Synopsis
Tax today

Nov/Dec 2012

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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The NWK Ltd decision – binding or not?

For the first time, a court of subordinate jurisdiction has been urged by SARS to apply the dictum of Lewis JA (who delivered the judgment in which her fellow Justices of Appeal all concurred) in CSARS v NWK Ltd 73 SATC 55 (SCA), modifying the test to be applied in determining whether a transaction was a simulation (paragraph [55] at page 71):

"The test should ... go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated."

In the matter of *Bosch and another v CSARS* Case No. A91/2012 in the High Court, Western Province (judgment delivered 20 November 2012), counsel for SARS argued that a share incentive scheme which had been designed to minimise the tax exposure of employees of subsidiaries of a listed company should be regarded as simulated, relying on the statement of Lewis JA.

There has been considerable debate among academics and practitioners on the implications of the principle laid down by Lewis JA. *Prima facie* it represents a departure from precedent stretching over more than a century laid down by some of the finest legal minds in our history. It is a judgment of the full bench of the Supreme Court of Appeal and should be regarded as binding on subordinate courts. It is therefore a matter of great interest that it has now been invoked by SARS in open court for (apparently) the first time.

Davis and Waglay JJ delivered separate judgments on this aspect, and each came to the decision that the principle stated above should not find application. The reasons for their respective decisions were profoundly different.

The approach taken by Davis J was similar to that taken by many commentators. He considered that the statements by Lewis JA were no more than a summation of the law and were not to be regarded as laying down new principle. Thus he concluded (at paragraph[79]):

"In my view, in NWK the Court was confronted with a starkly clear set of simulated transactions. The facts of the case illustrated, without doubt, that the parties had not created genuine rights and obligations but had constructed a loan for R 95 m as opposed to R 50 (sic), purely to enable the taxpayer to obtain a greater tax benefit. Beyond this finding, there is nothing in the careful judgment of Lewis JA which supports the argument that the reasoning employed in NWK was intended to alter the settled principles developed over more than a century regarding the determination of a simulated transaction for purposes of tax."

There can be no gainsaying the correctness of the finding of simulation in the NWK Case. However, the manner in which it was reasoned appears to be flawed. The structure of judgments is that the principles

of the law are first enunciated and then applied to the facts. The enunciation of the law is the kernel of the decision. On this basis, the approach adopted by Davis J in analysing the judgment is questionable, because it avoided the issue of whether the statement of the law by Lewis JA was a rejection of the principles laid down in earlier decisions.

Davis J examined the outcome and determined that, on the facts, applying the earlier principles, the decision was correct. By examining the end and concluding that it was consistent with the earlier principles, he justified the means.

He then continued to consider the principles of earlier decisions cited in NWK, and commentary on the decision by an eminent counsel, Advocate EB Broomberg, before concluding (at paragraph [86]):

"Broomberg thus views NWK as a new and unjustified rule which replaces the previous jurisprudence. In my view, without an express declaration to that effect, NWK should be interpreted to fit within a century of established principle, rather than constituting a dramatic rupture."

Waglay J was more direct. He took issue with the conclusions of Davis J, stating:

"Such interpretation would be somewhat strained. NWK was a dramatic reversal of what has been a consistent view of what constitutes a simulated transaction. NWK, considered in its entirety, not by extraction of words and phrases out of their real context, does in fact lay down the rule that any transaction which has as its aim tax avoidance will be regarded as a simulated transaction irrespective of the fact that the transaction is for all purposes a genuine transaction."

In our view, the approach of Waglay J is on point, as the following example would clearly indicate.

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In the matter of *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530, the Appellate Division had in fact found that a transaction will not be a simulation purely because its purpose is the evasion of a peremptory law (a law forbidding Asiatics to own property in a municipal area), and stated so in as many words (per Innes CJ at page 548):

"But an Act thus construed may nevertheless be evaded; parties may genuinely arrange their transactions so as to remain outside its provisions. Such procedure is, in the nature of things, perfectly legitimate."

