TAX UPDATE **PREPARED BY: JOHAN KOTZE**

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INDEX

1. INTRODUCTION 2

2. RETIREMENTS FUND DEVELOPMENT: TAXATION LAWS AMENDMENT BILL, 2013 3
   - 2.1 Revised contribution incentives for retirement savings 3
   - 2.2 Valuation of fringe benefit for defined benefit purposes 5
   - 2.3 Provident fund post-retirement annuity alignment 8

3. EMPLOYMENT TAX INCENTIVE BILL 8
   - 3.2 Frequently asked questions 10

4. REGULATIONS / NOTICES 15
   - 4.1 The Davis Tax Committee calls for contributions 15

5. TAX CASES 16
   - 5.1 ITC 1864 16
   - 5.2 ITC 1865 24
   - 5.3 ITC 1866 32

6. INTERPRETATION NOTES 35
   - 6.1 Income Tax – Year of assessment of natural persons and trusts: accounts accepted to a date other than the last day of February – No. 19 (Issue 2) 35
   - 6.2 Income Tax – Exclusion of certain companies and shares from a 'group of companies' as defined in section 41(1) – No. 75 37

7. BINDING PRIVATE RULINGS 38
   - 7.1 BPR 156 – Income Tax – Pension benefits accruing to a non-resident from a resident pension fund 38
   - 7.2 BPR 157 – Income tax – Receipt of foreign assets and the subsequent donation thereof to a non-resident trust 39

8. BINDING GENERAL RULING 42
   - 8.1 BGR 20 – Interpretation of the expression 'substantially the whole' 42

9. DRAFT GUIDES 46
   - 9.1 Draft comprehensive guide to dividends tax 46

10. DISCUSSION DOCUMENT – ON THE TAX IMPLICATIONS FOR THE SELLER AND PURCHASER IN RELATION TO THE ASSUMPTION OF CONTINGENT LIABILITIES IN PART SETTLEMENT OF THE PURCHASE PRICE OF ASSETS ACQUIRED AS PART OF A GOING CONCERN 46

11. INDEMNITY 48

1. INTRODUCTION

The purpose of this update is to summarise the developments that occurred during the fourth quarter of 2013 (i.e. 1 October 2013 to 31 December 2013) specifically in relation to Income Tax and VAT. Johan Kotze, Bowman Gilfillan's Head of Tax Dispute Resolution, has compiled this summary.

The aim of this summary is for clients, colleagues and friends alike to be exposed to the latest developments and to consider areas that may be applicable to their situation. The reader is invited to contact any of the members of Bowman's tax team to discuss their specific concerns and, for that matter, any other tax concerns.

The Rates and Monetary Amounts and Amendment of Revenue Laws Act, 2013, and Taxation Laws Amendment Act, 2013, were promulgated on 2 December 2013 and 12 December 2013, respectively.

The South African Tax Review Committee, which was initiated in the 2013 Budget, is requesting contributions with regards to the tax burden, the tax mix, the base erosion and profit shifting.

Three tax court cases are dealt with in this update and SARS succeeded in each of them. One wonders who advised these taxpayers, because none of them should have proceeded to tax court, but should have be conceded and settled prior thereto. Two of the cases were even dismissed with cost!

Interpretation notes, rulings and guides are all important aspects of the developments that took place, as they give taxpayers an insight into SARS' application of a specific provision. It is however important to note that these publications are not law, but may bind SARS. Taxpayers should nonetheless consider these publications carefully to determine whether, and how, they are actually applicable to their own circumstances.

Enjoy reading on!

2. RETIREMENTS FUND DEVELOPMENT: TAXATION LAWS AMENDMENT BILL, 2013

Categories of amendments

- Revised contribution incentives for retirement savings
- Valuation of fringe benefits for defined benefit purposes
- Provident fund post-retirement annuity alignment

Amendments will be effective in respect of contributions on or after 1 March 2015

2.1 Revised contribution incentives for retirement savings

- Tax deductible contributions = Encouragement to save
- Currently three main forms of retirement funds:
  - Pension funds – employee & employer funded
  - Provident funds – employee & employer funded
  - Retirement annuity funds – funded by separate individuals
- Employers (if taxable entities) may deduct contributions on behalf of employees to pension funds, provident funds and benefit funds
- Legislatively only 10%, but in practice SARS allows 20%
- Employer contributions now taxable fringe benefit
- Tax exempt employers are not affected

Proposal

- Members contributions - Uniform deduction regardless of the approved fund, and will be subject to an annual percentage and monetary limit

- Percentage limit – 27,5% of the greater of ‘remuneration’ or ‘taxable income’ (excluding retirement lumpsums)
- Monetary limit – No deduction in excess of R350 000 pa

- Contributions in excess of the annual limits may be rolled over to future years to:
  - serve as contribution (limited as above),
  - deductible from lump sum income or
  - deductible from compulsory annuities.
- Employer contributions are not taxable fringe benefit
- Tax exempt employers not affected
- Employer deductions
  - Employer contributions to all approved retirement funds will be deductible – section 11(l)
  - These deductions will effectively be unlimited
  - Employer contributions to benefit funds (friendly societies and medical schemes) are deductible in terms of general provisions.
  - Employer contributions, in particular to <u>defined benefit funds</u>, regardless whether in the fund allocated to both current and retired employees, are deductible.
- Employee fringe benefit
  - Any contributions made by an employer to an approved retirement fund, for the benefit of the employee member, will be taxed as a fringe benefit.
  - Value of fringe benefit depends whether the contribution is to a defined <u>benefit</u> fund or a defined <u>contribution</u> fund.
  - Contribution to a defined contribution fund – value of benefit is the contributions

- Contributions to a defined benefit fund – value determined by way of special formula
- Any contribution made by the employer will be deemed to have been made by the employee, thereby potentially qualifying as a deduction

2.2 Valuation of fringe benefit for defined benefit purposes

- Going forward, any contributions made by an employer to an approved South African retirement fund for the benefit of an employee will be taxable as a fringe benefit in the hands of the employee (excluding a retired employee).
- In the case of a defined contribution retirement fund, the contribution can be directly linked to the benefits that the member is entitled to upon withdrawal, retirement, or death. As a result, the employer contribution is an accurate measure of the value that the employee becomes entitled to through the fund.
- However, defined benefit funds have an inherent element of cross-subsidising across members where the value of actual contributions does not exactly match up with the benefits that a member receives.
- More specifically, the benefits of a defined benefit fund member upon retirement are mostly determined by the member's final salary at retirement, the years of service, and an accrual rate (which indicates how the pension benefits increase due to additional years of service).
- Therefore, the benefits are determined in relation to a formula, whereas the actual employee and employer contributions over years are based on the pensionable income in that year. It follows that there is no direct relationship between the value of the benefits that a member will receive on retirement and the contributions made.

- Certain retirement funds provide their members with risk benefits, such as death and/or permanent disability cover.
- If an employer makes a contribution to a defined benefit fund for the benefit of an employee, the employer must determine the value of the fringe benefit for that employee through the application of a compulsory formula.
- The formula approximates the increase in value of the annuity and lump sum benefit of the member as a result of one additional year of service, based on the value that the member will be entitled to as a retirement benefit, as funded by the employer.
- The formula was created using the following methodology:
    - A capital value is created which approximates the value of the pension benefits (present value of the annuity and the lump sum) of the member that would be received at retirement as if that calculation had been performed at the end of the current year.
    - Another capital value is created, with the same calculation, but assuming the calculation was performed at the beginning of the current year.
    - The difference between the two capital values represents the increase in the value of benefit within the fund (assuming no change in the definition of pensionable income over the year and no change in the benefit design of the fund.
    - The methodology assumes an average increase in salary.
- The formula to be applied by the employer to calculate the value of the fringe benefit for an employee in a particular month is:

$$\mathbf{Y \times ((A \times AF) + (L \times LF)) - V}$$

- The calculation of an employee's fringe benefit in respect of the employer contribution in the case of a defined contribution fund is done with reference to the employer's actual contribution.

