Synopsis
Tax today
September 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.
Where a taxpayer is engaged in the construction industry and is contracted to erect a building or effect improvements on land belonging to his client, the ordinary tax consequences would be that –

- since the taxpayer is being contracted to provide services (as distinct from supplying goods), no amount accrues to him for income tax purposes until he has fully performed his contractual obligations by rendering those services (except to the extent that the terms of the contract provide for interim progress payments); in short, no amount accrues to the taxpayer in respect of work-in-progress where the contract is one for services rendered;
- expenditure incurred in the performance of the contractual obligations is deductible when incurred;
- any fixtures that the taxpayer erects on the land with his own materials pass immediately, by operation of law, into the dominium of the land-owner by the principle of accessio.

In the judgment discussed below, the court accepted – see footnote 11 of the judgment – that the materials that were used to build the prison in question were trading stock.

Consequently, in the absence of legislation to the contrary, the building contractor’s deduction for the expenditure he incurred in purchasing construction materials that had passed out of his ownership would not be counterbalanced by their being included in his income as closing stock at the end of the tax year, and he would get the full fiscal benefit of the deduction in the year of purchase.

**The ordinary tax consequences are overridden where section 22(2A) applies**

Section 22(2A) of the Income Tax Act 58 of 1972 has the effect of overriding those ordinary tax consequences by providing that the building materials (the taxpayer’s trading stock) are, by a legal fiction, regarded as being “held and not disposed of” by him (although in reality they had passed out of his ownership when they became fixtures on the property of the land-owner) and must consequently be included in his year-end closing stock.

This artificial fiscal position endures until the contract has been completed, that is to say, until such time as the taxpayer has carried out all his contractual obligations and is entitled to payment of all amounts due by him. In practice, large building contracts usually provide that the builder is not entitled to final payment until an architect has certified that the building is complete.

In effect, a building contractor’s deduction in respect of his trading stock in the form of building materials that become fixtures on the client’s property is deferred until he becomes entitled to payment in full of the contract price. In the interim, the expenditure that he incurred in the purchase of such materials is counter-balanced by the continued recognition of their value in the determination of his taxable income in terms of section 22(2A).

**The dilemma of a taxpayer who failed to claim deductions in the appropriate tax year**

In *Commissioner of South African Revenue Service v South African*
Custodial Services (Pty) Ltd 2012 (1) SA 522 (SCA), 74 SATC 61 the building contractor in question tried to argue that the acquisition cost should be brought into account in terms of section 22(2A), thereby laying the foundation for claiming that expenditure in a later tax year.

The facts in SA Custodial Services
South African Custodial Services (Louis Trichardt) (Pty) Ltd (“SACS”) entered into a concession contract with the Minister of Correctional Services to design and construct a prison in Louis Trichardt on land owned by the Department of Correctional Services and to operate the prison for 25 years.

The contract in question provided that SACS was entitled to employ sub-contractors. SACS duly entered into a sub-contract (“the construction contract”) in terms of which the sub-contractor was appointed to “undertake the design, construction and commissioning” of the prison in question and to discharge SACS’s contractual obligations to the Minister in this regard. It was stipulated that the sub-contractor was to be an independent contractor and not an employee of SACS.

The prison was thereafter duly designed and built in accordance with the specifications contained in the concession contract.

The court pointed out (at para [43] of the judgment) that the relationship between SACS and its sub-contractor was expressly stated in the construction contract not to be that of employer and employee and that it was also evident that the sub-contractor was not to be SACS’s agent, for it was explicit that the sub-contractor was to be an independent contractor.

Moreover, the contract provided that the sub-contractor undertook to provide all goods and materials necessary for the works. From this, said the court, it followed that SACS had not provided the requisite materials and had never owned them at any stage.

The court concluded (at para [45]) that SACS did not fall within the scope of section 22(2A), in that it had never carried on any construction, building, engineering or other trade in the course of which improvements were effected to fixed property owned by another person as envisaged in that provision. Since it had never effected improvements to State-owned property and had never delivered materials to that property, SACS had not at any stage, for the purposes of section 22(2A), held trading stock that was capable of being deemed to be held and not disposed of by it.

The lessons of this judgment
It is clear from this judgment of the Supreme Court of Appeal that, from a tax perspective, it is of critical importance to be aware of the distinction between employees, independent contractors and agents, and the tax consequences that may flow from the way in which a party to a contract is categorised.