Solomon JA (in whose judgment Maasdorp and Juta JJA concurred) stated (at page 562) that the outcome " is far from satisfactory, and one at which I regret that I feel compelled to arrive." Thus, he and three other Judges of Appeal found themselves bound by the legal principles and the transactions were held not to be a simulation even though their sole purpose was to evade the prohibition in the law.

The approach of Waglay J is therefore considered more appropriate. He found that a statement of the law had been made in NWK that rejected principles laid down in earlier decisions. He therefore looked for legal justification from the Supreme Court of Appeal to satisfy him that it considered the principles distilled from the previous decisions to be incorrect. He reasoned:

"Before one is bound to a precedent setting judgment and is obliged to follow it, the judgment must be clear and unequivocal, it must be plain, unmistakable and explicit in its rejection of previous judgments which it seeks to reverse and it must be applicable to the facts in the matter before the court confronted with its possible application. While I do not believe that the reversal must be express, the reasoning should demonstrate a departure from previous binding judgments. NWK does not in my view do so. It does not provide any reasons why the judgments aptly dealt with by Davis J ... are no longer good law."

These findings provide a sense of balance in the wake of the NWK decision. Practitioners feared that the mere purpose of mitigating exposure to tax could render taxpayers open to attack by SARS, who could seek to declare the transactions to be simulations, applying the statement of Lewis JA. The Western Cape High Court has taken a brave stance by calling a principle established in a judgment of a superior court into question, and it will be interesting to see if SARS is prepared to press the issue by appealing to the SCA.

Does a decision by SARS to investigate a taxpayer constitute administrative action under PAJA?

The Promotion of Administrative Justice Act 3 of 2000 (PAJA) and its muscular interpretation by the courts has added a significant new dimension to taxpayers' rights and provides a substantial counterweight to SARS's draconian statutory powers.

However, it has taken more than a decade for the full impact of this legislation in the fiscal dimension to become apparent.

As the Supreme Court of Appeal observed in *Investigating Directorate: Serious Economic Offences v Hyundai Motor Distributors (Pty) Ltd: In re Hyundai Motor Distributors (Pty) Ltd v Smit NO & others* [2000] ZACC 12; 2001 (1) SA 545 (CC) at para 21 –

'All statutes must be interpreted through the prism of the Bill or Rights'

and this injunction of course holds as true for fiscal legislation as for all other legislation.

PAJA is, in its own right, constitutional legislation for it is the legislation, foreshadowed in the Constitution, that was to give detailed expression to the right to fair administrative action that is merely adumbrated in the text of the Constitution itself.

The thrust of PAJA is to create a right to take on judicial review any administrative action, which is defined in section 1 of that Act as –

'any decision taken, or any failure to take a decision, by —

(a) an organ of state, when —

(i) exercising a power in terms of the Constitution or a provincial constitution; or

(ii) exercising a public power or performing a public function in terms of any legislation;

which adversely affects the rights of any person and which has a direct, external legal effect.

Is a decision by SARS to audit a taxpayer "administrative action", and thus subject to judicial review under PAJA?

An important issue, on which there has hitherto been no direct authority, is whether a decision by SARS to audit a taxpayer, or to embark on other investigatory activity, in and of itself constitutes administrative action as envisaged in PAJA.

If the answer to that question is affirmative, SARS would be obliged in terms of section 3(2)(b) of PAJA to give the taxpayer notice of the nature and purpose of the proposed audit and the opportunity to make representations as to why no audit should be carried out.

Moreover, if the answer to that question is affirmative, SARS's decision to conduct an audit could be challenged as irrational on the basis that there was no reason or insufficient reason to do so and that the decision was therefore capricious and arbitrary – or was taken for an improper purpose, such as harassment. The taxpayer could then apply to court to set aside the decision to embark on the audit, thereby suffocating the investigation at birth and pre-empting any adverse findings.