- Formula mechanics:
    - The formula will result in a monthly fringe benefit by virtue of the pensionable income pertaining to a specific month (as opposed to being on an annual basis).
    - The formula in the main relies on information that must be provided by the valuator of the retirement fund to the employer.
    - It follows that the valuator will be required to provide the employer with the necessary information in a structured format and in a timeous manner.
- The value of the "annuity accrual rate" of the fund (A):

  The increase in the annuity benefit that the member will become entitled to upon retirement as a result of one additional year of service, expressed as a proportion of the member's “projected annuity income” at retirement.
- The value of the "lump sum accrual rate" of the fund (L):

  The increase in the lump sum benefit that the member will become entitled to upon retirement as a result of one additional year of service, expressed as a proportion of the member's “projected lump sum income” at retirement. If the fund does not provide a lump sum benefit to members this value will be zero.
- The value of the "annuity fund factor" for that fund (AF):

  Different values will be provided through a Regulation issued by the Minister of Finance by way of notice in the Government Gazette.
- The value of the "lump sum fund factor" for that fund (LF):

  Different values will be provided through a Regulation issued by the Minister of Finance by way of notice in the Government Gazette.

2.3 Provident fund post-retirement annuity alignment

- It is proposed that the same mandatory annuitisation requirements currently applicable to pension and retirement annuity funds be applied to provident funds as from 1 March 2015.
- More specifically, as from 1 March 2015, any person retiring from a provident fund or provident preservation fund cannot receive a lump sum upon retirement of more than one-third of their retirement interests.
- In other words, a mandatory compulsory annuity will now be required for the remaining two-thirds of their retirement interests (pre-retirement interests remains free from any mandatory compulsory annuitisation).

3. EMPLOYMENT TAX INCENTIVE BILL

3.1 Media Statement – President Jacob Zuma signs the employment tax incentive bill into law

Issued by SARS on behalf of National Treasury: President Jacob Zuma on 18 December 2013 signed the Employment Tax Incentive Act No 26 of 2013, making into law an initiative that will complement government's measures (as listed in the Youth Employment Accord) to create jobs for young workers and those in special economic zones.

Published yesterday as Gazette No. 37185, the Act will take effect on 1 January 2014.

The Act will encourage private employers to employ young workers by providing a tax incentive to employers, with government sharing the costs of such employment for a maximum of two years under certain conditions. This tax incentive can also

be used to provide jobs to the many matriculants and other school leavers who will be entering the labour market. Soon after the Special Economic Zones Bill is enacted, the incentive will also support employers in such zones, if the zone is designated as eligible by the Minister of Finance. Though not applicable initially, the Minister of Finance may also consider extending the incentive to cover workers in certain approved industries.

The employment tax incentive aims to share the costs of employment between government and employers. The incentive will function by decreasing the amount of pay-as-you-earn (PAYE) tax that is payable to the SARS for every qualifying employee that is hired by the employer. There will be no change in the wages that the employee receives but the effective cost of hiring the employee will be lower, making it more attractive for firms to increase employment. Government recognises that no one tool or incentive will be a panacea to solve our unemployment problem; however, the tax incentive has the potential to make a real contribution towards the creation of new and additional jobs. The Act contains checks and balances that are designed to prevent abuse and ensure that employers do not discriminate against older workers in order to merely access the incentive. Very importantly, this incentive will allow many unemployed young people to gain work experience and develop their skills, thereby improving their prospects for better employment opportunities.

The incentive is available to all private sector employers in all sectors of the economy who are registered with SARS for PAYE. Employers can claim the incentive on a sliding scale for any employee between the ages of 18 and 29 who has been hired on or after 1 October 2013, who possesses a South African ID and is receiving a monthly salary that is above the relevant minimum wage and less than R6 000 per month. If there is no legal minimum wage applicable in a particular sector, the monthly salary must be greater than R2 000. Domestic workers and employees connected or related to the employer are not eligible.

During the first year the value of the incentive will be 50% of the monthly wage up to a monthly wage of R2 000. For wages between R2 000 and R4 000 the value of the incentive will be R1 000 and for wages between R4 000 and R6 000 the incentive value will decrease linearly from R1 000 to zero. For example, an employer who hires a qualifying employee with a monthly salary of R3 500 may

decrease the amount of PAYE they need to pay SARS by R1 000, while for a qualifying employee who earns R5 000 the employer may decrease the amount of PAYE they need to pay to SARS by R500. The value of the incentive will decrease by half during the second year. An employer may only claim the incentive for a two year period for each qualifying employee.

Early in 2014, SARS will publish on its website www.sars.gov.za documentation that will provide further details to assist employers in both understanding how the employment tax incentive will work and how they can claim the incentive in practice.

National Treasury would like to encourage employers to use the incentive to increase the number of youth with limited work experience that they employ. The school leavers for 2013, who are likely entering the job market for the first time, are also good candidates for employers as potential qualifying employees. On-the-job experience is crucial for attaining the appropriate skills and for future employment prospects. Government is committed to work with the private sector to enhance employment opportunities and skills development for all workers, but especially for the youth with limited work experience. The existing learnership allowance provided for in the Income Tax Act and this employment tax incentive is but two of initiatives that Government encourage employers to access to increase the levels of employment and skills development.

3.2 Frequently asked questions

1. How will the employment tax incentive work?

The employment tax incentive will operate by decreasing the amount of tax that is owed by an employer through the pay-as-you-earn (PAYE) system. Employers withhold the amount of tax that is owed by their employees and pay this amount over to SARS. If the employer was to hire a 'qualifying employee' they can deduct the amount of the incentive from the amount of the employees' tax that is owed to SARS. The amount of tax that is owed by the employees will still be recorded as being paid (there will be no shortfall on

assessment) however the employer may retain the cash value of the incentive.

2. Which types of employers would be eligible for the employment tax incentive?

An employer is eligible if they are registered to withhold and pay tax on behalf of their employees (PAYE). There is no restriction to employers in a certain sector. Public sector employers are excluded, however the Minister of Finance may allow certain public entities to participate on a case-by-case basis (subject to performance and affordability).

Eligible employers do need to meet certain criteria in order to be granted the tax incentive. Employers who do not pay the qualifying employee according to the minimum wage prescribed by the relevant sector determination or bargaining counsel agreement would be disqualified from receiving the incentive. If there is no sector determination or bargaining counsel agreement the employer must pay a minimum salary of R2 000 per month to qualify for the incentive.

Where it has been found that an employer has unfairly dismissed an employee in order to hire a new 'qualifying employee' to take advantage of the incentive, the employer will face a penalty and be excluded from receiving the incentive in future. In addition, employers who have failed to submit a return or have a debt owed to SARS on the last day of the month will also not qualify. The Minister of Finance (after consulting the Minister of Labour) may also exclude specific employers or sectors in future if the incentive is not being targeted effectively.

3. What determines whether a potential employee is a 'qualifying employee'?

A 'qualifying employee' must be in possession of a South African ID document and must be older than 19 and younger than 30 years of age. The employee must also not be a 'connected person' to the employer (for example they cannot be a relative of the employer) and they cannot be a domestic worker. The employee must not have been employed with the current employer or an associated institution (for example a subsidiary) before 1 October 2013 and must not earn more than R6 000 per month.

If the employer is operating in a Special Economic Zone or designated industry then there is no age limitation for the 'qualifying employee'.

4. What is the value of the incentive per employee?

For a qualifying employee in the first twelve months of employment the monthly value of the incentive will be 50% of the monthly salary of an employee up to a salary of R2 000, which is R1 000, and will remain at R1 000 for employees with a salary between R2 000 to R4 000 per month. The value of the incentive will decrease from R1 000 to zero for qualifying employees with a salary between R4 000 and R6 000. For example, an employer who hires two 'qualifying employees' with a salary of R3 000 each will be able to deduct R2 000 from the PAYE amount that they owe SARS.

For a qualifying employee in their second twelve months of employment the monthly value of the incentive will be half of the amount described above.

5. Is there a limit or cap on the amount that an employer can use through the employment tax incentive to decrease their PAYE tax liability in each month?

There is no limit to the number of 'qualifying employees' that an employer can hire. However, the employer cannot deduct more than

the total amount of tax that is owed to SARS through the PAYE system.

6. The employment tax incentive is administered through the PAYE system. How will employers who have no PAYE tax liability be included?

Initially there will be no reimbursement mechanism, however if an employer does not have a large enough PAYE tax liability in a certain month to make full use of the incentive then the employer may roll over the amount of the incentive to the following month. Amounts that are rolled over may be used against a potential PAYE tax liability in future months. The amount that can be rolled over is limited to R6 000 for each 'qualifying employee' as at the end of the employer's six month tax reconciliation period.

Once the SARS systems have updated to allow for reimbursements on a bi-annual basis there will be an announcement by the Minister of Finance to bring this facility into effect. The change will extend the scope of the incentive to many firms in the informal sector who are not required to pay PAYE.

7. When will the employment tax incentive become available to employers and for how long will it last?

It is proposed that the employment tax incentive is implemented from 1 January 2014 and it will be available until 31 December 2016. To avoid the possibility of employers holding off hiring decisions until 1 January 2014 the employment incentive will apply to all qualifying employees who were hired after 1 October 2013. A decision on the future of the incentive will be made in 2016 after an evaluation of the original incentive has taken place.

