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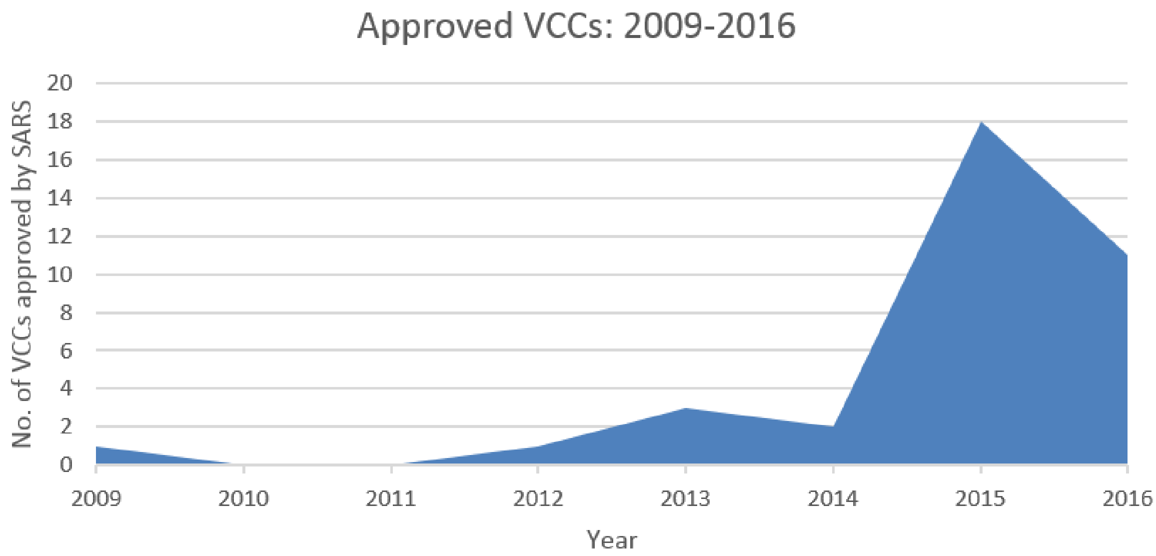
COMPANIES

2573. Venture capital companies

45 min CPD VERIFIABLE ARTICLE

Introduction

The venture capital company (VCC) regime was introduced in 2009, with an aim to encourage investors, by way of substantial tax benefits, to invest in small South African trading companies. VCCs are private investment companies, although they need not be, as the Income Tax Act, 1962 does not prevent VCCs from listing their shares on the Johannesburg Stock Exchange.



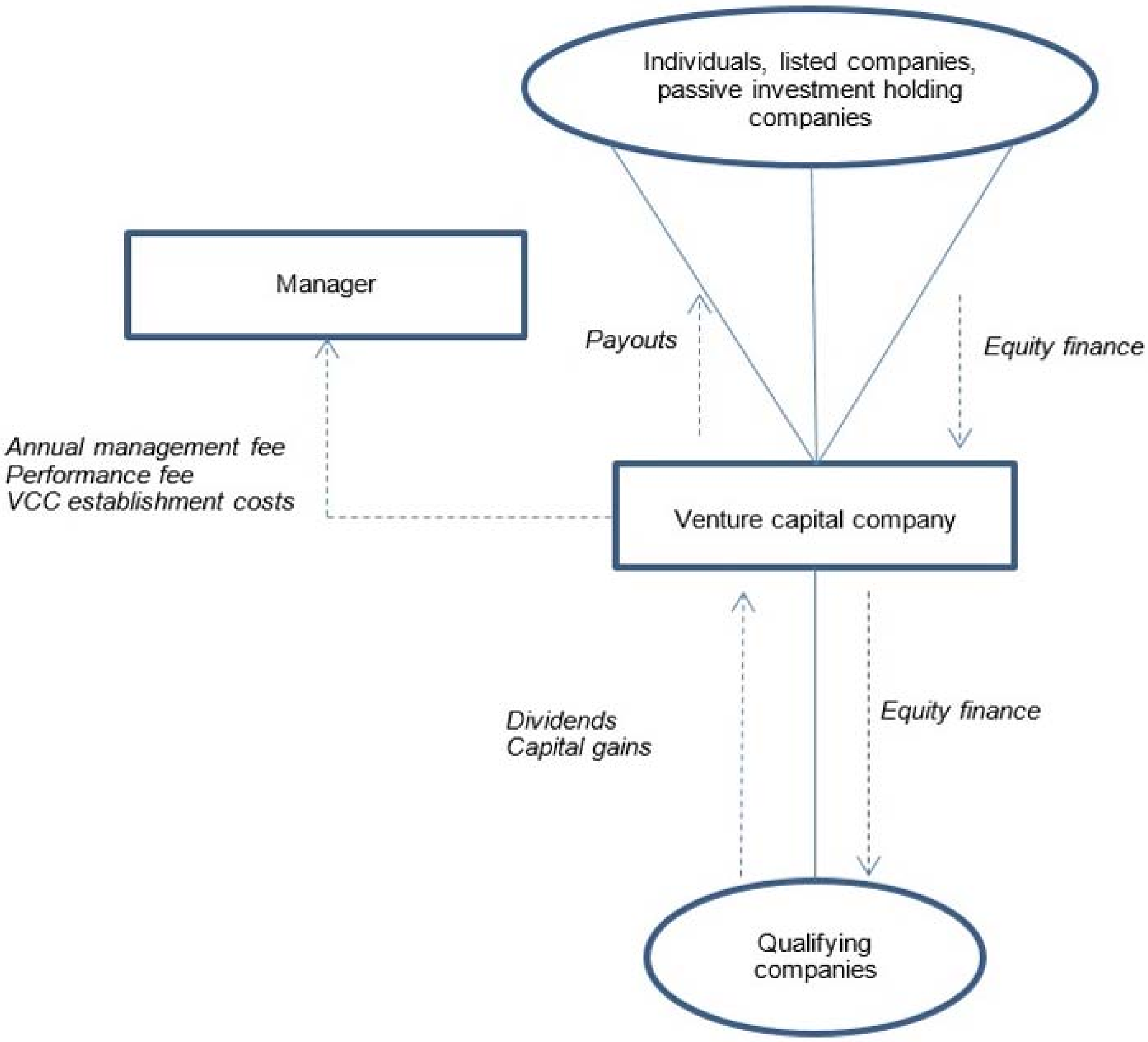
The past two years have seen a phenomenal increase in the number of VCCs. There are now 36 South African Revenue Service (SARS) approved VCCs, of which 29 were approved in the past two years.

