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COMPANIES

2579. Small business corporations

On 19 January 2017, The Taxation Laws Amendment Act was promulgated to give effect to the various tax proposals announced in the 2016 National Budget Speech. One of these proposals relates to the extension of the small business corporations (SBCs) tax regime to personal liability companies (PLCs).

By way of background, the SBC tax regime, which was introduced in 2001 to stimulate development and encourage fixed capital formation, allows for certain

concessions to entities which comply with the definition of an SBC as set out in section 12E(4)(*a*) of the Income Tax Act, 1962 (the Act). The concessions are in the form of progressive tax rates applicable to entities qualifying as SBCs (i.e. 0%, 7%, 21% or 28%) and the granting of special allowances for the manufacturing assets used by SBCs. These allowances include a 100% tax deduction for the costs of new and unused manufacturing plant and machinery brought into use by the SBC as well as a three-year accelerated write-off for other types of assets.

As mentioned above, for an entity to qualify as a SBC, the entity must meet certain requirements which comprise four key areas, namely

(i) a legal entity requirement;
(ii) a holder of shares requirement;
(iii) a gross income limitation requirement; and
(iv) a business activity requirement.

For purposes of this article, we will only discuss the legal entity requirement.

Legal entity requirement

When the SBC tax regime was introduced in 2001, one of the requirements for qualifying as a SBC was that the taxpayer had to be a juristic person in the form of a close corporation or a company registered as a private company in terms of the then applicable Companies Act, 1973 (Old Companies Act). According to the Explanatory Memorandum to the TLAB, the scope of the definition of SBC was "intentionally limited to curb the disguise of passive income and remuneration as business earnings". The reasoning for such limitation was that such a disguise would have allowed persons rendering professional services to take advantage of the progressive tax rates that apply to SBCs instead of having the disguised passive income and remuneration taxed at 28%.

As a result of the abovementioned limitation, an entity could not qualify as a SBC, if more than 20% of its income and capital gains was made up of passive income and income earned by the entity as a result of rendering certain professional services which were performed by a person who held an interest in the entity.

The abovementioned limitation was relaxed in 2005 and entities that rendered personal services could qualify as SBCs (provided that they employed at least three full-time employees who did not have an interest in the entity and were not 'connected persons' (as defined) in relation to those that have an interest in the entity).

Under the Old Companies Act, a PLC fell within the definition of a private company. Historically therefore, PLCs could have qualified as SBCs. This situation, however, no longer prevails due to the fact that when the new Companies Act, 2008 came into effect, PLCs were expressly excluded from the definition of a private company. Consequently, PLCs, which in most cases render personal services, cannot qualify as SBCs for tax purposes and as a result cannot benefit from the SBC tax regime.

In order to rectify this anomaly, Treasury proposed that PLCs be expressly included in the definition of SBC in section 12E(4) of the Act. However, PLCs will be subject to the requirement of employing at least three full-time employees who do not have an interest in the entity nor are related to any person who has an interest in the entity.

The TLAB proposed that the abovementioned proposal would take effect as of 1 March 2016. Pursuant to the public consultation process regarding the amendments proposed by Treasury, the Standing Committee on Finance indicated in its Final Response Document dated 15 December 2016, that PLCs will benefit from the SBC regime in respect of the years of assessment

commencing from the 2013 year of assessment, as the years of assessment prior to that would have prescribed.

In conclusion, it is quite clear that the move to include PLCs in the SBC tax regime will be welcomed by qualifying PLCs as such inclusion is in line with the objectives of the SBC tax regime, namely the development and fixed capital formation of SBCs.

Cliffe Dekker Hofmeyr

Companies Act, 1973: definition of 'private company'
Companies Act, 2008: definition of 'private company'
ITA: Section 12E
Final Response Document on Taxation Laws Amendment Bill, 2016 and Tax Administration Laws Amendment Bill, 2016

DAVIS TAX COMMITTEE

2580. Final Report on Estate Duty

On 24 August 2016, with the consent of the Minister of Finance, the Davis Tax Committee (DTC) published its final report on macro analysis of the tax system, small and medium enterprises and estate duty.

The committee advised that it would conduct a further investigation into wealth taxes and that this would be dealt with in a separate report.

The estate duty report dealt with estate duty and trusts, and contains a number of recommendations which need to be evaluated by the National Treasury with a view to amending the tax laws.

The DTC recommends that the estate duty regime should be reviewed in order to establish an effective and equitable package of major abatements and rates of duty.

The retirement fund abatement currently available should be retained, while the maximum threshold for tax deductible retirement fund contributions should be increased from the current cap of R350 000 per year to take account of inflation.

The DTC recommends that the inter-spousal estate duty deduction under section 4(*q*) of the Estate Duty Act, 1955 should be withdrawn and replaced with a substantial increased primary abatement thus ensuring consistent and equitable treatment for all taxpayers regardless of marital status.

The report recommended that the primary abatement for estate duty should be increased to R15 000 000 for all taxpayers. Furthermore, it has been proposed that the rate of estate duty be increased from 20% - 25% of the dutiable value of an estate exceeding R30 000 000.