8. Would a new employee who is eligible to qualify for the employment tax incentive receive any monetary benefit?

A new ‘qualifying employee’ would not receive any additional monetary benefit, the employee would receive the salary that was agreed upon between them and the employer. The incentive is paid to the employer by decreasing the employers’ total pay-as-you-earn (PAYE) tax liability.

9. If an employee qualified for the employment tax incentive but then moved to another employer would they be still be classified as a ‘qualifying employee’?

The value of the incentive that is attributed to each qualifying individual need not be utilised on a continuous basis or with the same employer. The eligibility for the incentive and the amount of the incentive is not determined from the time the individual starts working, but instead reflects the number of months that the person was employed. In the first twelve months of employment the employer can deduct the full value of the incentive, while in the second twelve months of employment the employer can deduct half of the previous amount.

For example, a qualifying employee who worked for an employer for 6 months on a salary of R2 500 a month would entitle the employer to deduct R6 000 (R1 000 per month) from their PAYE liability. If the individual became unemployed for six months but then took up a position with a new employer where they worked for a year on a salary of R4 000 the employer would be entitled to the full deduction for six months and half of that amount for the remaining six months (R9 000).

10. How will the potential displacement of older workers, or those who have been employed for longer than two years and are no longer eligible for the incentive, be avoided?

Employers will face a penalty of 150% of the value of the incentive that they have received for the previous twelve month period if it is

found that they have ‘unfairly dismissed’ (in accordance with the Labour Relations Act) an employee in order to hire a new ‘qualifying employee’ to take advantage of the incentive. These employers will also be excluded from any future participation in the incentive.

The finding of an unfair dismissal in this context must be made by the CCMA (Commission for Conciliation, Mediation and Arbitration), an accredited council or private agency or any competent court.

11. Does the employment tax incentive align with current labour legislation?

Yes, the incentive does align with current labour legislation and employers who do not abide by the minimum wages as determined by the sector determinations or bargaining counsel agreements will be excluded from the incentive.

4. REGULATIONS / NOTICES

4.1 The Davis Tax Committee calls for contributions

Following his 2013 Budget announcement, the Minister of Finance publicised the members of a tax review committee on 17 July 2013. The committee, now known as the Davis Tax Committee (DTC), will examine the role of South Africa’s tax system to promote growth, job creation, sustainable development and fiscal self-reliance. It will take the long term objectives of the National Development Plan into account in its work.

Using its Terms of Reference as the point of departure, the DTC has adopted a work programme that has prioritised the establishment of specialist sub-committees on small businesses, the appropriateness of the tax base and tax mix in South Africa, and base erosion and profit shifting (BEPS).

The DTC has also adopted an approach that is participatory and consultative. This will provide for wide engagement with all stakeholders. Special dialogue sessions are arranged on an ongoing basis to take into

account a diversity of interests and opinions. The DTC accordingly calls upon all interested parties to make use of the opportunity to contribute to the mentioned priorities for now.

Top priority of the DTC at the moment is to address ways in which the tax system can be improved to facilitate entrepreneurship and the growth of small businesses. Various tax packages already exist to encourage small businesses. The DTC needs to review these packages to find an optimal tax package that assists small businesses in contributing towards economic growth and reducing the high unemployment rate. Urgent contributions in this regard will be most welcome by 20 November 2013.

Contributions with regard to the tax burden and tax mix are invited by 30 November 2013. The BEPS Sub-Committee is working on a longer timeframe that is aligned with the OECD BEPS Action Plan. Contributions with regard to BEPS are welcome by 31 January 2014.

All contributions can be made via e-mail to taxcom@sars.gov.za . More details on the work of the DTC and its Terms of Reference can be found on its website, www.taxcom.org.za

5. TAX CASES

5.1 ITC 1864

The taxpayer, being Mr A, was an instrument technician who was also the sole trustee of an *inter vivos* trust, named the A Trust and the said trust is referred to as ‘the trust’. A trust deed governing the administration, structure and objectives of the trust was registered on 5 March 1997 and the trust deed is referred to as ‘the trust deed’.

The present matter related primarily to SARS’ tax assessments in respect of the taxpayer in his personal capacity for the tax years 1998 to 2001 but for reasons set out in the judgment SARS’ tax assessments relating to the trust, represented by the taxpayer, for the correlating period, were also germane to the appeal and to the extent that the tax affairs of the taxpayer were inextricably linked to the tax affairs of the trust, both the taxpayer and

SARS dealt with the two taxpayers in this matter jointly in the context of both the objection proceedings as well as the appeal proceedings.

The taxpayer, prior to 1997, had been employed by a labour broker, named D Entity and in terms of his agreement with D Entity, he provided services as an instrumental technician for certain divisions and subsidiaries of a client of D in the mining industry. The taxpayer accordingly worked for certain divisions of a number of affiliated companies including B Ltd, C (Pty) Ltd and E Ltd and the said affiliated companies as well as the divisions of the said companies, which utilised the taxpayer's services are individually and collectively referred to as 'the companies' in the judgment.

The taxpayer, at the end of 1996, was advised to form a trust with a view to continuing to provide his personal services as an instrument technician to the companies and it was established in 1997 and thereafter continued to provide services to the companies through the trust, with effect from the 1998 tax year and as such he did not provide any services to the companies on behalf of D entity, with effect from the 1998 year.

The trust then received income from the companies and the taxpayer testified that he was advised that he could claim expenses against such income. The beneficiaries of the trust were specified to be the taxpayer, his wife and their children.

The previous arrangement through D entity was replaced with a series of at least six similar agreements between the trust and the companies in terms of which the trust provided the services of the taxpayer to the companies as an instrument technician for specified periods.

It had been specifically provided in the agreements on record that the taxpayer was to provide services at the premises of the companies during normal working hours or at sites specified by the companies.

The agreements on record further provided that the remuneration payable by the companies to the trust was based upon the agreed hourly rate for the hours worked by the taxpayer and he was obliged to keep accurate time sheets to record the number of hours and places worked and the trust then

issued monthly invoices to the companies for the services rendered by the taxpayer in each particular month on the basis of the hours worked.

The companies were also obliged to reimburse the trust for all travel and accommodation expenses incurred for the purposes of the taxpayer's services to the companies and the agreements on record provided that income tax at the prescribed rate would be deducted from fees owing by the companies from time to time, unless a tax exemption certificate was issued.

The evidence revealed that the subsequent agreements between the trust and the companies between 1998 and 2002 were based upon his skills, expertise and reputation, as well as the personal relationship that he had established with the companies.

The taxpayer's stated intention at all relevant times was to continue rendering services as an instrument technician to the companies and he indicated that he was confident that he could continue rendering services to the companies through the trust but he also indicated that pursuant to the conclusion of the various agreements between the trust and the companies, no agreement had been in place between him (as an independent contractor) and the trust relating to his services to the companies, from time to time.

The evidence revealed that invoices had been issued by the trust to the companies from time to time and the invoices on record made provision for the hours worked by the taxpayer.

In these circumstances, in distinct contrast to the period when he was employed by D entity, the taxpayer did not receive a salary in respect of his services to the companies in the tax years between 1998 and 2001. However, he testified that he was advised at the time that he could transfer income from the bank account of the trust to his own bank account and he confirmed that as a matter of practice he transferred virtually all income received by the trust from the companies to his own bank account and he also stated that he was the sole provider for himself and his family and he

admitted that he was not constrained to comply with the trust objectives when he expended money from his personal bank account.

It was not in dispute that the trust submitted income tax returns supported by income statements of the trust as well as declarations of expenses for the tax years between 1998 and 2001 and in addition IRP5 certificates in terms of the Income Tax Act in relation to the taxpayer's employment with the companies for the relevant periods were also submitted to the SARS. Thus, in addition to claiming expenses, the trust also claimed refunds of the amount of employees' tax deducted by the companies in terms of the relevant IRP5 certificates.

In these circumstances it was not in dispute that the taxpayer supported himself and his family by rendering services as an instrument technician, both prior to and after 1997 and in so far as his personal income tax was concerned, in the years preceding the 1998 tax year, he was liable for tax on income earned from the companies but thereafter in the tax years between 1998 and 2001, the taxpayer had declared either no income at all or a minimal income in his income tax returns for each year.