The increase in the number of VCCs has also seen the emergence of VCC-specific advance tax rulings. The advance tax ruling system was introduced in 2006. Its purpose is to promote clarity, consistency, and certainty regarding the interpretation and application of tax legislation. An advance tax ruling is a written statement on how SARS will interpret and apply specific provisions of the applicable tax legislation. SARS publishes redacted versions of these advance tax rulings on its website.

On 11 September 2015, SARS issued binding private ruling 205, which dealt with the meaning of a "controlled group company" and "equity share". More recently, on 15 June 2016, SARS issued BPR 242 which, like BPR 205, also dealt with the meaning of a "controlled group company" and "equity share". However, BPR 242 goes further than BPR 205 in that it also considers the R50 million book value threshold and whether the qualifying company carried on business as a hotel keeper.

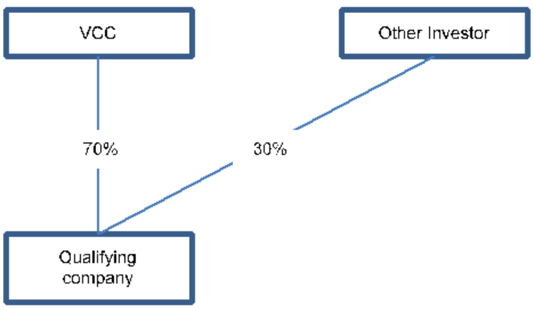
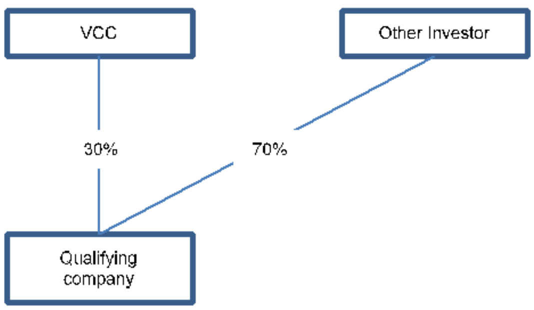
The guidance provided by these rulings is important as they deal with the rules governing the type of investments that can be made and the conditions VCCs must satisfy in order to raise funds from investors. In this article, we will deal with three issues that arose from these rulings: the controlled group company concept, the equity share requirement and the book value threshold.

Before dealing with these rulings, we recap the typical venture capital structure:



Controlled group company limitation

The VCC may not invest in a qualifying company if it is a controlled group company in relation to a group of companies. A controlled group company in relation to a group of companies is a company where at least 70% of its shares are held by a controlling group company or by other controlled group companies within the group of companies.

This structure is not permissible as the VCC (controlling group company) holds 70% of the shares in the qualifying company (controlled group company).	This structure is not permissible as the other investor (controlling group company) holds 70% of the shares in the qualifying company (controlled group company).
	

A very simple strategy to avoid the qualifying company becoming a controlled group company in relation to the VCC, is to ensure that the VCC subscribes for less than 70% of the shares in the VCC. But what about situations where the VCC would like to contribute, for example, 85% of the qualifying company's issued share capital? The applicants in BPR 205 and BPR 242 were faced with this problem.

In both BPR 205 and BPR 242, the applicants successfully avoided having the qualifying companies classified as controlled group companies. This was achieved because the qualifying companies issued different classes of shares. In BPR 205, the applicant subscribed for 20% of the qualifying company's issued shares (Class A ordinary shares) at a subscription price equalling 75% of the qualifying company's entire issued share capital. The other investors subscribed for Class B and C ordinary shares, respectively.

In BPR 242, the applicant subscribed for A class ordinary shares and the co-investor subscribed for B class ordinary shares in the qualifying company. The applicant held less than 70% of the total number of shares in issue in the qualifying company, but contributed more than its proportionate share in monetary terms to the qualifying company's share capital.

In BPR 205 and BPR 242, SARS issued rulings that the qualifying company was not a controlled group company in relation to a group of companies despite the fact that the VCC contributed more than its proportionate share in monetary terms to the qualifying company's share capital. These rulings confirm that the test is the number of shares that the VCC holds in the qualifying company, not the VCC's economic interest (i.e. the value of those shares) in the qualifying company. It is possible for classes of shares to be created where the value of those shares is disproportionate to the number of those shares.

