales occur. The motives which might stir a desire to move income from one jurisdiction to another by such means are multifarious: the rates of taxation may be more favourable in one jurisdiction than in another; there may be accrued losses in one company which can be better utilised against income earned in another; away from the revenue domain, those controlling the group may wish to provide financial support to one subsidiary at the expense of another. This family of practices, which are known together as transfer pricing, have the capacity to erode the collection of revenue even where the avoidance of taxation is not the end sought. There are several forms of transfer pricing. This appeal is principally concerned with only one: the practice under which a local member of a multinational pays increased prices for goods acquired from overseas members of the same group.

From1998 to 2004 the SNF Group of companies was a French-based multinational conglomerate manufacturing and distributing industrial chemicals known as polyacrylamides. The principal use of this substance was the cleansing of water in an industrial setting.

In short, the facts of this case involved an archetypal situation where the taxpayer in question – under the influence of the controlling entity in the group – had the power, if it wished, to engage in transfer pricing, internationally, with its parent company and co-subsidiaries.

The Federal Court found that the practices of the Australian subsidiary were not in contravention of the relevant provision of the Australian law, and, in so doing, established judicial guidelines for the application of the law.

The new transfer pricing provision of the Income Tax Act

The core of the new section 31 of our Income Tax Act is that part which says that where a transaction between connected persons falls within its scope and any term or condition of that transaction, operation, scheme, agreement or understanding—
(i) is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length; and
(ii) results or will result in any tax benefit being derived by any person that is a party to that transaction, operation, scheme, agreement or understanding, the taxable income of each person that is a party to that transaction, operation, scheme, agreement or understanding that derives the tax benefit must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

The focus is thus on the concept of a price or other term agreed between the parties that (emphasis added) –

The Australian provision is triggered where parties to an international agreement were not dealing with one another at arm's length and the consideration for the acquisition of property was greater than the arm's length consideration. In these circumstances, the consideration given is deemed to be the arm's length consideration.

is different from any term or condition *that would have existed had those persons been independent persons dealing at arm's length*

That apparently straightforward italicized phrase conceals a plethora of difficulties as the decision of the Full Federal Court in the *SNF* case reveals.

The broadly similar Australian provision

The provisions of section 136AD of Australia's Income Tax Assessment Act of 1936 are broadly similar to section 31 of our Income Tax Act.

Thus, the Australian provision is triggered where parties to an international agreement were not dealing with one another at arm's length and the consideration for the acquisition of property was greater than the arm's length consideration. In these circumstances, the consideration given is deemed to be the arm's length consideration.

Consequently, the decision in the *SNF* case provides useful guidance as to the issues which will arise where SARS invokes the provisions of the new section 31 in order to trigger the recalculation of taxpayer's taxable income on the basis of hypothetical arm's length terms.

As the *SNF* decision reveals, the issues that the application of such a provision raises include the following:

The court held (at para 7) that the investigation into an "arm's length consideration" does not involve (and indeed completely excludes) any inquiry into the taxpayer's motive or purpose. As the judge in the court a quo said, "Just as in a valuation, the focus is not on the subjective or special factors of the parties involved in the transaction (eg. whether they were financially sound or not), but is on the transaction itself and the consideration paid. In this sense, the task is not dissimilar to that undertaken in a valuation".

In order to determine whether the consideration was what would be expected in a transaction between independent persons dealing at arm's length, it is necessary to identify comparable transactions between independent persons, and ascertain what price was paid in such transactions. This inquiry could include whether the taxpayer had been charged more by the suppliers than the latter were charging other independent third party purchasers for the same or similar products; (see para [4]).

Is a transaction "comparable" only if the party to that transaction shared each and every quality of the taxpayer that has a bearing on price, save that the parties to the comparable transaction were transacting at arm's length? (See para [9]).

Are transactions comparable only if they occurred in the same economic circumstances, in similar market conditions? (See para [32]).

It is entirely conceivable that, in a given market for a given product, the price charged to different purchasers may differ as a result of the latter's differing negotiating power or because the respective markets are structurally different, and not because of transfer pricing. (See para [34].)

It is conceivable that a taxpayer may agree to purchase at a price that will not allow him to make a profit, with the objective of widening the range of goods that he offers, or to provide better service to existing and potential customers. (See para [45].)

The fact that the taxpayer has made persistent losses as a result of the price paid to its overseas suppliers does not of itself establish that the price was not an arm's length price, nor does it establish the existence of transfer pricing between the parties. Those losses could conceivably be caused "by a congeries of factors – unreasonably low sales per salesperson resulting in higher levels of commercial costs expressed as a percentage of sales; competition in the Australian market; excessive stock levels and poor management" (see para [7]).