Pursuant to the taxpayer's submission of income tax returns as well as the trust incorporating the above information for the years under discussion, SARS directed a request for factual information and documentary proof to the taxpayer and the taxpayer apparently in his personal capacity and on behalf of the trust had provided certain information and documents to SARS by way of response to the said request.

SARS subsequently initiated an audit relating to both the the taxpayer and the trust in relation to the 2001 year of assessment and the said audit revealed *inter alia* that the trust had claimed exorbitant expenses in relation to income resulting in a declared loss in 2001 and this loss was compounded by the declared losses from previous years which were carried forward to 2001. Thereafter a further audit was initiated by SARS in relation to the 1998, 1999, 2000 and 2001 tax years which revealed *inter alia* that during the correlating tax periods the taxpayer had declared to SARS either that he had no income at all or that he had a negligible tax liability.

SARS, on the basis of the above findings, assessed the taxpayer in terms of the Income Tax Act and determined the taxpayer's liability for tax for the 1998–2001 years of assessment and these assessments by SARS were based upon the amounts received by the trust for services rendered by the taxpayer on behalf of the trust in the tax years from 1998 to 2001.

There were the following main issues in dispute for determination by the court with respect to the amounts received by the trust during the 1998–2001 years of assessment:

- whether the creation of the trust and the conclusion of the service agreements between the trust and the companies could be regarded as a scheme to avoid income tax by the taxpayer as contemplated in section 103(1) of the Act;
- whether the remuneration paid to the trust constituted taxable income in the hands of the taxpayer on the basis of the relevant provisions of the Income Tax Act relating to gross income; and
- whether the deductions claimed by the taxpayer were allowable in terms of section 11(*a*) of the Income Tax Act read with section 23 of the Act.

To the extent that the taxpayer could not explain and/or substantiate specified expenses claimed by the trust from 1998–2001, the taxpayer conceded during the course of the present hearing that such expenses were not allowable in terms of the Act and the last issue was not really in issue at the hearing of the matter.

Judge Mayat held the following:

<u>As to whether the trust constituted a scheme to avoid income tax – section103(1) of the Act</u>

(i) That the taxpayer had the *onus* of proving that at least one of the four elements of section 103(1) of the Act was not present in the circumstances of this case.

(ii) That, as regards the first requirement of section 103(1), it can hardly be doubted that the notion of a 'transaction, operation or scheme' as

envisaged in section 103(1) of the Act, is sufficiently widely stated to incorporate the termination of the arrangement with D Entity, the establishment of the trust, and the subsequent use of the said trust by the taxpayer.

(iii) That in the present case the scheme from beginning to end involved a series of transactions entered into by the taxpayer and these transactions and surrounding circumstances included the following:

- terminating the contract with D Entity;
- establishing the trust with a view to continuing the taxpayer's association with the companies;
- the nomination of the taxpayer as trustee, as well as the nomination of the taxpayer, his wife and his children as beneficiaries;
- opening a bank account for the trust;
- negotiating and concluding service agreements with the companies;
- the taxpayer rendering services on behalf of the trust, in the absence of an agreement between himself and the trust; invoices being sent to the companies for services rendered by the taxpayer;
- the taxpayer not receiving a salary from the companies;
- the taxpayer not taking up employment elsewhere; and
- the transfer of virtually all the income received by the trust to the taxpayer's own account, apparently for the living expenses of the taxpayer and his family.

(iv) That, as regards the second element of section 103(1) of the Act, whilst a person can, of course, always enter into legitimate transactions, which have the effect of freeing him from taxation of future income by channelling such income through a third party, SARS is empowered in terms of the Act to declare such income to be

in reality the income of the person who entered into the relevant transactions, and not the income of the third party concerned.

(v) That the taxpayer had received income from D Entity for his services to the companies on a continuous basis prior to 1998, when such income was subject to taxation and it was common cause that the taxpayer had subsequently rendered the same services through the trust. Therefore, pursuant to the creation of the trust, the income, which the taxpayer had previously earned, effectively accrued to the trust and had it not been for the transactions detailed above, the income declared by the trust would have been taxable in the taxpayer's hands.

(vi) That it was quite clear from the evidence that the *raison d'etre* of the trust between the years 1998 and 2001 was the avoidance of income tax normally payable by the taxpayer and this was exacerbated by the fact that the trust also declared continuous losses on the basis of questionable expenses which were obviously intended to absolve the trust from any tax liability.

(vii) That in regard to the third element of section 103(1) of the Act, the taxpayer had testified that he did not conclude an agreement with the trust and he also admitted that he had appropriated all trust income at his sole discretion after he had transferred income from the trust bank account to his personal bank account from time to time, without accounting to the trust. Moreover, he admitted that he was at liberty to spend money which he had transferred from the trust bank account as he saw fit and not necessarily in accordance with the trust objectives.

(viii) That the admissions by the taxpayer obviously demonstrated an abnormal state of affairs, primarily so as the taxpayer was not obliged to account to the trust at all, even though he allowed the fruits of his labour to accrue to the trust and, therefore, the circumstances surrounding the scheme perpetrated by the taxpayer gave rise to abnormal rights and obligations between the taxpayer and the trust and such rights and obligations would not normally have been created between persons dealing at arm's length.

(ix) That, as regards the fourth element of section 103(1), SARS had to be satisfied that the scheme was entered or carried out solely or mainly for the purposes of the avoidance or postponement of liability for any tax imposed by the Act. In terms of section 103(4) of the Act, it is presumed, until the contrary is proved, that the sole or main purpose of a transaction, operation or scheme was the avoidance, postponement or reduction of liability for the payment of tax and this presumption places a heavy duty on the taxpayer.

(x) That in order to displace the presumption against him, it is not only necessary for the taxpayer to point to some compelling reason for entering the scheme and then the court has to be convinced, on an objective basis, that the reason so disclosed motivated the actions of the taxpayer. In the present case the taxpayer did not disclose any compelling reasons for the transactional elements or steps relating to his scheme set out above, other than that he intended to avoid liability for the payment of tax. Thus, objectively assessed, on the basis of the evidence of the taxpayer and the surrounding circumstances, the only inference is that the main or sole purpose of the trust was to avoid liability for the payment of tax.

(xi) That in these circumstances the court was persuaded that all four elements of section 103(1) of the Act were present in relation to the series of transactions executed by the taxpayer and, as such, the taxpayer had failed to discharge the *onus* on him of establishing the one or more of the said elements were not present and hence SARS was entitled to invoke the provisions of section 103(1) of the Act and was also entitled to determine the taxpayer's tax liability and the amount thereof and his objections were accordingly justifiably disallowed by SARS.

<u>As to whether the income received by the trust should be taxed in the taxpayer's hands</u>

(xii) That as to whether the money paid to the trust could be deemed to form part of the taxpayer's gross income, all the authorities in this sphere of law justifiably give weight to substance over legal form and

it was undisputed that the salary which the taxpayer had previously received for services rendered by him as an instrument technician to the companies was effectively still in place after the conclusion of the agreements between the trust and the companies relating to the taxpayer's services as an instrument technician.

(xiii) That SARS in the present case had justifiably invoked the relevant provisions of the Income Tax Act relating to the definition of gross income when making assessments relating to the taxpayer for the relevant tax years. Taking substance over form, the true nature and substance of the income received from the companies was that such income was effectively the income of the taxpayer and in these circumstances SARS also justifiably disallowed the taxpayer's objections in this regard *inter alia* on the basis that, all the income, which the trust had received from the companies, was effectively received by the taxpayer.

As to expenses and deductions

(xiv) That it was conceded that the taxpayer and the trust did not qualify for all the deductions claimed, particularly so as the taxpayer could not confirm in his evidence that all the expenses claimed were actually incurred in the production of income and/or were closely linked to the production of income and, as such, SARS had justifiably disallowed the expenses claimed, allegedly in the production of income for the relevant years of assessment.

Appeal dismissed with costs.

5.2 ITC 1865

The taxpayer, being a company named A (Pty) Ltd, was a registered vendor in terms of the VAT Act.

The taxpayer was a property owner and had conducted business purely as a landlord.

The taxpayer, prior to November 2006, had rented out specified commercial premises to a company named B (Pty) Ltd in terms of an oral lease agreement and it was common cause that on the basis of a subsequent written lease agreement, which was concluded in November 2006, the taxpayer had extended the period of the oral lease agreement with B (Pty) Ltd.

It was never in dispute that the taxpayer had rented out certain immovable property to B (Pty) Ltd for commercial use and the said building had been developed by the taxpayer on the immovable property described as Erf Y, Bryanston.