There has been some discussion regarding the imposition of estate duty and capital gains tax (CGT) on death and whether that amounts to double taxation. The DTC indicated that CGT is regarded as an income tax on capital and not a wealth tax and that estate duty and donations tax are wealth taxes and therefore the DTC does not agree with the contention that estate duty and CGT amounts to double taxation and does therefore not support the call for estate duty to be removed.

It has also been recommended that the current roll-over provisions available relating to inter-spousal bequests under the CGT rules should be repealed and replaced with a generous exemption available on death of R1 000 000.

Whilst proposing the removal of the inter-spousal exemption for estate duty and CGT the DTC recommends that the inter-spousal exemption within the donations tax system should also be removed. It proposes an exemption from donations tax that should provide for the reasonable maintenance of the taxpayer and their family.

It has been suggested that the transfer of assets in accordance with a divorce order should be subject to exemption similar to the death benefit for estate duty and CGT such that the taxpayer's death benefit reductions would be reduced by the quantum of any allowances available or utilised during the taxpayer's lifetime.

National Treasury has been urged to consider the possibility of extending the deeming provisions of section 3(3)(*d*) of the Estate Duty Act to contain deeming provisions such that where an interest-free loan is made available by a person to a trust, the assets attributable to that loan should be included in the deceased's estate for estate duty purposes. This is in addition to the recent proposal that where a funder makes an interest-free loan available to a trust, the funder be subject to donations tax thereon using the official rate of interest, currently 8% per year.

SARS has been urged to examine all trusts on registration and to investigate the transfer of assets into trusts to ensure the reduction of aggressive tax planning and to provide a level of assurance to taxpayers that their affairs are in order. The DTC proposed that donors and beneficiaries of all vested trusts should be subject to strict disclosure requirements and enforcement measures.

The DTC also recommended that SARS should concentrate on the examination of any trusts in which a deceased person may have enjoyed a vested interest thereby ensuring that all income and capital has been brought to account for both income tax and estate duty purposes.

Insofar as the taxation of discretionary trusts is concerned, the DTC has recommended that the revenue income must be taxed in the trust in accordance with the definition of the gross income definition contained in section 1 of the Income Tax Act and that capital gains realised by the discretionary trust should be taxed in the hands of the trust itself prior to those assets or gains vesting in the beneficiary. The DTC agreed that the current flat rate of tax applicable to trusts should be retained and subject to adjustment in line with any changes made in the maximum personal income tax rate.

The DTC recommended that SARS should establish a separate investigations unit to thoroughly and comprehensively examine foreign trust arrangements.

The DTC recommended that estates with a net value of less than R15 000 000 should be exempt from estate duty and that estates with a value exceeding R15 000 000 should be subject to estate duty at a progressive rate. The report proposes that SARS should establish comprehensive records of all bare dominium and trust arrangements utilised for estate duty purposes and that all holders of part interests in property should be required to submit tax returns regardless of their income derived.

As indicated above, the DTC proposes that where an interest-free loan is made available to a trust, the deeming provisions of section 3(3)(*d*) of the Estate Duty Act should be amended to include deeming provisions such that the asset acquired by the trust as a result of an interest-free loan should be added to the estate when the funder passes away. This would ensure that the interest-free loan no longer confers an estate duty advantage on the funder as a result of the deeming provisions set out in section 3(3)(*d*) of the Estate Duty Act.

The DTC

- considers that the inclusion of a general anti-avoidance rule in the Estate Duty Act has little prospect of success and therefore does not propose such a measure.
- has advised that it will conduct a further investigation into the implementation of wealth taxes in South Africa and that this will be dealt with in a separate report to be compiled by the DTC.
- did not agree with proposals that trusts should be regarded as corporates for tax purposes as that would mean that trusts would be liable to tax at the rate of 28% without being subject to dividends tax as is the case with a company.
- therefore recommended that the flat rate of tax applicable to trusts be retained at the current level but subject to adjustment from time to time in accordance with any changes made in the personal income tax rate.
- identified various issues relating to the treatment of foreign trusts and particularly the consequences of paragraph 80 of the Eighth Schedule and section 25B of the Income Tax Act.
- recommended that SARS and National Treasury review the legislation applicable to foreign trusts to address the deficiencies noted in the DTC's report.

Furthermore, the DTC points out that many foreign trust arrangements may in fact be managed from South Africa and as a consequence constitute South African resident taxpayers. Thus, taxpayers with foreign trust arrangements need to ensure that those are properly managed abroad and cannot be said to be tax resident in South Africa.

The DTC recommended that offshore retirement funds be further investigated by SARS to establish the nature of those funds and whether the South African resident contributing to such funds has made a donation to that fund.

The concerns raised by the DTC in this regard relate to the non-payment of donations tax and investments made into the offshore retirement fund and that upon the taxpayer's death the accumulated investment would not appear to be required to be included in the South African taxpayer's estate on the basis that no vested right exists in respect of the accumulated capital and capitalised income of the foreign trust.

In conclusion, it must be noted that the DTC makes recommendations to the Minister of Finance who will take into account the DTC's report and will make any appropriate announcements in the course of the normal budget and legislative process.

Thus, as is the case with all tax policy proposals, they will be subject to the normal consultative processes and parliamentary oversight once announced by the Minister. That means that the DTC is not entitled to make firm policy proposals which must be accepted by government.

