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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Transferring a business to a controlled trust does not mean that everything 'remains as before'

The decision of the Supreme Court of Appeal in* Raath v Nel *2012 (5) SA 273 (SCA) illustrates a hard truth that transactions that are entered into have consequences that need to be understood before committing to agreements.

So, for example, it is hazardous to counsel a person to form a trust and to shift assets into the trust without considering the consequences of doing so. And, as the decision in *Raath v Nel* shows, a step of this kind can be particularly hazardous where the assets that an entrepreneur transfers into the trust are shares in the company which he uses as the business structure to carry on his trade. For the consequence of doing so is that beneficial ownership of the business then passes out of the hands of the individual founder of the business and into the hands of the trust by virtue of its shareholding.

The transfer of personal assets into a trust is not a mere illusion

It may be tempting to think that forming a company or trust to carry on a business is just sleight-of-hand, that the documents with signatures and official stamps are just legal fairy-floss, and that, in reality, everything will carry on as before. Farlam J warned of this misconception in *Nieuwoudt NO v Vrystaat Mielies (Edms) Bpk* 2004 (3) SA 486 (SCA) when (giving the judgment of the court) he referred to the trust there in issue as being –

'typical of a newer type of trust where someone, probably for estate planning purposes or to escape the constraints imposed by corporate law, forms a trust while everything else remains as before'.

The truth of the matter is that, if the parties truly intend that 'everything shall remain as before', then the trust is a sham (for there will have been no genuine intent on the part of the founder to divest himself of the assets) and will be treated by the law as such. On the other hand, if the trust is genuine, then it is not the case that 'everything shall remain as before' – if the founder has transferred assets to the trust, then they are no longer his assets, and any gains or losses in respect of the assets accrue to the trust.

High Court regarded transfer of assets into a trust as "artificial"

When *Raath v Nel* was being heard in the High Court, the judge himself fell into the trap of regarding the formation of the trust and the transfer of assets as being "artificial" and therefore to be disregarded. His judgment was overturned by the Supreme Court of Appeal which remarked that –

'The trial judge regarded as artificial the approach that the loss to the trust is not in reality that of the respondent. He found that the business and the trust were in reality built up by the respondent for his old age and for posterity and that he had lawful control over the trust. The fact that no dividends had been declared and paid out .. had no relevance when the bigger picture was considered.'

The decision in Raath v Nel

The facts in *Raath v Nel* 2012 (5) SA 273 (SCA) were that Nel was a successful businessman and the driving force behind his numerous successful business ventures. On professional advice and with a view to reducing estate duty on his death he sold all his assets, including his shares and loan account in a company of which he was the sole shareholder, to a discretionary family trust in which

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It is hazardous ***to counsel a person to form a trust and to shift assets into the trust without considering the consequences of doing so!***

he was one of three trustees. He was not a capital beneficiary of the trust but was a potential income beneficiary.

Nel was, however, in effective control of the trust in that he had the right to remove a trustee and appoint another in the latter's place.

As a result of a failed surgical procedure which saw him hospitalised for a lengthy period, he neglected the business and its profits declined. Nel sued the anaesthetist in the surgical team for the loss he had allegedly suffered in his personal capacity from those declining profits.

At issue in the litigation was whether Nel had suffered a loss in his personal capacity or whether the loss had been suffered by the trust which held the shares in the company which now owned the business.

In reversing the decision of the High Court, the Supreme Court of Appeal said (at para [14] of the judgment) that although a trust is not a legal *persona* in its own right, "the separateness of the trust estate must be recognised".

Given that the business was now owned by the company whose shares were held by the trust, and given that Nel's reduced managerial input into the business had impacted negatively on the company's profits, the question was whether Nel had personally suffered any loss.

The court held (at para [17]) that Nel had adduced no evidence of any loss suffered by him in his personal capacity; that the court below had erred in upholding his claim for damages in the absence of proof that he had personally suffered any loss as from the date that the trust had been established, and held (at para [18]) that Nel was entitled to damages for loss of earnings in his personal capacity only for the period prior to the formation of the trust .

Although the decision in *Raath v Nel* was not concerned with the tax implications of what had occurred, the judgment holds an implicit tax planning lesson, for it is clear that any losses suffered by the trust could not, for tax purposes, have been claimed by Nel in his personal capacity.