Two further written lease agreements between the taxpayer as lessor and two other companies, named C (Pty) Ltd and D (Pty) Ltd were also concluded in July 2005 and in terms of these two lease agreements the taxpayer had leased the 'storage section' at the address in Bryanston and 'the north wing' at the said address to C (Pty) Ltd and D (Pty) Ltd, respectively.

The taxpayer, in the aforesaid circumstances, had concluded three lease agreements with three companies and it and all three lessees constituted a group of affiliated companies.

The evidence revealed that B (Pty) Ltd was the main trading company in the group which was involved in all spheres of the business of the sale of office automation equipment and, as such, B (Pty) Ltd employed a large number of employees based at the address in Bryanston.

By contrast, C (Pty) Ltd, which was a brokering company, and D (Pty) Ltd, which was a Black Economic Empowerment ('BEE') company, had no employees and did not occupy any premises and it was accordingly indicated in evidence that the lease agreements between the taxpayer and C (Pty) Ltd as well as D (Pty) Ltd were merely 'pre-emptive measures' which 'anticipated' a future arrangement.

Even though the lease agreement between the taxpayer and B (Pty) Ltd was never in dispute, it appeared that the taxpayer had initially denied that it had rented out property to either C (Pty) Ltd or to D (Pty) Ltd but

nevertheless did not deny in evidence before the court that it had in fact concluded lease agreements with both C (Pty) Ltd and D (Pty) Ltd and denied further that the agreements with C (Pty) Ltd and D (Pty) Ltd were fictitious.

The taxpayer also admitted that it had generated some 54 tax invoices relating to the monthly rentals payable by C (Pty) Ltd and D (Pty) Ltd to the taxpayer between the periods July 2005 and September 2007. It confirmed in this respect that it had generated the tax invoices on record after the conclusion of the written lease agreements with C (Pty) Ltd and D (Pty) Ltd and that these tax invoices were utilized for the purposes of opposing an application for the liquidation of the taxpayer in the North Gauteng High Court.

The taxpayer had stated under oath that its assets included *inter alia* rental amounts due and payable to it by B (Pty) Ltd and D (Pty) Ltd and that both C (Pty) Ltd and D (Pty) Ltd had been indebted to it for rental as reflected in the tax invoices generated by it.

Each of the tax invoices so generated, which were on record, had a heading in large bold letters stipulating 'Tax Invoice' and each of the said invoices further stipulated, *inter alia*, the name, company registration number, telephone number and VAT registration number of the taxpayer, the date upon which the said tax invoice was issued and the description of the goods or services supplied as 'Rent' as well as the month for which rent was supplied.

It further appeared from the tax invoices relating to B (Pty) Ltd, C (Pty) Ltd and D (Pty) Ltd that the physical address for each of these companies on each of the invoices issued was stipulated to be the address, Bryanston, i.e. the postal address of all these three companies was also the same on each invoice.

The evidence revealed that the taxpayer had been advised by its previous attorneys to substantiate its assets for the purposes of opposing an application for its liquidation and it had accordingly indicated that it had generated '*pro forma* invoices' relating to C (Pty) Ltd and D (Pty) Ltd merely

to demonstrate a potential revenue stream for the purposes of a healthy balance sheet and these invoices were not given to either C (Pty) Ltd or D (Pty) Ltd and these two companies had not utilized the tax invoices generated by the taxpayer for the purposes of claiming input tax from SARS in terms of the VAT Act.

The taxpayer, against the above background, had submitted returns for VAT to SARS for the relevant tax periods and it was common cause in this respect that there were communications between various officials of SARS and the taxpayer relating to its apparent under-declaration of output tax. Thereafter, a VAT audit was ultimately conducted by SARS relating, *inter alia*, to an assessment of output tax payable by the taxpayer in terms of the said Act.

SARS had, pursuant to such audit, issued an 'Assessment Letter' to the taxpayer in which Annexures A, B and C constituted a schedule of rental received by the taxpayer in the 2006, 2007 and 2008 tax years from B (Pty) Ltd, C (Pty) Ltd and D (Pty) Ltd, respectively. Each of the said schedules stipulated in two columns the amount of the monthly rental received by the taxpayer from each of the said three companies and the VAT component of the said rental each month.

SARS had accordingly conveyed to the taxpayer by way of the Assessment Letter that it had under-declared output VAT for the periods of assessment 2006, 2007 and 2008.

The taxpayer filed an objection to the Assessment Letter and also lodged an objection to the assessed penalties and interest. It objected to the assessment by SARS relating to C (Pty) Ltd and D (Pty) Ltd.

SARS partially allowed the taxpayer's objections relating to the Commissioner's assessment of supplies made by it to B (Pty) Ltd but had disallowed the taxpayer's objections to the Commissioner's assessment of supplies made by it to C (Pty) Ltd and D (Pty) Ltd.

The taxpayer contended by way of a point *in limine* that the assessment letter from the Commissioner did not constitute an assessment as envisaged in sections 31(4) and (5) of the VAT Act.

The taxpayer contended on the merits that it had not made supplies to C (Pty) Ltd and D (Pty) Ltd as envisaged in the VAT Act and had accordingly not under-declared output VAT and was not liable to SARS for output VAT in respect of rental payable by C (Pty) Ltd and D (Pty) Ltd as specified in the VAT invoices on record.

Judge Mayat held the following:

<u>As to whether assessment letter constituted an assessment</u>

(i) That in considering whether the letter from SARS in *C: SARS* v *South African Custodial Services* (*Pty*) *Ltd* constituted an assessment, the Supreme Court of Appeal took cognizance of the fact that an assessment in terms of the Income Tax Act was defined in essence as a determination by SARS by way of a notice of assessment (served on a taxpayer) of an amount upon which any tax is leviable and on this basis the court correctly found that the letter from SARS under consideration in that case on the face of it purported (with one exception) to be a determination as defined in the Act and it found that the overwhelming impression was that the letter sent was indeed an assessment.

(ii) That, for similar reasons, the overwhelming impression created by the assessment letter in the present case was that it was indeed an assessment as it determined, in a reasoned manner, SARS's assessment of the the taxpayer's liability and the assessment letter clearly stipulated by way of a heading that it constituted an 'Assessment Letter' and it was also clearly stipulated that the assessment period related to VAT for the period 2006, 2007 and 2008.

(iii) That, significantly, the said letter also stated: 'reasons for the adjustments to the above assessments have been explained above'. Most importantly, SARS's assessment was clearly premised upon computations set out in the Schedules marked Annexures A, B and C annexed to the assessment letter.

(iv) That, in these circumstances, SARS had effectively made the necessary determination as envisaged in section 31(4) of the VAT Act and this was also borne out by the fact that when the taxpayer's legal representative lodged an objection to the letter of assessment, as provided for in the letter of assessment, the said objection justifiably referred to the contents of the letter of assessment as an 'assessment' and thus the taxpayer had correctly acknowledged the assessment letter as an 'assessment' as contemplated in the VAT Act.

(v) That, accordingly, there was no merit in the point *in limine* to the effect that the assessment letter did not incorporate an assessment in terms of the VAT Act.

<u>As to the merits of the appeal</u>

(vi) That, as regards the taxpayer's case on the merits, the taxpayer admitted at the hearing of this matter that monthly tax invoices for rental as envisaged in the VAT Act, were issued by the taxpayer to C (Pty) Ltd and D (Pty) Ltd for the periods July 2005 to September 2007. However, it was also averred on behalf of the taxpayer, in this respect that to the extent that C (Pty) Ltd and D (Pty) Ltd did not really trade, these invoices were only '*pro forma* invoices' and it was further averred that to the extent that the taxpayer did not enforce the lease agreements with C (Pty) Ltd and D (Pty) Ltd, there was no 'performance' in terms of the said lease agreements and it was accordingly contended that no 'supply' took place as envisaged in the VAT Act.

(vii) That, as regards the evidence pertaining to the tax invoices issued by the taxpayer as being '*pro forma*' invoices, it was not in dispute that each of the invoices generated by the taxpayer stipulated *inter alia* the name, company registration number, telephone number and VAT registration number of the taxpayer; the name and address of the addressee (as either C (Pty) Ltd and D (Pty) Ltd, a space for the VAT number of the addressee; the date upon which the said tax invoice was issued; the description of the goods or services supplied as

‘Rent’ as well as the month for which rent was supplied; and the value of the supply, the amount of VAT charged by the taxpayer as well as the consideration for the monthly rental and it was also not in dispute that the format and particulars incorporated in these invoices were identical to the format and particulars in the tax invoices issued by the taxpayer for rental payable by B (Pty) Ltd.