ENSafrica
Estate Duty Act: Sections 3(3)(*d*) and 4(*q*)
ITA: Section 1(1) – 'gross income' definition, section 25B and paragraph 80 of the Eighth Schedule
Editorial Comment: Under the chairmanship of Judge Dennis Davis, the committee has been tasked with an enquiry into the role of the tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability.

A number of reports have already been issued by the committee and more will follow. While we will be publishing articles on the work and reports of the committee, it must be recognised that not all of its recommendations will be accepted by the Minister of Finance and find their way into our tax legislation.

FRINGE BENEFITS

2581. Expatriate employees seconded to South Africa

The nature of the business of many multinational companies requires them to send their employees to other countries across the globe in order to, among other things, manage and assist with special projects, implement firm-wide systems and ensure a standard level of quality in operations. Such seconded employees are often subject to tax in their host country, yet remain tax residents in their home country.

In order to avoid the potential double taxation of remuneration, many of these companies implement a tax equalisation package with such employees, whereby the tax on remuneration for the seconded employees remains the same regardless of where they are working in the world. In other words, it is agreed between the relevant parties that the host country company will cover all taxes incurred on remuneration derived in the host country, such that the seconded employee is in the same tax position as if he were working solely at home.

This mechanism is seen as useful in attracting many employees to sign up and agree to secondments which is essential to the sustainability of such businesses.
In *ABC (Pty) Ltd v CSARS*, as yet unreported, Tax Court (Johannesburg), Case No. IT13775, handed down on 29 April 2016, the Tax Court had to consider issues arising as a result of the tax arrangements entered into between the host country employer (taxpayer) and its expatriate employees who were seconded from their home countries to work in South Africa under a similar arrangement as described above.

Facts

Without repeating the facts verbatim, the following was relevant:

- the taxpayer was part of the ABC Group, a worldwide organisation which required its various operations throughout the world to operate on a similar basis and apply similar standards;
- as part of its global business imperative, employees of the ABC Group were required to work for short or medium term periods in foreign countries;
- invariably these seconded employees remained residents in their home countries and continued to submit tax returns there;
- the standard employment relationship within the ABC Group operated on a tax equalisation basis as described above but which essentially involved the expatriate employees paying the exact same effective rate of tax in their host country as they would have paid had they remained in their home country;
- in order to protect the interests of the taxpayer and the ABC Group, payments were made to identified tax consultancy firms for services rendered in respect of the taxpayer's expatriate employees; and
- the employees had no choice regarding the provision of the tax consultancy services as it was one of their conditions of employment.

Issues

The parties were in agreement that the following two issues needed to be considered by the court:

- whether the payments made by the taxpayer to the tax consultants fell within the ambit of paragraph (*i*) of the definition of 'gross income' in section 1 of the Income Tax Act,1962 (the Act) and, if so;
- whether the payments constituted taxable fringe benefits within the ambit of paragraphs 2(*e*) or 2(*h*) of the Seventh Schedule to the Act.

First Issue: whether payments made fell within definition of paragraph (*i*) of gross income of expatriate employees

The first question which needed to be considered was whether the expatriate employees received or accrued any benefit or advantage from the taxpayer's

payment of the tax consultancy fees within the meaning ascribed in paragraph (*i*) of the definition of 'gross income'.

The taxpayer's main contention that the expatriate employees received no benefit or advantage was that such employees were not placed in a better financial position as a result of the tax consultancy services than they would be without them being provided. Furthermore, the expatriate employees' position was not improved as a result of the taxpayer's payments to the tax consultants and the utilisation of their expertise because the employees' salary and tax obligations remained the same as a result of the tax equalisation arrangement.

SARS's main counter-argument was that the tax consultancy fee paid by the taxpayer in respect of the expatriate employees was a benefit for which they otherwise would have had to pay had the agreement between the taxpayer and the employees not provided differently. In other words, while there was no outward increased benefit to the taxpayer's financial position, there was also no reduction as a result of having to pay such expenses out of their own pockets in the ordinary course.

Keightley J held that SARS's argument was consistent with the historic case law and that the tax consultancy services which were provided free of charge to the expatriate employees were benefits with a monetary value and accordingly fell within the definition of 'gross income'. Therefore the taxpayer's argument that there was no actual outward benefit to the expatriate employees' financial position was not relevant.

Analysis

The very nature of a taxable benefit is that it often involves a salary sacrifice which is a substitution of a cash component of an employee's overall cost to company remuneration package, for a non-cash benefit, that may result in a lower amount subject to the deduction of employees' tax. As it happens, paragraph (*i*)

of the ‘gross income’ definition refers to the ‘cash equivalent value’ rather than an ‘amount’.

As the values of such benefits are often difficult to establish, the Seventh Schedule provides for specific calculation methods in this regard. It therefore follows that, in addition to the court’s reasons for its decision on this issue, the taxpayer’s argument would not hold water as it matters not whether employees are placed in a better financial position or not, but rather whether a benefit has been granted which has a ‘cash equivalent value’ calculated in accordance with the Seventh Schedule.

Clearly where payments are made by employers on behalf of employees for services provided to employees for private purposes, such payments will result in a measurable ‘cash equivalent value’.