Equity share requirement

Where the qualifying company issues different classes of shares, then careful attention must be paid to whether the different classes of shares are equity shares. For instance, assume that a VCC subscribes for 60% of the shares in a qualifying company while two other investors subscribe for the remaining 40% of the shares in the qualifying company. If the shares held by the two investors are not equity shares, then the VCC will, in fact, hold 100% of the equity shares in the qualifying company.

For tax purposes, equity shares are any type of share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution. Thus, the equity share definition excludes certain types of shares. The rationale for excluding these types of shares is that they have more features in common with a debt instrument, and are therefore a "safer" form of investment.

The words "any right" imply that a shareholder must be restricted from participating in distributions from a qualifying company in all respects in that there must be a restriction on both the right to a dividend distribution and a capital distribution before the share will not be an equity share. Put differently, if a shareholder is entitled to unlimited participation in any company distributions (whether dividends or returns of capital), the share will constitute an equity share.

In BPR 205:
As the applicant contributed a disproportionate amount of share capital, the Class A ordinary shares were entitled to a first distribution of profits or capital equal to the capital invested and a return to the equivalent of prime plus 2%.

Upon settlement of the Class A ordinary shares, the Class B and Class C ordinary shares subscribed for by Company A and Investor B, respectively, will be entitled to a second distribution of profits or capital equal to a return to the equivalent of prime plus 2%, paid in proportion to their respective shareholding.
Thereafter, the Class A, B and C ordinary shares will rank *pari passu* in all respects.

In BPR 242, the A and B class shares will carry the following distribution rights:

The A class shares will be entitled to a profit distribution on an annual basis in an amount equal to the guaranteed earnings before interest, taxes, depreciation and amortisation, less any third party debt payments.

The B class shares will be entitled to a distribution of the remaining profits on an annual basis.

On exit, the holders of the A and B class shares will be entitled to a return of capital distribution of their respective amounts contributed together with a cumulative compound annual return linked to prime, with the A class shares ranking ahead of the B class shares.

The A and B class shares will then participate in the remaining assets of the qualifying company on a *pari passu* basis, pro rata to their number of shares held. The B class shares may receive, as a distribution in specie, the common areas in a sectional title scheme in lieu of the cash distribution.

These rulings confirm that a class of shares can still be preferential in nature, without losing their “equityness”. It is possible to structure a particular class of shares so that the shares carry preferential rights to dividends. The VCC was clearly better off than the holders of the other classes of shares who have to wait in the queue. But in spite of the preferential nature of the VCC’s holdings, the shares held by the VCC remain equity shares by virtue of the equity share definition.

The R50 million book value threshold

The R50 million book value threshold applies to all qualifying companies (other than junior mining companies) where the book value threshold is increased to R50 million. The legislation requires the qualifying company’s assets to be valued at book value not market value. The book value determination must be made at the time the VCC acquires the equity shares in the qualifying company.

Book value is the price that the qualifying company paid for its assets. It differs from market value, which is the price at which the qualifying company could sell its assets. The book value determination is based on the original cost of the qualifying company’s assets less any depreciation, amortisation or impairment costs made against its asset. In many cases, the carrying value of the qualifying company’s assets and their market value will differ greatly.

Provided that the book value threshold is satisfied at the time the VCC subscribes for the shares in the qualifying company, any subsequent increase in the book value of the qualifying company’s assets will not impact the VCC’s tax status. In

BPR 242, the qualifying company will acquire sectional title units in two tranches. The combined value of the sectional title units will exceed R50 million which, on the face of it, suggests that the qualifying company will not comply with the R50 million book value threshold.

However, in the first tranche, the qualifying company will use the cash proceeds from the share issue to the VCC to acquire sectional title units with a value below R50 million. Thereafter, the qualifying company will obtain debt funding to acquire additional sectional title units. At the time of the VCC's investment, the qualifying company's book value will be below R50 million despite the fact that it has an option to acquire additional sectional title units. The qualifying company's later purchase of the additional sectional title units does not taint the VCC's initial share subscription in the qualifying company.

SARS ruled that the existence of the option granted to the qualifying company to acquire additional sectional title units will not constitute non-compliance with the R50 million book value threshold nor will the exercise of the option after the acquisition of the first sectional titles constitute non-compliance with the R50 million book value threshold.

ENSafrica

ITA: Section 1(1) - definitions of 'equity share' and 'controlled group company' and 12J(1) - definition of 'qualifying company'

BPR 205

BPR 242

Editorial Comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear.

EXEMPTIONS

2574. Renewable energy incentives

The recent announcement by Eskom that it would reconsider its position on the use of renewable energy has caught the attention of many in the renewable energy industry. The Income Tax Act, 1962 (the Act) contains a number of tax incentives which are available to participants in the renewable energy industry, including the exemption of certified emission reductions (CERs), contained in section 12K of the Act.

On 9 June 2016, the South African Revenue Service (SARS) issued Binding Class Ruling 053 (Ruling), which deals with the application of section 12K in the context of a Clean Development Mechanism (CDM) project. The parties to the Ruling are a non-profit association of green energy producers (Applicant), the project developer and sponsor of the registration of the CDM project with the Executive Board of the United Nations Framework Convention on Climate Change (UNFCCC) (Project Developer) and the owners of the CDM projects registered under the programme of activities (CPA owners).