(viii) That as regards the question whether all the invoices generated for the taxpayer incorporating the above details complied with the provisions of the VAT Act, it was significant that the taxpayer had partly conceded output VAT in relation to rental payable by B (Pty) Ltd and to the extent that the invoices issued to B (Pty) Ltd incorporated the identical format and details as the invoices issued in relation to C (Pty) Ltd and D (Pty) Ltd it could hardly be disputed that the latter invoices generated by the taxpayer complied in all material respects with the provisions of section 20(4) of the VAT Act.

(ix) That as regards the taxpayer’s averment that it had not supplied anything to C (Pty) Ltd and D (Pty) Ltd in terms of the VAT Act, it is specifically provided in terms of section 9(1) of the said Act that the supply of the goods or services by a vendor was deemed to take place at the time a VAT invoice was issued, at the very earliest. Thus, the supply is deemed to take place before such invoice is received by the recipient or paid by the recipient. As such, whether or not the taxpayer had received payment for renting its property, and whether or not the taxpayer actually enforced payment of rentals by C (Pty) Ltd and D (Pty) Ltd were of no consequence in relation to the taxpayer’s liability for declaring output VAT and, similarly, whether or not C (Pty) Ltd and D (Pty) Ltd actually traded was also irrelevant in the context of the present appeal.

(x) That, furthermore, a declaration of output tax by the taxpayer to SARS was not dependent upon a correlating claim for input tax by a vendor to whom the taxpayer ‘performed’ in terms of a rental agreement, as suggested by the taxpayer. Similarly, a declaration of output tax by a vendor such as the taxpayer, who rents out property, is not dependent

upon whether such vendor elects to enforce performance by a lessee in terms of a lease agreement during the term of the lease and, in the final analysis, in terms of the provisions of section 9(1) of the Act, VAT was payable by the taxpayer as soon as the various tax invoices were issued by it.

(xi) That it did not avail the taxpayer to contend that the invoices issued to C (Pty) Ltd and D (Pty) Ltd were actually fictitious and in this regard the unreported judgment of Hiemstra AJ in the case of *XYC CC* v *CIR* (North Gauteng Tax Court *case no* VAT 889) is instructive and where the court found that the taxpayer was liable for output tax in relation to fictitious VAT invoices in circumstances where the inference loomed large that he had participated in a fraud for his own gain and, as with that case, in this context the taxpayer did not provide a credible account of the tax invoices generated by it and whatever its explanation was, the taxpayer was liable for payment of output VAT in terms of the VAT Act.

As to interest and penalties

(xii) That SARS imposed the normal statutory penalty and interest in relation to the taxpayer's failure to pay output tax and, as such, SARS elected not to exercise his discretion to remit the applicable penalty and interest in terms of section 39 of the VAT Act; moreover, the taxpayer's failure to make payment within the prescribed period not only resulted in financial loss to the State but also resulted in the taxpayer benefitting financially. The taxpayer's failure to make payment in the circumstances of this case was obviously premised upon a clear intention on the part of the taxpayer not to make payment and in these circumstances there was no basis for the court to interfere with SARS's assessment pertaining to the statutory interest and penalties in this respect.

As to additional tax

(xiii) That where a taxpayer omits to render a return relating to any amount, or makes an incorrect statement, SARS is entitled in terms of

the provisions of the Income Tax Act, to impose an additional tax. In the present case SARS did not do so but SARS requested the court to refer the matter back to SARS for the assessment of an additional tax at a percentage determined by the court. However, as the taxpayer had already been properly penalized by way of the statutory penalty and interest it was not appropriate to impose an additional tax in the circumstances of this case.

<u>As to costs</u>

(xiv) That in terms of section 83 of the Income Tax Act the court may on application by SARS grant an order for costs against a taxpayer *inter alia* where the claim of SARS is unreasonable, or where the grounds of appeal, which are relied upon by the taxpayer are frivolous. In the only reported case in relation to frivolous grounds of appeal, the word 'frivolous' was construed to mean 'manifestly futile' by Squires J sitting as President of the Rhodesian Income Tax Special Appeals Court, see ITC 1316. The grounds of appeal relied upon by the taxpayer were frivolous and 'manifestly futile' in the circumstances of the present case and accordingly an adverse costs order against the taxpayer was warranted.

Appeal dismissed with costs.

5.3 ITC 1866

The taxpayer was a registered VAT vendor who had submitted vague VAT returns that were not supported by VAT input invoices even though he had deducted the purchase price of the goods he had obtained from the output amounts.

SARS had instituted a tax audit of the taxpayer's affairs.

The taxpayer objected on the basis that the tax invoices in issue could not be obtained from the supplier due to an alleged fraud perpetrated by an administrative official in the supplier's service and the taxpayer relied on section 20(7) of the VAT Act.

Section 20(7) provided that where SARS is satisfied that there are or will be sufficient records available to establish the particulars of any supply or category of supplies, and that it would be impractical to require that a full tax invoice be issued in terms of this section, SARS may, subject to such conditions as he may consider necessary, direct that any one or more of the particulars specified in the VAT Act shall not be contained in a tax invoice or that a tax invoice is not required to be issued.

SARS disallowed the taxpayer's objection to its assessment and the taxpayer then appealed to the Tax Court on the grounds of SARS' failure to act in terms of section 20(7) of VAT Act.

SARS raised the point *in limine* that the Tax Court did not have jurisdiction to deal with an appeal against the decision by SARS taken in terms of section 20(7) of VAT Act and reliance was placed by SARS on sections 32(1) and 32(4) of the VAT Act.

Section 32(1) provides for objections to certain decisions or assessments by SARS but does not include s 20(7) in the list of sections allowing for objections to decisions of SARS.

Section 32(4) provides that SARS may on receipt of a notice of objection to a decision, direction, or an assessment, alter the decision, direction or assessment or may disallow the objection and must send the person notice of such alteration or disallowance and record any alteration or disallowance made in the decision, direction or assessment.

Section 33 provides that an appeal against any decision, direction, supplementary direction or assessment of SARS, as notified in terms of s 32(4), shall lie to the tax court constituted under the provisions of section 83 of the Income Tax Act within the period prescribed and the rules issued in terms of section 107A of the Income Tax Act for the area in which the appellant resides or carries on business.

Judge Bertelsmann held the following:

(i) That section 20(7) of the VAT Act provides that when SARS is satisfied that adequate records are available and that it would be impractical to require a full tax invoice to be issued for each and every

supply he may make special arrangements with an enterprise to simplify the normal requirements for a tax invoice or, alternatively, he may rule that no such invoice need be issued or that the necessary particulars should be issued in some other manner.

(ii) That the provisions of section 20(7) of the VAT Act are not included in the list of sections set out in section 32 of the said Act which provides for objections to be lodged to certain decisions or assessments of SARS and therefore SARS was correct when he disallowed the taxpayer's objection to the assessment and no appeal can be lodged against SARS's decision to the Tax Court.

(iii) That SARS was consequently correct when he submitted that the Tax Court could not entertain the present appeal on the ground already referred to and the parties have agreed that the only manner in which the court could interfere with SARS' decision would be by way of a review of the decision which would be beyond the power of the Tax Court under the Constitution.

(iv) That the provisions of the Promotion of Administrative Justice Act (PAJA) do not support the stance that review would be possible in the Tax Court as the preamble of this Act underlines what was held in *Pharmaceutical Manufacturers Association of South Africa and Another In Re: Ex Parte the President of the Republic of South Africa and Others* 2000 (2) SA 674 (CC) that PAJA is the embodiment of administrative law and review as defined in the preamble to the Constitution.

(iv) That the Tax Court is a creature of statute without inherent jurisdiction as is the case with the High Court and it is inconceivable that the legislature would have intended to create competing and concurrent forums for the resolution of tax disputes which would result in confusion when selecting a forum and it would not be possible to establish any useful body of precedent for the benefit of taxpayers themselves if different forums developed different law on the same issue.

(v) That, accordingly, review procedure must be brought before the High Court (see *Rossi and Others* v *C: SARS*) and it followed that relief based upon a review which can only be launched in terms of PAJA is beyond the jurisdiction of the Tax Court.

(vi) That the taxpayer had indicated that he would take steps to launch a review in the High Court in the event that the point *in limine* was upheld.

6. INTERPRETATION NOTES

6.1 Income Tax – Year of assessment of natural persons and trusts: accounts accepted to a date other than the last day of February – No. 19 (Issue 2)

This Note provides guidance on SARS's discretionary power to grant permission to a natural person or trust to submit financial accounts for a period (the 'accounting period') which differs from the year of assessment ending on the last day of February.

This Note deals with natural persons and trusts that carry on a trade.