The Supreme Court of Appeal has now spoken on the underlying principle

A Supreme Court of Appeal judgment has now laid down a principle which supplies an authoritative answer as to whether a decision by SARS to embark on an audit or other investigation of a taxpayer would constitute administrative action, thereby triggering the application of PAJA.

The judgment in question is that in *Corpclo 2290 CC t/a U-Care v Registrar of Banks* [2012] ZASCA 156, handed down on 2 November 2012.

The background to the High Court application for an interdict in this case was that the Registrar of Banks had instigated an investigation by PricewaterhouseCoopers into whether Corpclo CC, which traded under the name U-Care (and was an entity that solicited contributions from the public which, after deduction of commissions and expenses, were to be distributed to charities) was conducting the business of a bank in contravention of section 11(1) of the Banks Act 94 of 1990.

When the Registrar of Banks applied to the High Court for an order in terms of section 81 of the Banks Act for an interdict prohibiting U-Care from continuing a business practice in contravention of the Banks Act, U-Care argued, inter alia (emphasis added) that –

"The Registrar <u>should not have been entitled to investigate</u> and arrive at adverse decisions impacting on the rights of Corpclo [trading as U-Care] <u>without showing due respect for Corpclo's administrative rights to procedural fairness.</u>"

In addition to finding fault with the procedural aspects of U-Care's challenge to the application for an interdict, the Supreme Court of Appeal held as follows (footnotes omitted and emphasis added) –

"[25] Regarding the appellants' right to just administrative action in terms of s 33 of the Constitution, the appellants' heads of argument attack the Registrar's decision … to appoint inspectors to investigate the appellants and to institute proceedings against them on the grounds that these were administrative decisions taken by an organ of State in the course of implementing legislation and that the Registrar failed to act in a manner that was lawful, reasonable and procedurally fair. This would require, so it is contended, that the appellants be given adequate notice of the nature and *purpose of the administrative action, a reasonable opportunity to make representations, a clear statement of the administrative action and adequate notice of the right to request reasons and of any right of review. It is also contended that administrative action must not be taken arbitrarily, capriciously, in bad faith or for an ulterior purpose. In support of these contentions the appellants refer to ss 1, 3 and 6 of PAJA. …*

[26] … [T]he appellants' reasoning is seriously flawed. … [T]he Registrar's decisions to investigate the appellants' business and institute proceedings against the appellants for an interdict in terms of s 81 of the Act were not administrative actions for the purposes of PAJA as they did not (as required by the definition of 'administrative action' in s 1 of PAJA) a*dversely affect the rights of the appellants or have a direct, external legal effect or have that capacity. … A decision to investigate and the process of investigation, which exclude a determination of culpability, could not adversely affect the rights of the appellants in a manner that has a direct and external legal effect. So too a decision to institute proceedings in the high court for an interdict does not affect the rights of the appellants or have that capacity. It is the high court which decides that the Act is being contravened and decides to grant the interdict."*

It follows that a decision by SARS to audit a taxpayer cannot, in and of itself, be the subject of judicial review on the grounds that the decision was irrational in that there were no reasonable grounds for embarking on such an audit.

The court held accordingly that there was no merit in U-Care's appeal against the granting of the interdict and dismissed its appeal.

The ratio of this judgment can be extrapolated to apply to a decision by SARS to embark on an audit of (or any other investigation into) a taxpayer's affairs in terms of its powers under fiscal legislation.

The essence of the Corpclo judgment

The Corpclo judgment holds in effect that a decision by an organ of state to conduct an investigation does not, in and of itself, *adversely affect the rights of the person concerned or have a direct, external legal effect* and it therefore does not constitute administrative action that can be the subject of judicial review in terms of PAJA.

It follows that a decision by SARS to embark on an audit of the taxpayer would not, in and of itself, constitute a *decision*, as defined in PAJA, and therefore would not trigger the procedural and substantive provisions of that Act.