Facts

The Applicant is a non-profit organisation which aims to raise awareness and facilitate the transition to a climate resilient society within South Africa. It achieves its objectives through, amongst other things, providing an independent platform for the hosting of programmes of activities (CPAs) for CDM projects registered under the Kyoto Protocol and acts as the coordinating and management entity for these CPAs.

The Applicant and the Project Developer, who is also a CPA owner, have established a CDM project in a programmatic form, contemplated in Article 12 of the Kyoto Protocol, which is registered with the CDM Executive Board. The

CPA owners intend to produce CER credits under the CPA which will be sold to industrialised countries, in terms of emission reduction purchase agreements.

The relationship between the parties will be governed by a CPA agreement which states, amongst other things, the following:

- The CPA is to be registered with the CDM executive board together with the first CDM project undertaken by the Project Developer. Other potential CPA owners who wish to participate in the CPA will be invited to do so upon payment of an inclusion fee and will be added by way of supplemental deeds of inclusion to the CPA as provided for by the CDM rules.

- The Applicant will do a number of things, including acting as the coordinating and management entity for the CPA and managing the CER credits sales process and collecting the revenue (carbon revenue) in its capacity as manager of the CPA on behalf of the CPA owners. It will receive a fee for services rendered as manager of the CPA.

- The Project Developer will fund the development phase budget to establish the CPA. All CPA owners will pay an annual fee to cover expenses of the CPA.

- The CER credits generated by the CPA will be jointly owned by the Project Developer and the CPA owners on the basis that ownership of a certain specified percentage of the gross CER credits will accrue to the Project Developer as the project sponsor and the balance will be jointly owned by all CPA owners and accrue to each CPA proportionally according to its contribution of CER credits in the relevant period.

- The Applicant will pay all the expenses related to the running of the CPA from the inclusion fees, annual fees and carbon revenue, if required, and will distribute the surplus to the CPA owners according to their proportional share of revenue calculated based on the CER credits contributed in the relevant period.

Background to section 12K

Section 12K came into effect on 11 February 2009 and according to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009 (2009 Explanatory Memorandum), the reason for this was the limited uptake of CDM projects within South Africa. The 2009 Explanatory Memorandum states that CDM was created by the Kyoto Protocol as a mechanism to ensure that developed countries can meet their carbon emission reduction targets, while also ensuring that developing countries can participate in a global reduction market. In this regard, the Kyoto Protocol makes it possible for CDM projects to yield CERs which are technically saleable to and usable only by developed countries.

According to the 2009 Explanatory Memorandum, the limited uptake of CDM projects within South Africa stems from the high financial (and bankable) hurdle rates due to the risks associated with CDM project activities (CPAs). Financial hurdle rates include, amongst other things, the high cost involved in financing CPAs. The South African government recognised that climate change requires a considered international and domestic policy response and as part of South Africa's domestic policy response to climate change, tax relief in the form of section 12K was introduced to overcome the marked failure associated with environmental protection.

The provisions of section 12K

Section 12K(2) provides for the tax exemption of any amount received by or accrued to or in favour of any person in respect of the disposal by that person of any CER derived by that person in the furtherance of a qualifying CDM project carried on by that person. Section 12K(1) states that for a CDM project to constitute a "qualifying CDM project", the designated national authority (DNA) must issue a letter of approval as contemplated in the Regulations establishing the DNA. Secondly, the CDM project must be registered in terms of the modalities and procedures for a clean development mechanism as defined in Article 12.

Ruling

SARS ruled that:

- The CPA will be a "qualifying CDM project" as defined in section 12K(1).
- The CPA owners and the first CDM project owner will be the persons carrying on the "qualifying CDM project".
- The carbon revenue generated by the CPA will be exempt from income tax under section 12K(2) in the hands of the CPA owners. The exemption is not affected by the fact that the carbon revenue will be received by the Applicant acting in its capacity as manager of the CPA.
- Only carbon revenue from the CER credits that the first CDM project owner derives from conducting its own CDM project of activities will qualify for exemption under section 12K(2) and the carbon revenue from the disposal of the extra CER credits accrued in terms of the CPA agreement will not be exempt from normal tax under section 12K(2).
- The CER credits need not be accounted for as "trading stock" as defined in section 1(1) of the Act.
- The sale of CER credits to non-resident purchasers will be subject to VAT at a zero rate under section 11(2)(*l*) of the VAT Act, 1991 provided all the requirements of that section are complied with.

Comment

It should be noted that in terms of the current Draft Regulations to the Draft Carbon Tax Bill, a CDM project, similar to the one discussed in the Ruling, can generate carbon offsets. The carbon credits generated by such project will have to be surrendered to SARS to make use of the carbon offset allowance. As the Draft Regulations to the Draft Carbon Tax Bill currently stand, it appears that it might be possible for carbon credits generated by a "qualifying CDM project" in terms of section 12K, to be used by a taxpayer to receive an offset allowance in terms of the Draft Carbon Tax Bill. However, we will only have clarity once the legislation regarding carbon tax has been finalised.

Cliffe Dekker Hofmeyr

ITA: Section 1(1) - definition of 'trading stock' and 12K
VAT Act: Section 11(2)(*l*)
BCR 053
Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009
Draft Regulations to the Draft Carbon Tax Bill
Kyoto Protocol

Editorial Comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear.