Exit charge – does the law really need amendment?

There has been considerable debate in tax publications concerning a recent decision in the Supreme Court of Appeal. Although we reported on the decision in our May 2012 edition, the continued interest in the decision and the fall-out that it generated have prompted a re-examination.

The Minister's statement

On 9 May 2012, the Minister of Finance issued a public statement in response to a judgment of the Supreme Court of Appeal in the matter of Commissioner for the South African Revenue Service v Tradehold Ltd [2012] ZASCA 61 (8 May 2012).

The crux of the statement was that persons who are resident in the Republic should be liable to pay tax on the gains that accumulate in respect of assets held by them, and that taxpayers who cease to be resident in the Republic are deemed to have disposed of their assets, except those with a close connection with the Republic, on the day prior to ceasing to be a resident (the so-called "exit charge"). However, the Supreme Court of Appeal had found that the deemed disposal was subject to the provisions of the double tax agreement between South Africa and Luxembourg (DTA), and this disturbed the balance that the law intended.

The statement continued:

"National Treasury and SARS are studying the judgment and, if necessary, I will propose amendments to further clarify that a DTA does not apply to deemed or actual disposals while a taxpayer is resident in South Africa. Measures such as the immediate termination of a taxpayer's year of assessment on the day before becoming non-resident, as is the practice in Canada, are being explored.

In order to maintain stability in the tax system, I will propose that any amendment take effect from 8 May 2012."

The question is, did the SCA really upset the stability of the tax system, or was there already a problem with the balance that SARS could not overcome?

How it all began

The saga started on 2 July 2002. Tradehold Ltd, a SA incorporated company, moved its place of effective management from the Republic to Luxembourg. It retained an office in the Republic and one of the directors continued to operate on its behalf from this office. The effect was that Tradehold Limited (under the law as then promulgated) was a resident of the Republic under the domestic rules, by reason of its incorporation, and a resident of Luxembourg under Luxembourg law and by reason of the DTA, by reason of its place of effective management.

The Income Tax Act at that time provided a primary trigger for the exit charge in this circumstance. The exit charge became payable in the case of:

- a person ceasing to be a resident
- a controlled foreign company ceasing to be a controlled foreign company, or
- a person who is a resident ceasing to be regarded as a resident by reason of the application of a valid double taxation agreement.

The resident was deemed to have disposed of its assets (subject to limited exceptions) on the day prior to the date on which the event occurred.

Tradehold Limited, having become a resident of Luxembourg by reason of the DTA, was deemed to have disposed of all of its assets on 1 July 2002, while it was still a resident, with the exception of immovable property in the Republic and assets attributable to a permanent establishment in the Republic.

SARS did not levy the exit charge as of 1 July 2002 (the date of the deemed disposal). Its only reason for not imposing the tax must have been that it conceded that the office in the Republic constituted a permanent establishment and that the assets of Tradehold Ltd were indeed attributable to that permanent establishment.

Closing the office

On 29 January 2003, the resident director left South Africa and Tradehold Ltd ceased to have an office in the Republic. The Income Tax Act at the time contained a provision that operated as a secondary trigger to catch the assets that were excluded from the primary trigger. This imposed an exit charge in respect of:

"…an asset of a person who is not a resident, which asset … ceases to be an asset of that person's permanent establishment in the Republic otherwise than by way of a disposal contemplated in paragraph 11…"

Tradehold Ltd's assets ceased to be an asset of a permanent establishment in the Republic when the director left the Republic. However, Tradehold Ltd still qualified as a resident under the law as then promulgated, by reason of its SA incorporation. Since it was not "a person who is not a resident" at that time, no exit charge could be imposed.

Herein lay SARS' problem. The secondary trigger event for the exit charge, where the assets ceased to have a close connection to the

Republic, applied only in the case of a person who is not a resident. Unlike the primary trigger event, which extended to include the situation of a resident being treated as a person who is not a resident in terms of a DTA, this secondary trigger contained no such extension.

If it's not broken, don't fix it

Had the extension been in place, the DTA between SA and Luxembourg would have given SARS the right to tax the deemed disposal. However, since no tax was imposed under the domestic law, no right to tax could be imported via the DTA.