If a sub-contractor is an employee or agent, then all fiscally relevant acts of the sub-contractor (for example the purchasing of trading stock and delivery to a building site) are regarded as acts of the principal; but if he is not an employee or agent, then those are his own acts and the fiscal consequences are attributed to him, and not to his employer or principal.

These distinctions are critical in relation to building contracts and the application of the provisions of section 22(2A).
Dividends deemed to be interest – the DTA conundrum

Dividends tax has been with us for almost six months now and we are soon to experience the reintroduction of a withholding tax on interest. As the practical application of the law relating to these taxes comes under scrutiny, new issues emerge.

One such issue is the treatment of instruments that are of a particular legal form but that are treated under tax law as having a substance that differs from that form. Section 8E of the Income Tax Act is an example. This section establishes conditions under which a share (an equity instrument) may be classified as a hybrid equity instrument (effectively, a debt instrument). It then provides that any dividend accrued to or received by any person in respect of a share during any year of assessment during which the share is a hybrid equity instrument must be deemed in relation to that person to be an amount of interest accrued to that person.

The dividend tax provisions define a dividend by reference to the definition of “dividend” in section 1 of the Income Tax Act and require companies that pay a dividend that is not otherwise exempt to withhold dividends tax at the prescribed rate on the amount of the dividend. The person liable for the tax is the beneficial owner of the dividend.

Double tax agreement

A double tax agreements (DTA) governs the right of the respective states to tax income derived by residents of the one state from sources within the jurisdiction of the other state. The provisions of a DTA, once proclaimed into law, have the effect of modifying the domestic law to the extent that they are in conflict with the domestic law. They too contain definitions of what constitutes a dividend, on the one hand, and what constitutes interest, on the other.

Currently, if an instrument is regarded as a hybrid equity instrument, the dividend in the hands of the shareholder will be regarded as interest, and will fall outside the scope of the dividends tax legislation. The amount will also be exempt from normal tax. The provisions of a DTA are not presently relevant because there is no double taxation or risk of double taxation of the amount that accrues to the non-resident.

There are 56 DTAs concluded by South Africa where the definition of “interest” does not include amounts that are deemed to be interest under the domestic law.

Final tax

But, the landscape will change when the withholding tax on interest is implemented. Under these provisions, a final tax will be imposed on interest derived by any person. The definition of “interest” for this purpose includes amounts distributed in respect of a hybrid equity instrument. A non-resident holder of such an instrument faces the prospect of double taxation, and the DTA will govern the tax treatment of the amount distributed.

In most DTAs the state of source has the right to tax dividend and interest income derived by residents of the other state. However, the amount of tax that may be imposed in the state of source may be limited. The limitation may differ depending on the circumstances. Typically a lower rate of withholding is imposed on dividends paid where the shareholder holds a substantial portion of the equity in the company paying the dividend. If the shareholder also holds ordinary shares (in addition to hybrid equity instruments), it may be in his interests to seek relief under the DTA and insist on distributions in relation to the hybrid equity instruments being taxed as a dividend.

For companies paying a dividend on a hybrid equity instrument, the appropriate treatment is critical to their compliance with the requirements of the Income Tax Act.

Terms have to be examined

The terms of the DTA have to be examined. Although most of the DTAs concluded by South Africa are based on the OECD Model Convention on the Taxation of Interest and Capital, each negotiation could result in the wording of the model convention being adjusted to suit the requirements of the respective negotiating states. Definitions of what constitutes a dividend or interest may vary from one DTA to the next.

There are 56 DTAs concluded by South Africa where the definition of “interest” does not include amounts that are deemed to be interest under the domestic law. In effect, the DTA does not recognise distributions in respect of hybrid equity instruments as interest, but rather as a dividend. The OECD makes the point that the definition recommended in its Model Convention is intended to be exhaustive and deliberately avoids reference to domestic law to ensure legal certainty. The OECD leaves it
open to contracting states to extend the definition in a DTA by reference to the domestic law should they so desire.

It is therefore considered that, where the DTA does not extend the definition of interest to include amounts that are not interest but are treated as interest under the domestic law, a dividend paid on a hybrid equity instrument may be regarded as a dividend for dividends tax purposes and not as interest subject to the interest withholding tax.