Second issue: whether the benefits granted were taxable under either paragraph 2(*e*) or 2(*h*) of the Seventh Schedule to the Act

The crux of the second issue was whether the employees had utilised the tax consultancy services for their private or domestic purposes. Importantly, the parties agreed that, to the extent that the tax consultancy services were not wholly utilised for the employees’ private use but also partly for the use of the employer’s business, then such payments would fall outside of paragraph 2(*e*) of the Seventh Schedule.

The taxpayer’s main argument in this regard was therefore that the contractual relationship between it and the employees were such that the taxpayer was bound to pay the employees’ tax and that the services of the tax consultant were, at the very least, partially for the taxpayer’s own business purposes. As it so happened, any refunds due by SARS were in fact paid over to the taxpayer and not the expatriate employees.

SARS on the other hand, stated that when considering the actual services rendered, they were plainly for the employees' domestic or private use, which was demonstrated in the description of the services in question, namely registration/de-registration as a taxpayer with SARS, preparation and submission of annual income tax returns, and review of annual income tax assessments. In essence these services related solely to the individual tax obligations of each employee and were quintessential to the relationship between SARS and the individual employee taxpayer.

The court agreed with SARS's contentions and held that if one had regard to the actual nature of the services rendered they were for the employees' private use, which was to comply with the individual tax obligations of the employees with SARS. Keightley J, however, pointed out that while it may be so that, as between the taxpayer and its expatriate employees, the intention of obtaining services was also to assist the taxpayer to fulfil its contractual obligations to those employees, such consideration of the intention of the parties was not the determinative factor.

Keightley J thereafter referred to *CSARS v Brummeria Renaissance (Pty) Ltd* [] [2007] 69 SATC 205, in which the Supreme Court of Appeal (SCA) held that even though a receipt or accrual is in a form other than money (in that case the benefit of the use of an interest-free loan), which cannot be alienated or turned into money, it did not mean that the receipt of the right has no monetary value. The Brummeria case stated that the test to be applied in order to determine whether a receipt or accrual has a monetary value is therefore an objective one and not subjective. The learned judge in the ABC case then applied the Brummeria principle in considering from an objective point of view, whether the tax consultancy services were for private use.

Analysis

There is an argument that the application of the objective test in the Brummeria case as to whether something is utilised for private or domestic purposes is

slightly misconstrued. This argument is based on the fact that, in Brummeria, the court applied such a test within a slightly different context. Despite this argument, the objective test is nevertheless the correct one as the court should look to the purpose of the cheap or free services and not the intention of the parties in providing such services. This is consistent with the literature on the issue and the parties in ABC agreed to this approach.

What is not clear from the judgment is the exact nature of the business of the taxpayer and the ABC Group. To the extent that the taxpayer could prove to the court that its business was of such a nature that it had to second employees offshore but that in order to attract such employees it had to offer tax equalisation packages, then the case may have had a different outcome.

In other words, there may be a persuasive argument in favour of the taxpayer that, in the event of the tax equalisation packages not being offered to employees, then such employees would not agree to secondments which would be irreparably detrimental to the ongoing sustainability of the taxpayer's business and therefore not wholly expended for the employees' private purposes. Unfortunately, the judgment is silent on any such evidence or arguments put forward in this regard.

Conclusion

The judgment re-emphasises that employers must be very careful when making any payments for and on behalf of employees no matter the extent of agreements between the parties and what their intentions are. Even to the extent that such services are provided voluntarily by the employer without regard to the employee's requirements, such as security services at a key employee's home, it is often difficult to ensure such benefits fall outside of fringe benefits tax as contemplated in the Seventh Schedule.

Cliffe Dekker Hofmeyr

ITA: Section 1(1) – definition of 'gross income', paragraph (*i*) and paragraphs 2(*e*) and 2(*h*) of the Seventh Schedule

GROSS INCOME

2582. Investment grants capital or revenue

In a judgment in the Tax Court for the Eastern Cape delivered on 20 August 2016 (*ABC (Pty) Ltd v CSARS* Case No. 13539/13673) the issue for decision was whether a subsidy, the Productive Assets Allowance (PAA), payable in terms of the Motor Industry Development Programme (MIDP), was a receipt or accrual of a capital nature.

The MIDP offered automotive manufacturers a number of potential benefits, including:

- tradable import rebate credit certificates awarded by reference to exports;
- A duty-free allowance to offset customs duties on imported components, based on the retail list price of motor vehicles adjusted by a factor specific to the manufacturer;
- phased reduction of duties on imported vehicles and components;
- duty drawbacks for exporters related to imported components on exported vehicles; and
- an investment subsidy in the form of the PAA, which provided import duty credits equivalent to 20% of the value of qualifying investments in productive manufacturing assets, payable over a five-year period.

In order to qualify for the PAA, an automotive manufacturer was required to invest in new productive capacity that was equal to or exceeded a prescribed minimum value. The investment must have been made with a view to rationalising the number of vehicle models produced, through which efficiencies and economies of scale might result. In turn, these would contribute to a more

competitive manufacturing industry which could export motor vehicles and generate foreign currency receipts.

Manufacturers would fill ‘gaps’ in the range of vehicle models offered to the public by way of importing these models. Import rebate credit certificates were the ‘currency’ in which MIDP benefits were paid. They were differentiated by the fact that PAA certificates were non-tradable, whereas certificates that related to export-import complementation could be traded.