Tradehold Ltd therefore escaped taxation at this point owing to a lacuna – an omission in the law.

Dual residence ceased

Tradehold Ltd continued to hold dual residence until amending legislation was promulgated on 21 February 2003.

In terms of the amendment, it was no longer possible for any person to enjoy dual residence if such person was regarded as exclusively resident in a country with which SA has a DTA. If the person is exclusively a resident of another state in terms of the DTA, that person is not tax-resident in the Republic in terms of the Income Tax Act.

Tradehold Ltd was exclusively a resident of Luxembourg under the DTA and therefore lost its SA tax-residence the moment the amendment came into effect. SARS therefore sought to levy an exit charge on the basis that Tradehold Ltd was deemed to have disposed of its assets on the day prior to ceasing to be a resident.

Tradehold Ltd claimed immunity from taxation in respect of the capital gain arising on the deemed disposal. It claimed that, with effect from 2 July 2002, it was a resident of Luxembourg. At 21 February 2003, it had no permanent establishment in the Republic. Therefore, in terms of the DTA, any capital gain on the alienation of movable assets was taxable only in Luxembourg.

SARS contended that the deemed disposal was not an alienation

as contemplated in the DTA and that the DTA did not preclude it from taxing the capital gain arising from a notional disposal.

The SCA decision

The SCA found that the DTA did indeed extend to events that were deemed to be disposals under the domestic law, and that SARS did not have a right to tax the capital gain.

It is evident that the perceived balance referred to by the Minister was lacking at the time the relevant events took place. There was inconsistent identification of the persons liable to the exit charge if the primary trigger and the secondary trigger are compared.

It may therefore be concluded that the decision of the SCA did not disturb the stability of the tax system: rather, it exposed the imbalance that existed at that time.

The stability was in place at 8 May 2012

If the media release is examined in the light of the law as promulgated at 8 May 2012, it is plain that the stability to which the Minister referred was in place at 8 May 2012.

A company can no longer have dual residence where the competing jurisdiction is a country with which SA has a DTA.

Further, where a company ceases to be a resident, it is deemed to have disposed of its assets on the day prior to ceasing to be a resident (i.e. at a time when it is a resident of the Republic only and subject to tax in the Republic). It cannot, in those circumstances, claim immunity under the DTA, as it is not entitled to immunity on the date of the deemed disposal.

Is the law really broken and in need of a fix?

A rational examination of the reasons for SARS' lack of success in the SCA and of the law as currently promulgated clearly establishes that there was a lacuna at the time the events leading to the Tradehold Ltd dispute occurred, but that the subsequent amendments that took effect on 21 February 2003 had effectively addressed the position by removing the possibility of dual residence status where there is a DTA.

The present exit charge legislation is to be repealed and replaced with new legislation with retroactive effect to 8 May 2012. A new section 9H is to be introduced into the Income Tax Act. One of its proposals is that, in addition to the person being deemed to have disposed of its assets on the day prior to ceasing to be a resident, the person's year of assessment is also deemed to have terminated on that day. It is difficult to see how this additional fiction relating to the year of assessment affects or improves the existing stability.

The proposed new provisions, which are significantly more voluminous than the existing provisions, cannot paper over the fact that the existing law is quite adequate and does not require amendment.

Armgold–Harmony decision provides clarity

In* Armgold/Harmony Freegold Joint Venture v CSARS *[2012] ZASCA 152, a decision handed down on 1 October 2012, the Supreme Court of Appeal has brought welcome clarity regarding the taxation of a mining company that owns and operates more than one mine, not all of which are operating profitably, where the company also derives income from non-mining activities.

This matter came before the court as an appeal from the decision of the Tax Court in ITC 1854 (2012) 74 SATC 42 and involved the interpretation of sections section 36(7C), (7E), (7F) and (7G) of the Income Tax Act 58 of 1962.

The central issue confronting the court in this case was to determine the correct method by which deductions for capital expenditure (for brevity, 'capex') and assessed losses are to be applied in calculating the taxable income of a mining company.

The facts of the case

In this particular case, the taxpayer company (a joint venture company established by the Armgold and Harmony mining groups) derived income from its three gold mines, known as Freegold, Joel and St Helena, respectively. Of the three mines, St Helena operated at a loss while Freegold and Joel produced a taxable income.