**The remaining 14 DTAs can be summarised thus:**

- Three DTAs (Zambia, Zimbabwe and Malawi) do not define what constitutes a dividend or what constitutes interest, and no decision is required – the domestic rules apply and the amount paid in respect of a hybrid equity instrument is classified as an amount of interest.
- In six DTAs (Germany, Greece, Italy, Kuwait, Lesotho and The Seychelles) the definition of “interest” includes amounts that are treated as amounts of interest under the domestic law. The definition of dividend does not exclude these amounts from being treated also as dividends. However, the DTAs are silent whether the dividend definition or the interest definition is to be applied. In the circumstances that the states have seen fit to extend the definition of interest to include deemed interest, it is considered that the domestic definition of interest should prevail and the distributions in respect of hybrid equity instruments must be taxed as amounts of interest.
- In five DTAs (France, Ireland, New Zealand, UK and USA), an amount payable in respect of a hybrid equity instrument is capable of interpretation under the DTA as either interest or dividend, but the DTA contains a tie-breaker clause, which states that an amount that meets the requirements of a dividend shall not be classified as interest for the purposes of the DTA. Distributions to residents of these states in respect of hybrid equity instruments must be taxed as dividends.

When the withholding tax on interest comes into effect, in order to comply with the requirements of the Income Tax Act, the issuer of a hybrid equity instrument will have to identify whether the dividend payable in respect of that instrument is to be regarded as a dividend or as interest. This will likely be an election that will be made by the non-resident shareholder, who will probably elect the status by reference to the likely cash flow implications of the withholding taxes. Based on the decision, the non-resident will make the necessary declaration to the issuer to secure that the lowest available rate of withholding tax should apply.

It is unclear whether SARS has identified this issue and whether there will be processes in place to deal with applications for DTA relief where the DTA classification is in conflict with the domestic classification.

There may also be issues relating to payments to non-residents of amounts of interest that are regarded as dividends under the domestic law, and these will be examined in a later issue.
Liability for donations tax in respect of an executory contract of donation

Liability for donations tax does not arise unless what has transpired is a legally valid donation.

Controversy in this regard usually arises in relation to an executory contract of donation, that is to say, a contract of donation in terms of which delivery of the donated property is to take place in the future, because of the statutory requirements as to the formalities required for such a contract.

The requisite statutory formalities

Section 5(1) of the General Law Amendment Act 50 of 1956 provides in this regard that –

‘[N]o executory contract of donation entered into after the commencement of this Act shall be valid unless the terms thereof are embodied in a written document signed by the donor or by a person acting on his written authority granted by him in the presence of two witnesses.’

Where the donated property is immovable property, section 2(1) of the Alienation of Land Act 68 of 1981 is also applicable. This provision states that –

‘No alienation of land after the commencement of this section shall ... be of any force or effect unless it is contained in a deed of alienation signed by the parties thereto or by their agents acting on their written authority.’

Where an executory contract of donation does not comply with the former provision (and, where the property in question is immovable property, where it does not in addition comply with the latter provision) it is of no legal force or effect and no liability for donations tax will rise unless the donation is indeed carried into effect.

There are many circumstances in which an executory donation that did not comply with these provisions may not be carried into effect. For example, the donor may change his mind. Or he may die and his executor may (indeed, he should) refuse to deliver the donated property to the donee since there is no obligation that is legally binding on the estate.

Lacunae in the terms of an executory contract of donation

Where the drafter of a written executory contract of donation is careless or inexpert, it may happen that the document is silent on a material issue.

The question then arises as to whether there is a valid and binding contract, given that section 5(1) of the General Law Amendment Act, quoted above, requires of an executory contract of donation that ‘the written terms thereof are embodied in a written document’.

In Scholtz v Scholtz 2012 (5) SA 230 (SCA) the intending donor had donated his half-share of certain immovable property to the donee. The property in question was encumbered by a substantial mortgage and the written deed of donation was silent as to whether the property was being donated free of the bond (in other words, on terms whereby the donor was to pay off the bond) or whether the property was being donated in its encumbered form (such that payment of the balance of the mortgage would become the obligation of the donee).

In the Western Cape High Court, Le Grange J had held that the agreement of donation was invalid for failure to comply with the statutory requirements.
Liability for donations tax in respect of an executory contract of donation cont/.. 

Apparently missing terms can be supplied by interpretation or by a tacit term

The Supreme Court of Appeal overturned that judgment, and laid down important dicta on the legal implications where a contract of donation is silent in regard to a material term.