CAPITAL GAINS TAX

2575. Meaning of immovable property

The term 'immovable property' is found in section 9H(4)(a) of the Income Tax Act, 1962 (the Act) within the phrase 'immovable property situated in the Republic'. It is also found in articles 6.1 and 13.1 of the double taxation agreement between South Africa and the Netherlands (the DTA), albeit in a slightly different guise ('immovable property situated in the … Contracting State'). One would expect the term to be interpreted the same way for all purposes. However, this view is apparently not shared by the South African Revenue Service (SARS).

Background

The disposal of an asset by a person who is tax resident in South Africa gives rise to a potential liability to capital gains tax. In the case of a person who is not tax resident in South Africa, such disposal will only give rise to a potential liability to capital gains tax if the asset is within the scope of our capital gains tax legislation.

The Eighth Schedule

In the case of non-resident persons, in terms of paragraph 2(1)(*b*) of the Eighth Schedule to the Act, disposals of assets of three descriptions may lead to the taxation of capital gains:

- Immovable property situated in the Republic;
- Any interest or right in immovable property situated in the Republic; and
- Any asset effectively connected with a permanent establishment of that non-resident person in the Republic.

Clarification is provided in paragraph 2(2) of the Eighth Schedule by defining the term ‘interest’ as it appears in ‘interest in immovable property situated in the Republic’ to include ownership of shares in a company or an interest in a partnership or other entity or a vested interest in a trust of at least 20%, where 80% or more of the value of the company, entity or trust is attributable to immovable property situated in the Republic.

Section 9H

Section 9H of the Act deals with the situation where a person ceases to be a resident. In that event, the person is deemed to have disposed of all of their assets on the day prior to ceasing to be a resident and therefore faces a potential liability to capital gains tax.

Section 9H(4) lists circumstances in which the provisions of section 9H do not apply. Section 9H(4)(*a*) states that the provisions do not apply in respect of ‘immovable property situated in the Republic that is held by that person’. This means that the person is not deemed to have disposed of such property for purposes of section 9H, and no potential exposure to capital gains tax arises in relation to such property.

The double taxation agreement

Article 13.1 of the DTA provides that capital gains derived by a resident of one of the contracting states from the disposal of immovable property referred to in Article 6 and situated in the other contracting state may be taxed in that other contracting state.

Article 6.1 of the DTA deals with income derived from 'immovable property … situated in the other contracting state'. The nature of this property is defined in Article 6.2. Article 13.4 states that gains from the alienation of any asset other than as described in paragraph 1 of that Article shall be taxable only in the state in which the alienator is resident.

Placed in context, if a resident of the Netherlands (a contracting state) disposes of an asset that is not immovable property situated in South Africa (the other contracting state), Article 13.4 reserves the sole right to tax any capital gain for the Netherlands and denies any such right to South Africa.

What is the problem?

SARS recently issued the fifth edition of its Comprehensive Guide to Capital Gains Tax (the Guide). In the Guide it interprets the term 'immovable property', as it appears in 'immovable property situated in the Republic', in the context of both section 9H and Article 13.1.

One would expect the interpretation to be the same in both instances. Unfortunately, and paradoxically, though, this expectation is not met.

General interpretation

The Guide includes a classification of assets as movable or immovable in Chapter 4: paragraphs 4.1.2.3 and 4.1.2.4.

In 4.1.2.3, the Guide examines the legal classification of things as immovable and concludes that immovable property encompasses:

- Land;
- Buildings with foundations in the soil;
- Trees;
- Growing crops;
- Real rights over immovable property (e.g. usufructs, registered long-term leases and servitudes);
- Life rights in a retirement complex; and
- Mineral and prospecting rights.

In paragraph 4.1.2.4, in a discussion of the nature of movable assets, the Guide states:

A member's interest in a close corporation is deemed to be movable property under section 30 of the Close Corporations Act, 1984. Section 35(1) of the Companies Act, 2008 confirms that a share issued by a company is movable property.

The Guide therefore apparently recognises that a share in a company is movable property.

Section 9H(4)

The application of section 9H(4)(*a*) is dealt with in Chapter 6 of the Guide under paragraph 6.2.2A In interpreting the phrase 'immovable property situated in the Republic', the following interpretation is provided:

Under para 2(1)(b)(i) a non-resident must account for any capital gain or loss on disposal of immovable property situated in South Africa or any interest or right of whatever nature to or in such property.

Paragraph 2(2) deems certain indirect interests in immovable property to constitute an interest in immovable property for the purposes of para 2(1)(b)(i). For example, a person who holds at least 20% of the equity shares in a company when 80% or more of the market value of those shares is directly or indirectly attributable to immovable property in South Africa would fall within para 2(2). However, the exclusion of immovable property from the ambit of s 9H does not extend to these indirect interests.

In other words, SARS' interpretation is that, for the purposes of section 9H(4), shares in a company that owns property are not 'immovable property', regardless of whether or not they are equivalent to an 'interest in immovable property' contemplated in paragraph 2(2).

Article 13.1

This interpretation has a history. Certain of the DTAs that South Africa has concluded and that remain in force were based on the 1997 version of the Model Tax Convention on Income and on Capital issued by the Organisation for Economic Co-operation and Development (OECD). Issue 4 of the Guide discussed the application of treaty provisions identical to Article 13.1, as follows:

Treaties such as those with Luxembourg, Mauritius and the Netherlands (Article 13(4) of the treaties with Luxembourg and Mauritius and Article 14(4) of the treaty with the Netherlands) provide that sales of assets other than immovable property are only taxable in the country of residence. Since shares are not 'immovable property' under South Africa's domestic law, it follows that the provisions of these tax treaties will override paragraph 2(1)(b).