In the matter before the Tax Court, the appellant, a motor manufacturer, had claimed that PAA certificates awarded were receipts or accruals of a capital nature. SARS opposed this view, contending that they were amounts of a revenue nature.

The law

The Income Tax Act does not define what constitutes capital nor does it explain the meaning of the term ‘of a capital nature’. As a result, the term has been interpreted in the courts in a variety of contexts. From this, it has emerged that it is impossible to distil a single overriding conceptual principle from all the decisions. The issue is one of law, which must be determined based on the prevailing facts and circumstances.

By far the majority of determinations of whether an accrual is income or capital relate to the disposal of assets. As this circumstance was not under consideration, much of the body of our law on the issue is not relevant to it. Instead, the general principles should be revisited.

In early decisions, the courts were at pains to identify income by reference to the activity that gave rise to its accrual. Thus, in *WH Lategan v CIR* [1926] 2 SATC 16 at 19, Watermeyer J stated:

"But the word 'income' in its ordinary sense did not always consist of money, as had been pointed out in Booysen's case (1918, A.D. 576). 'Income', unless it was in some form such as a pension or annuity, was what a man earned by his work or his wits or by the employment of his capital. The rewards which he got might come to him in the form of cash or of some other kind of corporeal property or in the form of rights."

The principle that emerged was that income is the result of some form of activity, such as employment or investment. Capital, on the other hand, was the source from which income could be generated, and could take the form of personal attributes (diligence, education, ingenuity) or physical or financial assets (land, buildings, plant and machinery, company shares, cash). Amounts that accrued fortuitously or otherwise than from the performance of services or the investment of capital were typically regarded as being of a capital nature. It is evident that the reason the amount was received by or accrued to a taxpayer is a critical factor in determining whether or not an amount is of a capital nature.

In the case of subsidies, there are only three reported cases in South Africa.

ITC 402 [1937] 10 SATC 111 was a matter in which a produce merchant had claimed subsidies in respect of products exported under the Export Subsidies Act of 1931. A portion of the claim relating to the 1932 year of assessment was rejected but, after repeated applications by a number of exporters, the relevant Minister approved payment of that portion in 1936. The taxpayer asserted that the amount that accrued was of a capital nature as it had accrued as a result of a 'goodwill' exercise of discretion by the Minister. This view was not shared by the President of the Court, who stated at 114:

"The subsidy was only payable to him because he was an exporter of a primary product. Therefore, his claim to subsidy arose out of his trade, and, in the ordinary course, any receipts by him on account of subsidy would be trade

receipts, and would be included in his income or takings as a produce merchant. The position does not seem to us to be altered by the fact that the claim was disputed. It does not appear to us to be different from any other claim, such as a claim for damages for non-delivery of goods which might be made by a trader. If the claim is disputed, but subsequently paid, it may be said that the claim is paid without admitting liability, and in that sense the payment may be said to be one ex gratia. It can never, however, be regarded as a gift in the sense that the making of a present is a gift. That is something entirely different from the making of a payment to a trader in terms of an Act conferring a special subsidy upon traders in respect of their trade or in respect of a presumed loss sustained in their trading. Therefore, the basis of the payment is entirely the appellant's trade. As such, it appears to us to be a trading receipt."

ITC 1435 [1987] 50 SATC 117 involved the treatment of a subsidy which had been paid by a company to a cooperative society of dairy farmers as a grant-in-aid in respect of the purchase of a sophisticated machine for monitoring milk quality. The Court had no hesitation in identifying the amount of the subsidy as a receipt or accrual of a capital nature, a classification with which, it appears from the judgment, the Commissioner for Inland Revenue agreed.

These two Tax Court decisions have no binding effect. However, the third matter, *Moolman v CIR* [1954] 19 SATC 127 was a decision of the Appellate Division (now Supreme Court of Appeal), which is of binding effect on courts of subordinate jurisdiction.

The facts were that, in terms of an agreement between the governments of South Africa and the United Kingdom during the Second World War, the South African government purchased the wool production of South African farmers, which was sold to the UK government at a fixed price. It was agreed that any surplus remaining at the termination of the arrangement would be sold on the open market and any profit shared between the respective governments equally. When a

surplus was realised, the SA government enacted legislation to pass on its share of the profit by way of a subsidy to every producer of qualifying wool in proportion to the gross proceeds of qualifying wool produced by that producer.

Moolman received a payment in terms of the legislation and asserted that it was a receipt or accrual of a capital nature. Centlivres CJ, who delivered the judgment, was not prepared to accept the argument that the statutory right was a fortuitous event, and set out the approach to be adopted in the following terms at 136 to 137:

"His title to that sum is derived from that Act but the question still remains why Parliament decided that he should receive that sum. To adapt the language of the Judicial Committee of the Privy Council in Australia (Commonwealth) Commissioner of Taxation v Squatting Investment Company Limited*, [1954] All E.R. 349 at 360-2, that sum was awarded to the appellant simply because he had sold wool in the Union to the Government of the United Kingdom during the period from the first day of August, 1940, to the thirty-first day of July, 1946, and section 2 of the Act makes this abundantly clear. The Act directly associated the payment of that sum with the participating wool sold by the appellant to the Government of the United Kingdom, first by directing payment to the appellant as a seller and, secondly, by making the total of the payment depend on the ratio between the gross proceeds of the participating wool produced by the appellant and the amount of the wool-profits payable to the Union Government in pursuance of the disposals plan."*

If one examines the rationale in this statement, it isolates the inquiry to identifying the cause of the entitlement. Thereafter, it finds corroboration by establishing that the basis upon which the amount of the compensation was determined was related to that cause. The inescapable conclusion was that the subsidy represented additional proceeds from the sale of wool and was not of a capital nature.