However, the capital expenditure incurred in respect of Freegold and Joel, if deducted from their taxable income, would reduce that taxable income to nil. Neither Freegold nor Joel had a balance of assessed loss brought forward from previous years. The taxpayer also derived a taxable income from non-mining activities in an amount that exceeded the operating loss of St Helena in each year.

The contrasting arguments

The taxpayer argued that its overall taxable income for the year should be assessed at R105 million, being its taxable income (R156 million) from non-mining activities less the R51 million loss made by the St Helena mine.

SARS did not agree with this methodology, and argued that the St Helena loss for the year in question (namely its gross income minus operating expenses in terms of section 11(a)) should be deducted from the taxable income before capital expenditure of the two other mines, after apportioning the loss between them. This would have the effect of reducing the taxable income before capital expenditure of each profitable mine while at the same time reducing their capital expenditure deductions.

The taxpayer argued that, in the assessment of its taxable income, each of its mines should be treated as a separate trade, and that the loss incurred by its St Helena mines should constitute an assessed loss as envisaged in section 20(1)(b); moreover, that in calculating the taxpayer's overall taxable income, the assessed loss of the St Helena mine should be deducted only after the taxable income of the other mines (being separate trades) had been determined.

The taxpayer argued further that it was impermissible to allow the St Helena loss (that is to say, its gross income less its operating expenses) to be deducted from the taxable income of the Joel and Freegold mines because this would, in effect, mean that St Helena's operating expenses would be set off against the other two mine's incomes to determine their respective taxable incomes before making their capex deductions.

The decision of the Supreme Court of Appeal

The determination

The issue before the Court was how to reconcile the apparent conflict between sections 36(7E) and 36(7F) of the Income Tax Act.

Leach JA (who delivered the unanimous judgment of the Court) pointed out (paragraph [15]) that the purpose of section 36(7F) was to prevent the use of capex of one mine from being allowed as a deduction against the income derived by another mine. It therefore "ring-fences" mining capex on a "per mine" basis.

The operation of the "per mine ring-fence" is straightforward as long as all of the mines are generating a taxable income. However, difficulties emerge where one of the mines generates a loss. Here, the litigants were at odds. The appellant asserted that the provisions of section 36(7F) of the Act effectively required each mine to be taxed as a separate trade, and this is what it (the appellant) had done in preparing its return of income. Reliance was placed on the requirements of section 36(10) of the Act which requires that the capex in respect of each mine is to be computed separately and paragraph (2)(d) of the Schedule of Rates of Tax which provides that rate of tax in relation to a person who mines for gold may vary from mine to mine.

On this issue, after generally identifying what constitutes a "trade" for income tax purposes, Leach JA rejected the argument (at [23]):

"Had the legislature intended each mine's operations to be regarded as a separate trade, it could easily have said so. Not only did it not, but the provisions of s 36(7E) in which reference is made to the 'aggregate of the amounts of capital expenditure . . . in relation to any mine or mines' clearly exclude different mining operations being regarded as different trades. The appellant's argument based upon the necessity to regard its operations at its different mines as different trades must therefore fail."

Having so determined, the Court then turned to the appellant's argument that it is impermissible to set off the losses derived on one mine against the income of another mine. Leach JA found merit in the appellant's argument that the basis applied by SARS was unacceptable in principle (at [24]):

"Section 36(7F) envisages the capex deduction of each mine to be determined by having regard to the taxable income derived from that mine, an objective that will be defeated if the operating expenses incurred of one mine are to be taken into account in respect of another."

After examining the available precedent and the apparent purpose behind the enactment of section 36(7F), the learned Justice of Appeal concluded:

"...s 36(7C) provides for the amount to be deducted under s 15(a) to be the capital expenditure on a particular mine, determined by the income derived from working that mine. Violence would be done to this if the operating expenses of one mine were set-off against the income of another, and I have therefore concluded that it is impermissible to do so."

However, the appellant was not yet out of the woods. The Court then had to determine how the capex deduction should be applied. This, Leach JA pointed out (at [25]), required that he analyse the appellant's argument that the capex deduction is subject to both section 36(7E) and section 36(7F).