SARS' conclusions at that time were consistent with the views of the OECD. In its 1997 commentary on Article 13 in its Model Tax Convention on Income and Capital (which is identical to Article 13 of the Netherlands DTA), the OECD concluded:

Certain tax laws assimilate the alienation of all or part of the shares in a company, the exclusive or main aim of which is to hold immovable property, to the alienation of such immovable property.

In itself, Article 13.1 does not allow that practice: a special provision in the bilateral convention can alone provide for such an assimilation.

Contracting States are of course free either to include in their bilateral conventions such special provision, or to confirm expressly that the alienation of shares cannot be assimilated to the alienation of the immovable property.

No amendments have been made to paragraphs 2(1)(*b*) or 2(2), between the publication of Issue 4 and Issue 5 of the Guide. The provisions of Article 13 were not renegotiated. No decision of a competent court indicated that the interpretation in Issue 4 was incorrect.

Despite this, in Issue 5 of the Guide, SARS inexplicably changed the interpretation of the application of Article 13.1 in the treaties referred to.

Interpretation of terms in the DTA must first be by reference to any definition in the DTA. Where the DTA does not define the terms, Article 3.2 of the DTA explains the process to be applied:

As regards the application of the provisions of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

SARS reiterates that section 35(1) of the Companies Act states that a share in a company is movable property. However, says the Guide, paragraph 2(2) deems shares, in the circumstances there described, to be *an interest in immovable property*.

Next, the Guide accepts that there is a definition of immovable property in Article 6.2 of the DTA which provides:

The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats and aircraft shall not be regarded as immovable property.

Having regard to Article 6.2, SARS contends that, in applying the law, it must assign the meaning given to the term under the tax law:

The definition of 'immovable property' in article 6(2) is not restricted to corporeal immovable property such as that held under freehold or sectional title. It includes

'rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources'.

Thus under para (b) of the definition of 'immovable property' in s 102(1) of the Deeds Registries Act 47 of 1937 a registered lease of not less than 10 years is 'immovable property'. A usufruct, being an incorporeal real right, is also an interest in immovable property...

Then comes the logical masterstroke:

… Having established that article 6(2) includes interests which would be regarded as immovable property under the law of South Africa it must follow that an interest in immovable property referred to in para 2(2) should also fall within article 6(2).

There are two strong arguments that this conclusion is not supportable:

- The first is that one accepts that the term ‘immovable property’ should have the meaning assigned to it in law, and for that purpose the first source of reference is to look to a definition in the tax law. SARS cannot point to a definition of the term that applies for all purposes of the Act, yet it seeks to manufacture one.

- The second is that Article 6.2 then continues to state that, whatever the definition may be in the law, the term for purposes of the DTA will include ‘rights to which the general law respecting landed property apply’.

In interpreting this requirement, SARS does not look to the provisions of the general law which it has so ably and accurately summarised in paragraph 4.1.2.3. It takes a different approach in which it ignores the general law, transposes the term ‘interests’ found in paragraph 2(1)(*b*) for the term ‘rights’ found in Article 6.2, and comes up with a conclusion that shares in a property company are ‘immovable property’ for tax purposes.

SARS, on this questionable basis, concludes that, *for the purposes of the tax law*, the term ‘immovable property’ includes an interest in immovable property as defined in paragraph 2(2). It makes no attempt to explain or reconcile the fact that it also interpreted the same term in relation to section 9H(4) and concluded that an interest contemplated in paragraph 2(2) is not immovable property.

Which interpretation is correct?

There is a clear conflict that requires resolution. The meaning of a term cannot be selected by SARS to suit itself.

This is best illustrated by reference to section 9H. When a person ceases to be a resident, that person is deemed to have disposed of shares at their market value *as movable property* on the day prior to ceasing to be a resident and to have reacquired the same shares *as immovable property* on the day of ceasing to be a resident. SARS would have us believe that the shares, without changing hands and without any registration process that affects their status under general law relating to immovable property, metamorphose into immovable property by logical alchemy. SARS is a regulatory agency whose duty is to interpret the law consistently and fairly.

SARS can only place reliance on the interpretation of a term if that term is interpreted in the same way for all purposes of the Act. There is no ground for finding that the contexts require different interpretations. Both interpretations take cognisance of the fact that paragraph 2(2) defines the term as it appears in 'interest in immovable property' and does not define the term 'immovable property' itself.

The interpretation of the term 'immovable property' suggested by SARS in the context of Article 13.1 is untenable not only because it is not supported in logic or by authority, but more importantly because SARS itself applies conflicting interpretations in the same public document.

PwC
ITA: Section 9H and paragraphs 2(1)(*b*) and 2(2) of the Eighth Schedule
SARS Comprehensive Guide to Capital Gains Tax (Issues 4 and 5)
South Africa/Netherlands Double Tax Agreement
Close Corporations Act, 1984: Section 30
Companies Act, 2008: Section 35(1)

Deeds Registries Act, 1937: Section 102(1)

Editorial Comment: It should be noted that section 9H(4)(b) was deleted by National Treasury in order to trigger the exit charge on shares in land-rich companies. It provided that section 9H did not apply to 'any interest or right of whatever nature of that person to or in immovable property situated in the Republic, including an interest in immovable property contemplated in paragraph 2(2) of the Eighth Schedule'.

It also be noted that section 35(15) defines immovable property as meaning 'immovable property contemplated in paragraph 2(1)(b)(i) and (2) of the Eighth Schedule'.