From this it follows that SARS is not obliged to give the taxpayer advance notice of its intention to conduct an audit; the taxpayer is not entitled to demand reasons for the proposed audit; and a decision by SARS to audit a taxpayer cannot, in and of itself, be the subject of judicial review on the grounds that the decision was irrational in that there were no reasonable grounds for embarking on such an audit.

Of course, once it is under way or complete, the *process* of the audit (as distinct from its outcome) can be the subject of constitutional challenge, either under the Constitution itself or under PAJA. Such a challenge could take the form of an application for judicial review, for example, on the grounds that the manner in which the audit was conducted constituted 'conduct' that violated the taxpayer's constitutional right to the privacy of confidential or privileged information. The results of the audit, when incorporated into an assessment, can of course be challenged on the merits by way of objection and appeal.

SARS rejects pleas to extend legal professional privilege to tax practitioners

SARS has recently rejected pleas for the draft Tax Administration Laws Amendment Bill to extend to tax practitioners the same professional privilege as is enjoyed by lawyers in their communication with clients.

SARS has taken the view that tax practitioners in South Africa are, in the main, regulated not by law but by self-constituted professional bodies and that regulation by law would be a prerequisite for extending a limited privilege to tax practitioners. A SARS spokesman is reported as saying that this issue will be revisited in about eighteen months when the model of regulation is evaluated.

This was a rather unexpected response by SARS in that the conventional reason given for limiting privilege to legal advice given by a qualified lawyer has nothing to do with the nature of the regulatory body to which that person is professionally accountable, but rather with the necessity, as a matter of public policy, for a client to feel free to make full and frank disclosure - including information that is adverse to him – when seeking legal advice, without fear that the tax authorities will later demand access to the written communications to and from that adviser.

The present position

As matters stand, a taxpayer cannot refuse to disclose to SARS tax advice given by an accountant or tax practitioner (as distinct from an advocate or attorney) or the documentation that records or accompanies such advice. (See for example *Chantrey v Martin* [1953] 2 All ER 691.) Nor can the taxpayer refuse to furnish SARS with bilateral communications with his accountant or tax practitioner.

This is, of course, a matter of great concern to the accounting profession and the enbryonic profession of tax practitioners, for it inhibits their relationship with clients and the giving of advice, in that such advice may record factual disclosures made by the client which would be to his disadvantage if they came to the knowledge of SARS – as would occur in the context of a tax dispute if SARS were to demand that the taxpayer make available all non-privileged documents, or in the context of litigation where a litigant is obliged to disclose and make available for inspection all non-privileged documents.

The lack of privilege enjoyed by accountants and tax practitioners applies even where the advice given is legal advice. Thus, advice given by an attorney or advocate to a client will enjoy privilege whilst the self-same advice, if it were given by an accountant or tax practitioner, will not.

The common law basis of legal professional privilege

Legal professional privilege is a common law concept that applies to advice given by an attorney or advocate (so-called "advice privilege") or advice given by an attorney or advocate to a client (or, indeed, to a third party) in anticipation of litigation involving that client ("litigation privilege"). Such privilege has been recognised and applied by the South African courts in a tax context; see for example *Heiman, Maasdorp and Barker v Secretary for Inland Revenue* (1968) (30 SATC 145 and *Jeeva v Receiver of Revenue, Port Elizabeth* 1995 (2) SA 433 (SE)).

Advice given by an attorney or advocate to a client will enjoy privilege whilst the self-same advice, if it were given by an accountant or tax practitioner, will not.

In *S v Safatsa* (1988) (1) SA 868 (A) the Appellate Division described legal professional privilege as a fundamental right that is necessary for the proper functioning of the legal system in South Africa.