It fell to the Court to reconcile the provisions of the two subsections and direct how the capex deduction should have been calculated. This, Leach JA explained (at [32]), should be achieved by apportionment:

"Although s 36(7F) provides for a maximum (or particular cap) that may be deducted for capital expenditure in respect of each of the Freegold and Joel mines, it does not necessarily entitle the appellant to deduct the full amount of each such cap. Thus, the answer seems to me to be for the individual capex caps of the Freegold and Joel mines to be reduced so that their total does not exceed the general cap imposed by s 36(7E). In this way the two sub-sections will work in tandem, setting a maximum total deduction and reducing the Freegold and Joel mines maximum caps proportionally (an exercise similar to that adopted by the respondent in prorating the St Helena loss of R51 million between the Freegold and Joel mines)."

In the result, the effect of apportionment of the capital expenditure in the manner determined by the Court resulted in the same taxable income as assessed by SARS, and the appeal was dismissed and the assessment made by SARS was confirmed.

SARS Watch
20 September - 20 October 2012

Legislation		
21 September	**Taxation Laws Amendment Bill**	
5 October	**Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2012.**	This Act was assented to on 5 October 2012. It includes amendments of the tax rates and rebates for 2012-13, of the dividends tax rate to 15% and of increases in the capital gains tax inclusion percentages.
Interpretation		
5 October	**Interpretation Note No. 58 (issue 2) – The Brummeria case and the right to use loan capital interest free**	This Note has been published as a result of the judgment of the SCA in the Brummeria case. For the purposes of interpreting the definition of the term "gross income" this Note outlines the treatment of receipts or accruals in a form other than money; and serves as a binding general ruling issued under section 89 of the Tax Administration Act, 2011 on the meaning of the term "amount" as used in that definition
Binding Rules		
5 October	**Binding General Ruling 8: Application of the principles enunciated by the Brummeria case (issue 2)**	This BGR reproduces paragraph 7 of Interpretation Note No. 58 (Issue 2) "The Brummeria Case and the Right to Use Loan Capital Interest Free" dated 4 October 2012, which comprises a BGR under section 89 of the Tax Administration Act, 2011.
11 October	**Binding Private Ruling 122: Transfer if a business of a company as a going concern to its holding company as a result of an amalgamation or merger transaction.**	BPR 122 deals with whether the transfer of a business as a going concern to its holding company as a result of an amalgamation or merger will constitute an "intra-group transaction" as defined in section 45(1) of the Act. It also deals with the dissolution of the amalgamating company, and the treatment of the cancellation of shares, as well as the dividend tax implications and the treatment of contingent liabilities transferred.
11 October	**Binding Private Ruling 123: Fibre optic cable to be used for electronic communications**	BPR 123 deals with the question of whether a fibre optic cable to be used for electronic communications will constitute an "affected asset" as defined in section 12D(1) of the Income Tax Act.
14 October	**Binding Class Ruling 31: Income distributed by a discretionary trust and benefit units allocated to beneficiaries by virtue of employment**	This ruling deals with the questions as to whether dividends received and distributed by a trust will retain its nature as dividends in the hands of the beneficiaries of the trust and thereafter, whether beneficial units allocated to beneficiaries will constitute equity instruments in their hands.
Case Law		
1 October	**Armgold/Harmony Freegold Joint Venture (Pty) Ltd v C:SARS [2012] ZASCA 152**	The decision relating to mining capital expenditure and assessed losses is reviewed in this edition of *Synopsis*.
17 October	**(UK case) HMRC v FCE Bank PLC A3/2011/3302**	This case dealt with the issues of group relief for UK resident companies which were subsidiaries of a US resident company, in terms of the non-discrimination article in the UK-USA Double Taxation Agreement.
PwC Publications		
2 October	**Tax Alert – UIF contribution threashold increase**	The Minister issued a notice on 26 September that the annual earnings threshold for UIF will increase from R149 736 to R178 464, effective from 1 October. This increases the monthly levy for persons earning above the threshold by R47.88.
5 October	**Tax Alert – Tax Administration Act notices**	On 1 October, SARS released the first four notices in terms of the TAA which came into effect on the same day. The notices determine various administrative matters regulated in terms of the TAA.