TAX ADMINISTRATION

2576. Legal professional privilege in discovery proceedings (Refer to article 2531 July 2016 - Issue 202)

General principles

Legal professional privilege applies to communications between a client and legal advisor, where the legal advisor is acting in a professional capacity and is consulted in confidence for the purpose of the client obtaining legal advice (other than advice facilitating crime or fraud), and where legal professional privilege is claimed by that client.

However, it is possible for legal professional privilege to be waived, either expressly or by way of that waiver being implied or imputed. The manner in which legal professional privilege may be implied or imputed was summarised as follows by the court in *S v Tandwa and Others* [2008] (1) SACR 613 (SCA), at paragraph 18:

"Implied waiver occurs (by analogy with contract law principles) when the holder of the privilege with full knowledge of it so behaves that it can objectively be concluded that the privilege was intentionally abandoned. Imputed waiver occurs where – regardless of the holder's intention – fairness requires that the court conclude that the privilege was abandoned. Implied waiver entails an objective inference that the privilege was actually abandoned. Imputed waiver proceeds from fairness, regardless of actual abandonment."

In discovery proceedings, documentation and correspondence in respect of which legal professional privileged is claimed, and in respect of which this privilege has not been waived, are generally listed in a separate schedule to the respective parties' discovery affidavits. These documents will not be provided to the other side, and may not be relied upon in subsequent proceedings unless a supplementary discovery affidavit is lodged, in which the document previously listed as privileged is fully disclosed.

Practical application

Each document discovered during litigation proceedings should be considered for purposes of establishing whether or not that document may be subject to legal professional privilege, and/or whether it contains any references to a legally privileged communication that may inadvertently constitute a waiver of privilege in relation to that privileged communication.

Could the document be privileged?

When reviewing documentation and correspondence for purposes of determining whether or not it may be subject to legal professional privilege, it is important to carefully consider whether or not all of the requirements of legal professional privilege have been met, and whether or not legal professional privilege may have been waived.

The first of these requirements that is often overlooked, is that the documentation or correspondence must have formed part of communications between a client and legal advisor, which are intended to be, and remain, strictly confidential.

Where, for example, a client provides their legal advisor with a marked-up document for purposes of on-providing that document to the counter-party to a transaction, it is unlikely that legal professional privilege may be claimed in respect of that document. However, each item should be considered in its particular context, with a view to establishing the intentions of the particular parties involved.

Another requirement that is important to note, especially in the context of tax related matters, is that this privilege currently only extends to lawyers.

For example, communications between clients and their tax advisors who are not also legal advisors, would not be subject to legal professional privilege, despite the fact that such communications may have been entered into in confidence, with a view to obtaining legal advice from the tax advisor acting in their professional capacity.

Has privilege been waived?

Once it has been established that a document may be subject to legal professional privilege, it should be considered whether or not that privilege may have been waived prior to discovery proceedings.

While legal professional privilege may not be waived when privileged advice is disclosed to a third party under express conditions of strict confidentiality, waiver of privilege may be imputed or implied where no such express conditions are stipulated. Any sharing of a potentially privileged document beyond the client/legal advisor relationship should therefore be carefully considered.

Does the document reference a legally privileged communication?

In addition, some references to legally privileged communications in non-privileged correspondence and/or documentation may potentially constitute a waiver of privilege in respect of that document. It would therefore be important that, where applicable, any such non-privileged correspondence and/or documentation be redacted.

Preparing for discovery is key

Legal professional privilege is just one of the many complex considerations that must be addressed during the course of discovery proceedings in tax litigation matters. Given the limited time periods applicable in tax litigation and the often voluminous amount of documentation involved, it is critical that clients mandate their advisors to prepare for a discovery well in advance, and provide for sufficient time to properly consider all of the documentation and correspondence being discovered, among other things, with a view to identifying and properly dealing with potentially privileged items.

In addition, given the fact that legal professional privilege is generally assessed for the first time when preparing discovery in a tax matter, it is very important to be aware of the relevant principles during any transaction in which legal advice is obtained so that one can ensure that legal professional privilege is protected. There is more often than not a gap of many years between the time a transaction is entered into and the time an audit of the transaction may be conducted by the South African Revenue Service, which may result in a dispute, and therefore, any party who is the recipient of legal advice should keep such advice well protected.

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2577. Appeals in terms of the transitional provisions

The decision of the Tax Court in *ITC 1882* [2016] 78 SATC 165, delivered on 27 January 2016, although not a binding precedent, provides guidance on the process of appealing against the imposition of additional tax under now-repealed provisions of the Income Tax Act, 1962 (the Act).

The decision also usefully discusses whether an accountant’s error in drawing up a tax return provides an excuse to the taxpayer for an under-declaration of income.

The facts

In this case, the taxpayer, a 73-year-old lady, was the trustee and beneficiary of four *inter vivos* trusts.

Her accountant had prepared and filed her personal tax returns; but it seems (at paragraph 26) that he was not involved in preparing the trusts’ tax returns and that he merely extracted figures from the trusts’ financial statements.

The taxpayer’s return for the 2009 tax year had been submitted (at paragraph 24) at a time when the financial statements for the trusts were not yet available, and the return the accountant lodged on her behalf under-declared her income from the trusts by some R27 million.

The issue

The only issue in dispute in the Tax Court hearing was the quantum of the additional tax levied by the Commissioner in respect of that understatement. The Commissioner had originally imposed a 100% penalty, which the SARS Objection Committee had reduced to 50%.