The underlying rationale

The rationale for legal professional privilege was explained as follows by Lord Hoffman in R (on the application of *Morgan Grenfell and Co Ltd v Special Commissioner of*

Income Tax [2002] UKHL 21, who said that such privilege –

"is a fundamental human right long established in the common law. It is a necessary corollary of the right of any person to obtain skilled advice about the law. Such advice cannot be effectively obtained unless the client is able to put all the facts before the adviser without fear that they may afterwards be disclosed and used to his prejudice."

On 29 October 2012 in *Stewart v Australian Crime Commission* [2012] FCAFC 151 (which concerned the long-standing dispute between the actor, Paul Hogan, of *Crocodile Dundee* fame, and the Australian Tax Office) the Full Federal Court of Australia referred with approval to the decision of the High Court of Australia in *Grant v Downs* [1976] HCA 63; (1976) 135 CLR 674 where Stephen, Mason and Murphy JJ said at 685 –

"The rationale of this head of privilege, according to traditional doctrine, is that it promotes the public interest because it assists and enhances the administration of justice by facilitating the representation of clients by legal advisers, the law being a complex and complicated discipline. This it does by keeping secret their communications, thereby inducing the client to retain the solicitor and seek his advice, and encouraging the client to make a full and frank disclosure of the relevant circumstances to the solicitor. The existence of the privilege reflects, to the extent to which it is accorded, the paramountcy of this public interest over a more general public interest, that which requires that in the interests of a fair trial litigation should be conducted on the footing that all relevant documentary evidence is available. As a head of privilege legal professional privilege is so firmly entrenched in the law that it is not to be exorcised by judicial decision."

Legal professional privilege is widely recognised in other countries

Legal professional privilege has been recognised in the European Union. In *Campbell v UK (*1992) 15 EHRR 137 and *Foxley v UK* (2001) 31 EHRR 25 it was held that interference with the privacy of a person's communication with his lawyer would violate article 8 of the European Convention on Human Rights.

Privilege is a matter of substantive law, not of evidence or procedure

The modern view is that legal professional privilege is a matter of substantive law, and not of evidence or procedure.

Thus, in *Daniels Corporation International Pty Ltd v Australian Competition and Consumer Commission* (2002) HCA 49, (2002) 213 CLR 543, the High Court of Australia, per Gleeson CJ, Gaudron, Gummow and Hayne JJ, said that the privilege is a rule of substantive law and is not merely a rule of evidence that is restricted to the processes of discovery and inspection and the giving of evidence in judicial proceedings.

The complexities involved in extended legal professional privilege

In *R (on the application of Prudential plc) v Special Commissioner of Income Tax* [2010] EWCA Civ 1094 the English Court of Appeal refused to extend legal professional privilege to accountants for the following reasons:

(a) Legal professional privilege is linked to the status of the adviser and applies only to communications between a qualified lawyer and client.

(b) The decision of the Court of Appeal in *Wilden Pump Engineering Co v Fusfeld* [1985] FSR 159) that, at common law, legal professional privilege applies only to advice given by lawyers, is a binding precedent.

(c) If legal professional privilege is to be extended to the accounting profession, the complex question of how to define that profession and whether the privilege should then be further extended, for example, to pension consultants, would best be decided by parliament and embodied in legislation, rather than by an adaptation of common law principles by the courts.

It is unlikely that South Africa will depart from established international norms

It should be noted that the United States of America and New Zealand have afforded professional privilege to information passing between a client and his tax advisor by statutory enactment. The United Kingdom also provides a limited statutory privilege in relation to communications between a tax advisor and the client. Although the law in these respective jurisdictions does not operate to allow the same extent to the statutory privilege as applies under the common law, it provides a level of assurance to persons who consult tax advisors.

In the present circumstances, it seems unlikely that any extension of legal professional privilege in South Africa will be effected by the judiciary and any change to the common law principles in this regard is likely to be effected by legislation, perhaps after a full commission of inquiry.