In earlier years partnerships or professionals were allowed to render accounts for their business income for periods ending on dates other than the last day of February under section 66(13)*ter* but that provision was deleted in 2002 and replaced by section 66(13A).[1] Section 66(13A) came into effect on 1 July 2002 and provides that a taxpayer (individual or trust) may apply to SARS to draw up financial accounts to a date other than the last day of February when SARS is satisfied that the whole or some portion of the taxpayer's income cannot be conveniently returned for any year of assessment.

Section 66(13A) applies when it is not convenient for a taxpayer to render accounts for business income derived during the period ending on the last

day of February. It does this by allowing the taxpayer to draw up accounts for the business for a period ending on a date agreed to by SARS.

A distinction must be made between a 'year of assessment' as defined in section 1, and the 'accounting period' for which financial accounts are drawn up. The 'year of assessment' of all natural persons and trusts runs from 1 March of one year to the last day of February of the succeeding year and this is not changed by section 66(13A). The 'year of assessment' will not necessarily coincide with the accounting period approved by SARS for which the financial accounts of the business are drawn up.

SARS may approve an application to draw accounts to a date other than the last day of February if satisfied that the whole or some portion of the taxpayer's income cannot be conveniently returned for any year of assessment, subject to any conditions as may be imposed.

Section 66(13A) deems the income for the accounting period to be the income for the year of assessment ending on the last day of February. It is not required to apportion any income to fall into the year of assessment.

The term 'income' is not used in its defined sense as contained in section 1 but rather in the sense of 'profit' or 'taxable income'. Such an interpretation is necessary in order to ensure that any deductions or allowances relating to an accounting period can be taken back or carried forward to a year of assessment.

Under section 66(13A) a taxpayer who cannot conveniently return income from a business or profession to the last day of February may apply to the SARS branch office at which that taxpayer is on register for permission to draw up accounts to another closing date. Any request of this nature is subject to conditions that SARS may impose. Generally the closing date so approved will determine into which year of assessment the results for the accounting period must be included and the dates on which provisional tax payments must be made.

6.2 Income Tax – Exclusion of certain companies and shares from a 'group of companies' as defined in section 41(1) – No. 75

This Note provides guidance on the application of the proviso to the definition in section 41(1).

Under certain circumstances the corporate rules provide relief from income tax when assets are disposed of between companies forming part of the same 'group of companies' as defined in section 41(1). Generally these relief measures defer the income tax on income and capital gains until the asset is disposed of to a third party or until a degrouping occurs.

The Act contains two definitions of a 'group of companies', namely, a wider definition in section 1 and a narrower definition in section 41(1). The narrower definition generally applies for the purposes of the corporate rules but is also used elsewhere in the Act.

The definition in section 41(1) starts with the definition in section 1 and then proceeds to exclude certain companies and shares by way of a proviso.

This Note is concerned with the application and effect of that proviso.

It is not permissible to interpret the proviso as an independent enacting clause and its provisions must be read as if they formed part of the opening words of the definition in section 41(1). The exclusion by the proviso of, for example, a controlling company from a group of companies will accordingly impact on whether its controlled companies remain part of a group of companies under the corporate rules.

The exclusion of non-resident companies by the proviso does not constitute discrimination under South Africa's tax treaties.

7. BINDING PRIVATE RULINGS

7.1 BPR 156 – Income Tax – Pension benefits accruing to a non-resident from a resident pension fund

This ruling deals with the question as to whether and to what extent a pension annuity and a retirement fund lump sum benefit, received by or accrued to a person who is not a resident of South Africa from a pension fund registered in South Africa, will be taxable in South Africa.

In this ruling all references to sections are to sections of the Income Tax Act applicable as at 13 August 2010 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of the definition of 'gross income' paragraphs (*a*) and (*e*).

<u>Parties to the proposed transaction</u>

The Applicant: An individual who is not a 'resident' as defined in section 1

The Pension Fund: A pension fund registered in South Africa and approved in terms of the Act

<u>Description of the proposed transaction</u>

The Applicant was employed by a company which is a resident of South Africa and forms part of a group of companies. In 1999 his employment with the company was terminated. He left South Africa to join another company, within the same group of companies, situated outside South Africa and became ordinarily resident in that other country. He subsequently moved to two further countries. While working in South Africa he contributed to the Pension Fund, and continued to contribute, although he stopped being a resident of South Africa

Conditions and assumptions

This ruling is subject to the following additional condition and assumption:

- The Applicant is not a resident of South Africa on the date that the pension annuity and retirement fund lump sum benefit from the pension fund accrues.

Ruling

The ruling made in connection with the proposed transaction is as follows:

- The portion of the pension annuity and retirement fund lump sum benefit received or accrued from a South African source, that is, which relates to services rendered in South Africa, will be included in the Applicant's gross income in South Africa.

7.2 BPR 157 – Income tax – Receipt of foreign assets and the subsequent donation thereof to a non-resident trust

This ruling deals with the income tax consequences arising from, and the attribution rules applicable to a distribution of foreign assets to be made by two non-resident discretionary trusts to a beneficiary who is a resident of South Africa, and the subsequent donation by the beneficiary of such assets to another non-resident trust.

In this ruling references to sections and paragraphs are to sections of the Income Tax Act and paragraphs of the Eighth Schedule to the Act, applicable as at 14 August 2013 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of the provisions of:

- section 25B;
- section 10B(2)(*a*);

- section 56(1)(*g*);
- section 7(8); and
- paragraphs 20(1)(*h*)(vi) and 80(3) of the Eighth Schedule.

Parties to the proposed transaction

The Applicant: A natural person who is a resident of South Africa

Trust A: A non-resident testamentary discretionary trust

Trust B A non-resident discretionary trust

Trust C: A non-resident trust to be founded by the Applicant

Company A: A non-resident company 2

Company B: A non-resident company

Description of the proposed transaction

The Applicant is a beneficiary of Trusts A and B. Trusts A and B hold all the shares in Companies A and B.

It is proposed that Trusts A and B will, in due course, distribute certain foreign assets in the form of loan accounts, cash reserves and shares to the Applicant. Upon receiving the distributed assets the Applicant intends to donate them to Trust C.

Conditions and assumptions

This ruling is not subject to any additional conditions and assumptions.

Ruling

The ruling made in connection with the proposed transaction is as follows:

- Distribution of Trust B's loan account in Company A to the Applicant
  - The distribution of the loan account to the Applicant will fall outside the ambit of section 25B(1), (2) and (2A).
  - The provisions of paragraph 80 of the Eighth Schedule will not apply to the distribution of the loan account to the Applicant.
  - The base cost of the loan account in the Applicant's hands will be equal to the market value (or face value) of the loan as at the

date of distribution in terms of paragraph 20(1)(*h*)(vi) of the Eighth Schedule.

- Distribution of Trust B's cash reserves to the Applicant
  - The distribution of the cash reserves to the Applicant will fall outside the ambit of section 25B(1), (2) and (2A).
- Distribution of Trust A's loan account and shares held in Company A to the Applicant
  - The distribution of the loan account and shares to the Applicant will fall outside the ambit of section 25B(1), (2) and (2A).
  - The provisions of paragraph 80 of the Eighth Schedule will not apply to the distributions of the loan account and shares to the Applicant.
  - The base cost of the loan account and shares in the Applicant's hands will be equal to the market value (or face value) of the loan and shares respectively as at the date of distribution in terms of paragraph 20(1)(*h*)(vi) of the Eighth Schedule.
- Donation of the foreign assets to Trust C
  - The donation by the Applicant of the foreign assets to Trust C will be exempt from donations tax under the provisions of section 56(1)(*g*)(ii).
- Section 7(8), read with section 10B(2)(*a*), will apply to the donation of the Company A shares to Trust C.
- Section 7(8) will apply to the donation of Trust A and B's loan accounts to Trust C to the extent that any interest is charged or there exists any obligation to pay interest on these loans.
- Section 7(8) will apply to the donation of Trust B's cash reserves to Trust C to the extent that any interest is earned on such reserves, or from any amounts arising in Trust C as a result of the utilisation of such funds for the purchase of an income–generating asset.

- The application of section 7(8) as per points 6.5 to 6.7 above will be limited to the amounts generated in Trust C, as a result of the donation of the foreign assets by the Applicant, and it will not apply to any amounts generated in or by Company A.

8. BINDING GENERAL RULING

8.1 BGR 20 – Interpretation of the expression 'substantially the whole'

For the purposes of this ruling:

- **'PBO'** means a public benefit organisation approved by the Commissioner under section 30(3);
- **'section'** means a section of the Act;
- **'the Act'** means the Income Tax Act No. 58 of 1962;
- **'Transfer Duty Act'** means the Transfer Duty Act No. 40 of 1949; and
- any word or expression bears the meaning ascribed to it in the Act.