The taxpayer sought to have the additional tax reduced still further, and lodged the requisite objection and appeal against the assessment. The complicating factor in this case was that the tax return in issue, and the objection and appeal lodged against the additional tax, pre-dated the coming into force of the Tax

Administration Act, 2011 (TAA) and the appeal was being determined in the Tax Court after that Act came into force.

Transitional provisions

The TAA came into force on 1 October 2012 and repealed many provisions of the Act, including those relating to objection and appeal and the associated onus of proof, and relocated these provisions, in an amended form, in the TAA.

Where a disputed assessment arose under the Act prior to the coming into force of the TAA, and had not been resolved when the latter Act came into force, the transitional provisions of the TAA must be applied in the determination of the dispute.

This follows from section 270(2)(*d*) of the TAA, which provides as follows:

'270. Application of the Act to prior or continuing action.

(1) ...[T]his Act applies to an act, omission or proceeding taken, occurring or instituted before the commencement date of this Act ..

(2) The following actions or proceedings taken or instituted under the provisions of a tax Act repealed by this Act but not completed by the commencement date of the comparable provisions of this Act, must be continued and concluded under the provisions of this Act as if taken or instituted under this Act –

(a) –(c) ...

(d) an objection, appeal to the tax board, tax court or higher court, alternative dispute resolution, settlement discussions or other related High Court application'

Consequently, in this particular matter, the provisions of the TAA governed the objection and appeal against the additional tax that had been imposed in terms of a now-repealed provision of the Act.

The onus of proof

Section 82 of the Act, which imposed on the taxpayer a wide-ranging burden of proof in relation to disputed assessments, has been repealed.

Its current counterpart, section 102 of the TAA, preserves a general rule that the onus of proof is on the taxpayer, but now lays down a specific rule that *SARS bears the burden of proving the facts on which an understatement penalty has been imposed.*

This rule is buttressed by section 129(3) of the TAA, which provides that–

'In the case of an appeal against an understatement penalty imposed by SARS under a tax Act, the tax court must decide the matter on the basis that the burden of proof is upon SARS and may reduce, confirm or increase the understatement penalty.'

Change takes effect immediately

Section 270, quoted above, is silent on the important issue of whether the rules regarding the *onus of proof* to be applied in a disputed assessment that arose under now-repealed provisions of the Act are the rules laid down in the (now-repealed) section 82 of the Act (in terms of which the general onus was on the taxpayer) or are the rules as to onus laid down in section 129(3) of the TAA (which in certain respects impose the onus of proof on SARS).

The Tax Court, correctly, it is submitted, applied the legal presumption (at paragraphs 10 to 11) that where a new law makes a change to *procedure*, that change applies immediately, even where litigation has already commenced in terms of the old law or where the cause of action arose while the old law of procedure applied.

The Tax Court took the view that the issue of the *onus of proof* is a matter of procedure, not of substantive law, and that this presumption therefore applied.

Accordingly, in terms of the legal presumption outlined above, the current provisions of the TAA in regard to the onus of proof had to be applied in the present case, meaning that the onus was on SARS to prove the facts on which the understatement penalty (the quantum of which was the sole issue in this case) had been applied.

Reliance on an accountant is no excuse

In this case, the judgment records that the taxpayer–

'placed the blame [for the under-declaration of her income from the trusts of which she was a beneficiary and a trustee] squarely on her accountant's shoulders ...'.

The accountant gamely testified (at paragraph 24) that he was indeed to blame for the under-declaration, having filed the taxpayer's tax return reflecting the amount of her income as a trust beneficiary at a time when the trusts' financial statements were not yet available.

The judgment makes clear that even if the under-declaration error had been made by the accountant, this in no way relieved the taxpayer from responsibility.

The court said (at 32-33) that–

'This court must agree that Mr Z's behaviour as an accountant in this matter was less than exemplary. The question is whether the appellant should be punished for Mr Z's dilatory behaviour, or only because she did not make enough enquiries as to whether the correct tax return had been submitted timeously and making sure that all was done to have the correct tax return furnished to SARS timeously.

...

She had a duty not to leave all her financial affairs in the hands of her attorney and her accountant, without overseeing their actions and ascertaining that all her *taxes were paid timeously. ... She had a duty to enquire from Mr Z whether her tax return had been submitted correctly, which she obviously failed to do'.*

The court said further (at paragraph 36)–
'The court has to be careful, especially in this instance, not to punish the appellant for her accountant's actions, but has to consider her actions in isolation in this regard. There is, however, a duty on taxpayers to ensure that the professionals they employ are diligent and not to leave it to the tax consultants. It is ultimately the duty of the taxpayer to ensure that the correct amount of tax is paid timeously.'

Conclusion

In the result, the Tax Court reduced the understatement penalty from the 100% imposed by the Commissioner and the further reduction decreed by the SARS Objection Committee, to a penalty of 35%. It needs to be borne in mind that the Tax Court had a wide discretion to reduce an *additional penalty* imposed under the now-repealed provisions of section 76(2)(*a*) of the Act.

By contrast, the Tax Court has a far narrower discretion (see section 223(3) of the TAA) to reduce a percentage-based *understatement penalty* imposed in terms of that Act.

PwC
ITA: Sections 76(2)(*a*) and 82 (repealed)
TAA: Sections 102, 129(3), 223(3) and 270

SARS NEWS

2578. 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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