Our law has therefore made it clear, in the above three judgments, that the determination of whether an amount is of a capital or revenue nature should be made by reference to the originating cause for the grant of the subsidy.
However, the application of this principle has not been uniformly interpreted by commentators. Subsidies have been linked with the payment of damages or compensation, in which the focus is frequently on the nature of the loss that is compensated. For example, *Silke on South African Income Tax* at Chapter 3.43 states:

"If a subsidy takes the form of a contribution towards the producer's cost of production of a certain commodity, it is submitted that it is of an income nature. On the other hand, if the subsidy is paid as a contribution towards the cost of fixed capital assets –for example, the government may contribute towards the cost of a new factory or plant and machinery –it is submitted that it partakes of the nature of capital and is not taxable."

This interpretation suggests that the form of the subsidy, rather than the cause giving rise to its payment, may be critical.

Application to the facts

In the judgment in the matter of *ABC (Pty) Ltd v CSARS*, Schoeman J acknowledged that she had been referred to the three South African decisions. Footnotes to paragraph 21 of the judgment confirm this. In that paragraph it is stated:

"It is the appellant's case that to determine whether the grant is revenue or capital, the predominant focus is on the purpose or cause of the grant. The appellant referred us to three cases where the courts asked 'What was the origin of the claim?', that the grant was to assist [the] appellant with the capital expenditure involved and was therefore of a capital nature, and why the grant was paid to the appellant." (Footnotes deleted)

Paradoxically, the learned Judge identified the origin of the claim but denied its relevance, as the judgment continued, in paragraph 22:

"In the instant matter the grant was made due to capital expenditure. However, if the PAA certificate was not utilised, within a stipulated period, as payment for customs duties on imported motor vehicles, the PAA certificate would lapse. The certificate was not tradable. The certificate was conditional and did not accrue until there were imports .If there were no imports within the necessary time frame, the condition had not been fulfilled and the certificate could not be used. The certificates only had value upon import of motor vehicles and not when the capital expenditure was incurred. The grant was to assist the appellant with the revenue expenditure, customs duty payable on imports." (Emphasis added)

Nowhere in the judgment is there any prior mention that the time of accrual was an issue. No mention is made of the argument adduced by the parties on the question of accrual. It is regrettable that Schoeman J should have dealt with the issue of accrual, apparently *mero motu*, in five short sentences with no apparent reference to authority to support the conclusion at which she arrived.

Conclusion

It is evident that the finding on the time of accrual was a new issue that had been introduced into the judgment by Schoeman J of her own volition. Had this element not been introduced, it is submitted that Schoeman J should have been led to adopt the approach of Centlivres CJ, such that the finding should have been that the grant was awarded to the appellant simply because it had made an investment in qualifying productive assets. The MIDP directed payment to the appellant *qua* investor and it made the total of the payment dependent on the amount of the investment.

The validity of the finding on accrual is critically analysed in a subsequent article.

PwC

ITA: Section 1(1) definition of ‘gross income’

TAX AVOIDANCE

2583. Assessed losses revisited

Section 103(2) of the Income Tax Act, 1962 (the Act) empowers the Commissioner for the South African Revenue Service (SARS) to disallow the setting off of an assessed loss or balance of an assessed loss against the company’s income if the relevant requirements are met. Western Cape Tax Court decision, Case No *IT 13164* as yet unreported, has again focused taxpayers’ attention on the requirements to be met in order for section 103(2) to apply. In this case, SARS relied on section 103(2) to disallow the set off of ABC (Pty) Ltd’s (ABC) assessed loss against income derived by ABC in respect of its 2005 to 2008 years of assessment.

Section 103(2) provides that whenever the Commissioner is satisfied that, *inter alia*:

- any agreement affecting any company or any change in the shareholding in any company;
- has been entered into or effected by any person solely or mainly for the purpose of utilising any assessed loss, any balance of assessed loss, any capital loss or any assessed capital loss, as the case may be, incurred by the company, in order to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof; and

- as a direct or indirect result of which income has been received by or has accrued to that company during any year of assessment;

the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed.

Briefly, the facts in *IT 13164* were as follows.

ABC was incorporated during 2000 and its shareholder was DX Ltd (DX), an Australian company. Prior to 2002, ABC had established a 120 seat call centre in Cape Town and used this to provide services to telecommunications companies. With effect from 2001, ABC terminated its cellular service provider contracts and disposed of its cellular phone subscriber base to telecommunications companies.

This resulted in disputes between ABC and the telecommunications companies in respect of amounts ABC alleged were due to it. ABC still owned the call centre and was bound to the lease in respect of the call centre property.

DX wanted to sell the shares in ABC and on 1 March 2002, concluded an agreement with JK (Pty) Ltd (JK). The agreement was for the sale of the call centre but excluded the shares in ABC. In terms of an option granted to JK, once the disputes with the telecommunications companies had been resolved, JK concluded a sale of (ABC) shares agreement with DX on 5 March 2003. Prior to this, JK had already been searching for a buyer for ABC; it wanted to sell the call centre and lease 30 seats according to its needs.