In particular, the court ruled (at para [11]) that a ‘missing term’ in such a contract may be found via a proper interpretation of the express terms of the agreement; alternatively, the missing term may be tacitly incorporated into the agreement. In both of these circumstances, the apparent lacuna is remedied and the contract will be valid.

The court said in this regard (at para [11]) that – ‘in the event of ambiguity, the process of interpretation is not restricted to the wording of the document. So, for example, reference may be had to the context or the factual matrix of the contract which include both the background and surrounding circumstances’.

The court said (at para [12]) that tacit terms of a contract – ‘are by definition not to be found through interpretation of the express terms. They are by definition neither recorded nor expressly agreed upon by the parties. They often pertain to matters which the parties did not even consider. They emanate from the common intention of the parties, as inferred by the court from the express terms of the contract and the surrounding circumstances’.

The court referred with approval to dicta in Wilkins v Voges 1994 (3) SA 130 (A) where Nienaber J said (at 143-144) that – ‘A tacit term in a written contract, be it actual or imputed, can be the corollary of the express terms – reading, as it were, between the lines – or it can be the product of the express terms read in conjunction with evidence of admissible surrounding circumstances. Either way, a tacit term, once found to exist, is simply read or blended into the contract: as such it is “contained” in the written deed.’

Consequently, a tacit term, since it is an integral part of the contract, is taken into account in determining whether the contract in question complies with the requirements of the Alienation of Land Act.

It seems clear from the decision of the Supreme Court of Appeal in Scholtz v Scholtz, noted above, that a tacit term is also taken into account in determining whether a contract of donation complies with section 5(1) of the General Law Amendment Act, quoted above.

In the circumstances of Scholtz v Scholtz, therefore, the court held that the executory contract of donation in question was not invalidated by the absence of an express term as to whether the donor or the donee was to be liable for the balance of the bond over the donated property, for this lacuna was capable of being filled, either by an interpretation of the express terms of the contract or by a tacit term.
# SARS Watch

## 20 August - 20 September 2012

### Legislation

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<tr>
<td>3 September</td>
<td><em>Draft Taxation Laws Amendment Bill Annexure</em></td>
<td>A proposed annexure to the Income Tax Act was put forth as section 64EB which deals with ‘deemed dividends in specie’ in relation to joint Dividend Schemes</td>
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<tr>
<td>14 September</td>
<td><em>Proclamation – Tax Administration Act</em></td>
<td>The Tax Administration Act, with the limited exception of certain provisions relating to interest, is to come into effect from 1 October 2012. Simultaneously certain provisions of tax acts relating to issues dealt with in the Tax Administration Act are repealed.</td>
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### Interpretation

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<td>17 September</td>
<td><em>Interpretation Note: IN 46 (Issue 4) – Amalgamation of Sporting Bodies</em></td>
<td>This IN provides information and guidance on the amalgamation of amateur and professional sporting bodies.</td>
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### Binding Rules

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<td>31 August</td>
<td><em>Binding Private Ruling: BPR 119</em></td>
<td>This BPR deals with the tax consequences arising from a transfer of pension fund interest from a source outside of South Africa to a South African retirement annuity fund.</td>
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<tr>
<td>12 September</td>
<td><em>Binding Private Ruling: BPR 120</em></td>
<td>This BPR deals with the treatment of interest-bearing receivables to be transferred in terms of the corporate rules contained under section 45 of the Income Tax Act as read with section 24J.</td>
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<tr>
<td>14 September</td>
<td><em>Binding Private Ruling: BPR 121</em></td>
<td>This BPR deals with the question as to whether a dividend to be paid to shareholders will be subject to secondary tax on companies or dividends tax.</td>
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### Case Law

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<td>23 August</td>
<td><em>Metlika Trading and Ben Nevis Holdings Pty v CSARS</em></td>
<td>This case dealt with the application for an interim interdict and the prevention of executing against certain assets pending resolution by trial and arbitration of disputes.</td>
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### PwC Publications

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<td>21 August</td>
<td><em>Tax Alert – Medical Scheme Credits</em></td>
<td>The introduction of medical tax credits in place of medical expense deductions has resulted in system compatibility challenges for SARS and has necessitated the introduction of interim solutions.</td>
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<tr>
<td>14 September</td>
<td><em>Tax Alert – Tax Administration Act commences</em></td>
<td>The President has issued a proclamation to the effect that the majority of the Tax Administration Act 28 of 2011 (TAA) comes into effect as of 1 October 2012.</td>
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