This binding general ruling provides clarity on the interpretation of the expression 'substantially the whole' as referred to in sections 10(1)(*c*N), 10(1)(*c*O), 30B, and paragraph 63A of the Eighth Schedule to the Act and section 9(1)(*c*) of the Transfer Duty Act.

Background

Under the partial taxation system a PBO is permitted to conduct a business undertaking or trading activity within certain prescribed parameters and becomes taxable on receipts and accruals derived from those activities in excess of prescribed limits while at the same time retaining exemption for its public benefit activities. In view of their partially exempt status PBOs should not enjoy an unfair tax advantage over other taxpaying entities.

The legislature recognised that it was not possible for an organisation to carry on separate activities that were completely independent of one

another. The concept of 'substantially the whole' was accordingly introduced into the legislation to ensure that the sole or principal object of the PBO remains the carrying on of public benefit activities, while at the same time allowing certain parameters within which the PBO can carry on its trading operations.

The concept of 'substantially the whole' was later also introduced into legislation affecting the exemption of approved recreational clubs and membership based organisations.

As the PBOs and approved recreational clubs effectively use assets to carry on trading activities to produce exempt and non-exempt income, the legislation dealing with capital gains and losses as well as transfer duty was also amended to give effect to the concept of 'substantially the whole'.

The law

Set out below are the relevant provisions of the Act and the Transfer Duty Act which refer to the expression 'substantially the whole'.

Public benefit organisations

Section 10(1)(*c*N)(ii)(*aa*)(B) provides that the receipts and accruals of a PBO approved by the Commissioner under section 30(3) derived from any business undertaking or trading activity will be exempt from normal tax to the extent that the receipts and accruals are derived from a business undertaking or trading activity which:

> 'is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost'.

Paragraph 63A of the Eighth Schedule provides among other things that a PBO approved by the Commissioner under section 30(3) must disregard any capital gain or capital loss determined in respect of the disposal of an asset if substantially the whole of the use of that asset by that PBO on and after valuation date was directed at:

- a purpose other than carrying on a business undertaking or trading activity; or

- carrying on a business undertaking or trading activity contemplated in section 10(1)(*c*N)(ii)(*aa*), (*bb*) or (*cc*).

<u>Recreational clubs</u>

Section 10(1)(*c*O) provides that the receipts and accruals of a recreational club approved by the Commissioner under section 30A will be exempt from normal tax to the extent that they are derived from any business undertaking or trading activity that:

> 'is carried out on a basis substantially the whole of which is directed towards the recovery of cost'.

<u>Membership-based organisations</u>

Section 10(1)(*d*)(iii) and (iv) provide that the receipts and accruals of the following entities are exempt from normal tax:

- A mutual loan association, fidelity or indemnity fund, trade union, chamber of commerce or industries (or an association of such chambers) or local publicity association approved by the Commissioner in terms of section 30B [section 10(1)(*d*)(iii)].
- A company, society or other association of persons established to promote the common interests of persons (being members of such company, society or association of persons) carrying on any particular kind of business, profession or occupation approved by the Commissioner under section 30B [section 10(1)(*d*)(iv)].

Section 30B(2)(*b*) provides among other things that the Commissioner must approve an entity for the purposes of section 10(1)(*d*)(iii) or (iv) whose constitution or written instrument provides that:

- 'the entity is required to utilise substantially the whole of its funds for the sole or principal object for which it has been established' [section 30B(2)(*b*)(iv)];

- ‘substantially the whole of the activities of the entity must be directed to the furtherance of its sole or principal object and not for the specific benefit of an individual member or minority group’ [section 30B(2)(*b*)(vi)]; and
- ‘substantially the whole of the entity’s funding must be derived from its annual or other long-term members or from an appropriation by the government of the Republic in the national, provincial or local sphere [section 30B(2)(*b*)(ix)].

Transfer duty

Section 9(1)(*c*) of the Transfer Duty Act provides that no duty shall be payable in respect of the acquisition of property by a PBO approved by the Commissioner under section 30(3) or by any institution, board or body, which is exempt from normal tax under section 10(1)(*c*A)(i) which has as its sole or principal object the carrying on of any public benefit activity contemplated in section 30:

> ‘in respect of property acquired by such public benefit organisation, institution, board or body, the whole, or substantially the whole, of which will be used for the purposes of one or more public benefit activity carried on by such public benefit organisation, institution, board or body, as the case may be . . .’.

Ruling

The expression ‘substantially the whole’ is regarded by SARS to mean 90% or more. However, in order to overcome certain practical difficulties SARS will accept a percentage of not less than 85%. The percentage must be determined using a method appropriate to the circumstances.

9. DRAFT GUIDES

9.1 Draft comprehensive guide to dividends tax

The purpose of this guide is to assist users in gaining a more in-depth understanding of dividends tax. While this guide reflects SARS' interpretation of the law, taxpayers who take a different view are free to avail themselves of the normal avenues for resolving such differences.

The foundation for this guide can be found in the various Explanatory Memoranda[1] which supported the dividends tax legislation. The initial explanations contained therein have been expanded with additional explanations and examples.

This guide is not an 'official publication' as defined in s 1 of the TA Act and accordingly does not create a practice generally prevailing under s 5 of that Act. It is also not a binding general ruling under s 89 of Chapter 7 of the TA Act. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

This guide reflects the law as at 1 February 2013 including amendments effected by the Tax Administration Laws Amendment Act 21 of 2012 and the Taxation Laws Amendment Act 22 of 2012.

10. DISCUSSION DOCUMENT – ON THE TAX IMPLICATIONS FOR THE SELLER AND PURCHASER IN RELATION TO THE ASSUMPTION OF CONTINGENT LIABILITIES IN PART SETTLEMENT OF THE PURCHASE PRICE OF ASSETS ACQUIRED AS PART OF A GOING CONCERN

Following recent South African and International court decisions, SARS has received a number of requests for clarity regarding the income tax implications for

the seller and the purchaser in relation to the assumption of contingent liabilities in part settlement of the purchase price of assets acquired as part of a going concern.

The purpose of this discussion paper is to set out SARS' preliminary views and to invite comments from taxpayers and practitioners by 31 March 2014. Accordingly, this discussion paper sets out SARS' views on the income tax implications for the seller and purchaser when the transaction is structured so that the purchase price of assets acquired as part of a going concern is settled or partly settled by the assumption of free-standing contingent liabilities. The outcome will be the same regardless of whether the sale agreement reflects the purchase price as comprising a lump sum net amount or as an itemised list of assets less liabilities and contingent liabilities.

This discussion paper does not consider the effect, if any, of the application of the corporate rules contained in sections 41 to 47 of the Income Tax Act. The views set out in this document are not final and, as mentioned above, interested parties are invited to submit comments to policycomments@sars.gov.za by 31 March 2014. Once comments have been received SARS will consider publishing Interpretation Notes on appropriate aspects of the discussion paper.

The expression 'sale of a business as a going concern' is generally used to refer to the circumstances in which a person sells all or a part of a business which is capable of separate operation and constitutes an income-earning activity in its own right at the date of sale. The nature of the particular business will dictate the assets which need to be transferred in order to ensure that the business (or part of it) is capable of operating in its own right.

A business, generally speaking, does not need to be transferred with any liabilities in order to be able to operate as an income-earning operation in its own right. Liabilities may, however, need to be transferred for legal reasons (for example, a requirement under environmental laws) or commercial reasons (negotiated between the parties). The nature of the liabilities transferred or taken over could be absolute and unconditional (for example, trade creditors or loan obligations) or conditional (for example, leave pay provisions, bonus provisions, post-retirement medical aid provisions and warranty provisions).

The sale of a business as a going concern can be structured in a variety of ways. The purchase price is often settled by the purchaser through a combination of a cash payment to the seller, the undertaking to settle specified debts on behalf of the seller, the assumption of specified contingent liabilities (that is, the undertaking to settle a seller's contingent liabilities if and when they materialise), a loan account and the issue of shares (when the purchaser is a company). This discussion paper considers the income tax implications for the seller and purchaser when a portion of the purchase price is settled by the purchaser assuming the seller's free-standing contingent liabilities.

11. INDEMNITY

Whilst every reasonable care has been taken in the production of this update we cannot accept responsibility for the consequences of any inaccuracies contained herein or for any action undertaken or refrained from taken as a consequence of this update.