The shareholder (A) of the H group of companies (H), had, since the late 1990s, envisaged establishing an enterprise providing business processing outsourcing services. H already had a fitment call centre in Johannesburg (MNO branch). A had various ideas for expanding the business process outsourcing model to other call centre areas.

Among others, H envisaged providing processing services to its main competitor, VD and while the parties signed a memorandum of understanding in respect of a joint call centre, this did not materialise and H merely performed work for VD. For various commercial reasons, A was considering acquiring a separate call centre and expressed an interest in acquiring ABC's Cape Town call centre.

During November 2003, H (through MM Investments (Pty) Ltd), acquired the shares in ABC, subject to a lease between JK and ABC in respect of 30 seats. H consolidated the MNO branch into ABC and used the Cape Town call centre for the processing of other claims.

Testimony on behalf of H was that the offer to purchase the ABC shares was based on sound commercial grounds;

- to acquire an established call centre which could give effect to A's plan to expand the business process outsourcing model to other areas of call centre business,
- the lease agreement in respect of the Cape Town call centre premises,
- rental income from the 30 seats leased to JK; and
- the assessed loss.

While it was initially envisaged that H could use the Cape Town call centre for a joint venture with VD, as noted, this didn't materialise.

When questioned about the motive for acquiring the ABC shares, it was agreed on behalf of JK that the primary financial gain for JK at that stage was the assessed loss and easy access to an established call centre. In terms of an earlier court order, the first change in shareholding (i.e. from DX to JK) is the relevant change in shareholding for purposes of the case before the Tax Court. The rationale for this order is not evident from IT 13164.

The court summarised the requirements to be met in order for section 103(2)(*b*) to apply, i.e. the Commissioner must be satisfied that:

- any agreement affecting a company (ABC) or any change in shareholding in a company (ABC) has been entered into. This requirement was met and the case was limited to the change in ABC's shareholding from DX to JK,
- the agreement or change in shareholding directly or indirectly resulted in income being received by such company, i.e. ABC (the 'result requirement'), and
- the agreement or change in shareholding was entered into solely or mainly for the purpose of utilising any assessed loss, any capital loss or any assessed capital loss (the 'purpose requirement').

"as a direct or indirect result"

In *IT 13164*, the court held that the result requirement is an objective requirement and that the unbroken chain and tainted income must be identified. Since the case is limited to JK's acquisition of the ABC shares, the causal link between JK's motivation for the acquisition and the income had to be established for purposes of section 103(2).

According to the court, "direct and indirect" must not be applied in isolation. The income which is derived by the taxpayer must result from the change in shareholding. It was stated that: "If the legislature intended it to be any remote cause, the section would have been expressed in manner [sic] which reflects that the income could derive from any cause whatsoever."

Reference was made to *ITC 1123* [1968] 31 SATC 48. In this case, a new shareholder acquired the shares in a company which was previously involved in the manufacturing industry. The manufacturing business was not revived but

income from, *inter alia*, commission and interest was received. It was held that it is a question of fact whether a company has derived income "directly or indirectly" as a result of the change of shareholding. The company was an empty shell when the new shareholder acquired the shares. The shareholder then arranged financing and introduced a new and separate business. It was held that the income was derived as a direct or indirect result of the change in shareholding.

The court, in IT 13164, held that where the chain of causation is broken between the change in shareholding and the income being derived by the company, the income would not be as a result of the change in shareholding. In this regard, Allie J referred to the "*novus actus interveniens*" principle, i.e., where a new intervening event interrupted the chain of causation.

It was held that in the case of ABC, the income was derived from a later, intervening event and that the income was not contemplated when JK acquired the shares. Allie J held that even if JK had acquired the shares with the intention of selling them to a new shareholder who could utilise the assessed loss, it could not be said that JK, when it acquired the shares, contemplated that the new shareholder would in fact have sufficient income to utilise the assessed loss.

"sole or main purpose"

In this regard, the court held that:

"Although the section refers to 'any' change in shareholding; 'any' proceeds, 'any' time, 'any' person, 'any' assessed loss 'any' such income, the section contemplates a causal link between the change in shareholding, the motivation for the acquisition of the shares by the person who seeks to utilise the assessed loss and the means by which that income came to be owned and declared by the taxpayer.

The more contentious aspect of the formulation is the motivation for the change in shareholding. Those taxpayer companies that can show a sound commercial

purpose for the acquisition of the shares will have less difficulty in establishing that they don't fall foul of the section."

It was stated that had income been received or accrued to ABC when JK acquired the shares, JK would probably have fallen foul of section 103(2). However, since the income was derived from the efforts of H and after it had acquired the shares, it is the motivation of H in acquiring the shares that should be relevant in determining whether the anti-avoidance provision can be applied. The court referred to various facts and held that those facts supported the conclusion that the specific transaction had strong commercial substance as opposed to being an attempt to purely utilise the assessed loss of ABC.

In terms of section 103(4), the taxpayer bears the onus of proving or showing that the relevant agreement or change in shareholding was not entered into with the sole or main purpose of utilising an assessed loss to reduce, postpone or avoid tax.