A central difficulty as revealed in the *SNF* decision is, firstly, to define what constitutes a "comparable transaction" between independent parties as a means of determining an arm's length price for the transaction and, secondly, applying that definition in the search for "comparable transactions".

Having identified one or more apparently "comparable transactions", they then have to be put under a magnifying glass to determine whether they are, in fact, truly comparable.

It is significant that the Court upheld the comparative uncontrolled price (CUP) basis used by the taxpayer to establish what constituted an arm's length consideration in preference to the Commissioner's Transactional net margin method (TNMM).

The deduction of contingent expenditure in going concern sales

As envisaged in the current draft Taxation Laws Amendment Bill

The taxpayer in* Ackermans Ltd v CSARS *2011) (1) SA 1 (SCA), 73 SATC 1 may be permitted a wry smile on reading section of the proposed new section 11F in the draft Taxation Laws Amendment Bill of 2011.

In that reported Supreme Court of Appeal decision, SARS contested the taxpayer's claim for a deduction of contingent expenditure that (so the taxpayer claimed) had become uncontingent, and therefore deductible when the taxpayer sold its business as a going concern on terms whereby the purchaser took over those contingent liabilities in return for a reduced purchase price.

The Supreme Court of Appeal ruled that, in these circumstances, the liabilities in question had not been "actually incurred" and were therefore not deductible by the seller in terms of section 11(a) of the Income Tax Act.

The reason for the taxpayer's wry smile is that the proposed new section 11F is tailor-made to permit a deduction in precisely the circumstances of the *Ackermans* decision. The proposed amendment will become effective on 1 April 2012.

Perhaps only a tax lawyer can understand SARS's stance in fighting, tooth and nail, the taxpayer's claim for a deduction, whilst simultaneously drafting amending legislation that would permit such a deduction.

The explanation for this apparently contradictory stance lies of course in the oft-cited maxim that *there is no equity about a tax*. The *Ackermans* case was decided on the law as it stood at the time. The fact that economic rationality and good business sense were on the side of the taxpayer was irrelevant because the Income Tax Act did not support his claim.

Perhaps only a tax lawyer can understand SARS's stance in fighting, tooth and nail, the taxpayer's claim for a deduction, whilst simultaneously drafting amending legislation that would permit such a deduction.

The proposed new section 11F reads as follows –

Where, in terms of any transaction, a person disposes of a business undertaking as a going concern to a purchaser and

(a) that person is, in terms of that transaction, partially or fully relieved of any contingent liability of that person as a result of the assumption of that contingent liability by that purchaser;

(b) the consideration payable by the purchaser in terms of that transaction has been determined by that person and that purchaser after taking into account the assumption of the contingent liability by that purchaser; and

(c) the contingent liability relates to that business undertaking,

the fair market value of that contingent liability must, on the date of that disposal and for the purposes of determining the taxable income derived by that person

from carrying on a trade, be deemed to be an amount of expenditure actually incurred in the production of the income of that person derived from trade.

This amendment will be coupled with an amendment to the definition of "gross income" that will provide that a taxpayer's gross income includes –

in the case of any resident, the total amount (in cash or by way of partial or full relief from any liability of such resident or otherwise received by or accrued to or in favour of such resident: Provided that, where the amount is received by or accrued to or in favour of such resident by way of relief from any liability of such resident and that liability is contingent, that total amount must be limited to the fair market value of that liability.

A similar amendment is to apply in respect of the gross income of non-residents.

Exactly how the *fair market value* of a contingent liability will be determined for purposes of the amendment to the definition of gross income is far from clear.

The removal of uncertainty

Aside from creating a deduction where none previously existed, the proposed new section 11F will remove the current uncertainty (or at least the uncertainty that prevailed prior to the *Ackermans* decision) as to whether, in the sale of a business as a going concern, it is the purchaser or the seller who can claim a deduction for contingent liabilities when and if they materialise.

The amendment will make clear that it is the seller who is entitled to the deduction.

A special statutory regime is to be introduced to prevent both purchaser and seller from claiming the same deduction.

The seller is to be required to add the assumed contingent liabilities to his gross revenue receipts or capital gains proceeds, depending on whether the relevant consideration is in respect of trading stock or capital assets. However, such revenue receipts or capital proceeds are to be based on the fair market value of those liabilities, and not on their face value.

The value of contingent liabilities assumed by the purchaser will be added to the consideration paid by him in terms of his purchase of the business by being added to cost price or base cost, depending on whether the consideration is allocated to trading stock or capital assets, but the purchaser will simultaneously be provided with an upfront allowance of the same amount. This allowance will be added back and rolled forward in the post-acquisition tax years. This allowance will reduce as payments in respect of contingent liabilities materialize or become remote.