SARS Watch
20 October - 20 November 2012

Legislation		
25 Oct	Taxation Laws Amendment Bill 34 of 2012	The official text of the Bill has been published.
25 Oct	Tax Administration Laws Amendment Bill 35 of 2012	The official text of the Bill has been published.
Interpretation		
2 Nov	Interpretation Note 67 - Connected Persons	This Note provides guidance on the interpretation and application of the definition of a "connected person" in section 1(1).
5 Nov	Interpretation Note 37 (issue 3) - Wear and tear allowances s11(e)	This Note provides guidance on the circumstances under which the wear-and-tear or depreciation allowance provided for in section 11(e) may be claimed as a deduction.
6 Nov	Interpretation Note 64 (issue 2) - Tax exemption shareblocks and sectional title	This Note provides guidance on the application and interpretation of section 10(1)(e).
6 Nov	Interpretation Note 46 (issue 4) - Amalgamation of Sporting Bodies	This Note provides information and guidance on the amalgamation of amateur and professional sporting bodies carried out under section 125.
16 Nov	Interpretation Note 68 - Tax Administration Act provisions that have not commenced	On 1 October 2012 the Act came into operation except for certain provisions relating to interest. This Note provides guidance on the identification of those interest provisions which have not come into operation.
Binding Rules		
22 Oct	Binding Private Ruling 124 – Repayment of shareholders' loans from proceeds of a new issue of redeemable preference shares	This BPR deals with the income tax and capital gains tax consequences arising from the repayment of shareholders' loans from the proceeds of a new issue of redeemable preference shares (a new issue of shares) under technically insolvent circumstances.
26 Oct	Binding Private Ruling 125 – Vesting by discretionary trust of dividend rights to the beneficiary of the trust	This ruling deals with- • the capital gains tax (CGT) treatment arising from the vesting by a discretionary trust of dividend rights in its beneficiaries; • whether the capital gain arising from the vesting of the dividend rights by the trust in the beneficiary will be disregarded in the hands of the beneficiary; and • whether the beneficiary will be the "beneficial owner" of the dividend amounts when the dividends are paid, and whether the company paying the dividend is required to withhold dividends tax from the payment of the dividend.
2 Nov	Binding Class Ruling 35 - Tax implications arising from the conversion of par value shares to no par value shares	This ruling deals with the tax implications arising from the conversion of par value shares to no par value shares.
2 Nov	Binding General Ruling 7 (issue 2) - Wear and tear allowances for depreciation	This BGR reproduces the parts of Interpretation Note No. 47 (Issue 3) "Wear-and-Tear or Depreciation Allowance".
8 Nov	Binding Private Ruling 126 - Disposal of a business and investment shares, as a result of restructuring, and the distribution of certain shares to shareholders	This ruling deals with the question as to whether restructuring, which leads to the disposal of a business (as a going concern) and investment shares by a company to another company at book value, in exchange for shares in that other company will comply with section 42 of the Act and whether the distribution of that other company's shares to its holding company will be an unbundling transaction under section 46(1) of the Act
Case Law		
31 Oct	SARS v Beginsel and Others	This decision deals with the introduction of business rescue proceedings as opposed to the re-introduction of the liquidation process.
16 Nov	Venfin v CSARS	This ruling deals with the issue of whether Section 103 of the Income Tax Act applies to the purchase by Venfin Ltd of its own shares from its subsidiary Venfin Securities.
PwC publications		
29 Oct	Tax Alert - Tax Administration Act confusion	Most provisions of the Tax Administration Act 2011(the Act) came into operation on 1st October 2012; however, unclear transitional provisions and a single effective date have resulted in confusion as to the status of many administrative processes, particularly in relation to penalties.
29 Oct	VAT Alert - SAICA subscriptions	The VAT ruling issued by SARS during 2010 to the South African Institute of Chartered Accountants (SAICA), allowing VAT vendors to deduct input tax on SAICA annual membership fees paid on behalf of employees, has been withdrawn.