In this case, the court was satisfied that ABC had discharged the onus of showing that the sole or main purpose of the change in shareholding to H was not to acquire ABC to utilise its assessed loss and held as follows:
"When the facts are considered in totality, then the H group's vision and projected business plan dovetailed with the existing call centre business that the taxpayer company had been engaged in, prior to the acquisition of the shares in the taxpayer company".

The case serves as a reminder that it remains a question of fact whether the requirements of section 103(2) will be met.

ENSafrica
ITA: Section 103

TRUSTS

2584. Section 7C loans

In draft legislation made public in July 2016, it was proposed that low interest loans to trusts by related parties (including founders and beneficiaries) would create a tax cost for the lender equivalent to 8% of the capital value of the loan (less any interest actually paid). If that tax cost was not refunded by the trust, the tax paid would be treated as a donation subject to 20% donations tax at the top marginal tax rates.

On an interest free loan of R5 000 000 the annual cost could be R196 800 per annum. This is equivalent to an annual tax cost of 3.936% of the capital value of the loan.

After numerous representations, Treasury has agreed to amend the proposal. The interest not charged on the loan (i.e. the amount of interest below interest at the official rate of (currently) 8% per annum) would be treated as a donation on the last day of the tax year and subject to donations tax at the rate of 20% payable by the lender.

This provision, which has been promulgated into the Income Tax Act as section 7C, applies to any loan, advance or credit made directly or indirectly to a trust by a natural person, or by a company at the instance of a natural person and that company is a connected person in relation to that natural person and the natural person or company is a connected person in relation to the trust.

The annual tax cost (based on the figures in the above example) would be R80 000 (5 000 000 x 8% x 20%). Although this is far less than the previously suggested R196 800, the annual amount of R80 000, where there was previously no cost, will necessitate a substantial reconsideration of current trust structures. The

amount of R80 000 is equivalent to an annual cost of 1.6% of the capital value of the loan.

Donations tax at 20% will only apply on annual donations (whether to trusts or others) in excess of the primary exemption (applicable to the donor/lender) of R100 000 per annum. This means that loans below R1 250 000 will not give rise to donations tax (8% of R1 250 000 is R100 000).

Loans to the following are excluded from the application of this new provision:

- Special trusts established solely for the benefit of persons with disabilities.
- Trusts that are registered with SARS as Public Benefit Organisations.
- Vesting trusts where the rights of beneficiaries are clearly established.
- To the extent that a loan is used by the trust for funding the acquisition of the primary residence of the lender.
- International loans where non-arms' length loans are subject to adjustment in terms of special tax rules in section 31 of the Income Tax Act.
- Loans in terms of Sharia compliant financing arrangements.
- Loans which are deemed to be dividends.

Section 7C will apply to all loans with effect from 1 March 2017 whether such loans were advanced before or after that date.

Although some might view these new proposals as a relief compared to the previous proposal, it needs to be borne in mind that the Davis Committee has made further recommendations in regard to trusts and we may not have seen the end of changes to tax legislation relating to trusts.

Even without any further changes, it must be noted that section 3(3)(*d*) of the Estate Duty Act, 1955 although virtually never applied to date, deems as property of the deceased for estate duty purposes, the assets of the deceased which he

(briefly) had the power to control. This may include the assets of a trust where the deceased was in effective control of the trust. Whether this would be strictly applied in future or whether other trust transactions would be seen as tax avoidance in the future is obviously not clear at this stage.

Careful consideration should be given before new trust structures are created and that existing structures should be carefully examined to ensure their continued effectiveness from a tax point of view. Obviously the many other valid reasons for the use of Trusts may well override any negative tax consequences.

Crowe Horwath
Estate Duty Act: Section 3(3)(*d*)
ITA: Sections 7C and 31

Editorial comment
The following is an extract from the Explanatory Memorandum on the Taxation Laws Amendment Bill issued by SARS on 15 December 2016. It explains clearly the thinking of SARS relating to loans created by the vesting of awards in a beneficiary without payment of the whole or portion of such award to such beneficiary:

"The proposed rules will apply only in respect of loans advanced or provided by a natural person or, at that person's instance, by a connected company. An amount that is vested irrevocably by a trustee in a trust beneficiary and that is used or administered for the benefit of that beneficiary without distributing or paying it to that beneficiary will not qualify as a loan or credit provided by that beneficiary to that trust if

- ***the vested amount may in terms of the trust deed governing that trust not be distributed to that beneficiary, e.g. before that beneficiary reaches a specific age; or***

- ***that trustee has the sole discretion in terms of that trust deed regarding the timing of and the extent of any distribution to that beneficiary of such vested amount.***

An amount vested by a trust in a trust beneficiary that is not distributed to that beneficiary will, however, qualify as a loan or credit provided by that beneficiary to that trust if that non-distribution results from an election exercised by that beneficiary or a request by that beneficiary that the amount not be distributed or paid over, e.g. if the beneficiary has reached the age at which a vested amount must be paid over or distributed to him or her and

- ***the trustee accedes to a request by that beneficiary that this not be done; or***
- ***the beneficiary enters into an agreement with the trustee in terms of which the amount may be retained in the trust."***

SARS NEWS

2585. Interpretation notes, media releases and other documents

Readers are reminded that the latest developments at SARS can be accessed on their website http://www.sars.gov.za.

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