

Tax Effective Structuring – When falling foul or is the fowl flying?

By Johan Kotze

So, is NWK the new buzz in the world of tax, taken over from Brummeria? Lenders and borrowers, who made use of tax effective structures, no doubt, are (and must be) concerned that they may be at risk. Borrowers are suddenly pulling out their files, contacting their lenders and, perhaps, even asking who approved these arrangements?

This excitement is also heightened by SARS' Media Release regarding the NWK case and SARS' statement that they are 'aware that a number of other taxpayers have entered into simulated transactions, including compulsorily convertible loans similar to the one at issue in the NWK case, with the effect of artificially reducing their tax liabilities. Starting from 15 February 2011 SARS will commence audits of these taxpayers'.

To give credence to the new Voluntary Disclosure Programme (VDP) SARS invites taxpayers to make use of the VDP prior to commencement of the audits.

So, is there reason to be concerned?

If a lender has entered into a transaction similar to NWK's a taxpayer should certainly be concerned and a taxpayer should seriously consider making use of the VDP.

NWK and First National Bank (FNB) entered into discussion with a view to updating NWK's existing banking facilities by the addition of a 'term finance facility' of R50 million. Pursuant to these discussions NWK and FNB entered into the following series of agreements:

- a subsidiary of FNB, that dealt in financial instruments, being Slab Trading Company (Pty) Ltd (Slab) lent NWK R96 415 776, to be repaid over five years.
- the capital amount would be repaid by NWK, delivering to Slab, at the end of the five year period, 109 315 tons of maize;
- the interest would be payable on the capital sum at a fixed rate of 15.41% per annum, payable every six months. To this end NWK issued ten promissory notes with a total amount of the interest, R74 686 861;
- to fund the loan, Slab discounted the notes (sell them for an amount less than their face value) to FNB. NWK, on due date, would pay FNB;
- Slab sold its rights to take delivery of the maize at the end of the five year period to First Derivatives, a division of FNB. This 'forward sale', for the sum of R45 815 776, enabled FNB to pay the full amount of the loan to NWK;
- NWK purchased from First Derivatives the right to take delivery of the same quantity of maize for the sum of R46 415 776, payable immediately on the conclusion of the contract, but delivery to take place only five years hence. This contract would neutralize the risks associated with delivery in the future;
- Slab would cede its rights to a trust company to relieve Slab of the 'administrative burden' of the transaction. (This transaction never eventuated.)

What should also be of concern is the Supreme Court of Appeal's use of the term 'tax evasion' (being unlawful, as opposed to lawful tax evasion) to label the transaction.

Under certain circumstances the evasion of tax shall be guilty of an offence and liable on conviction to a fine or imprisonment for a period not exceeding five years.

A recent case in the Supreme Court of Appeal even held that a transaction structured solely to evade tax was invalid.

As to the consequences of visiting invalidity upon the transaction, what has to be borne in mind is that the parties to the transaction have actively conspired to perpetrate a fraud against SARS. In this context the Supreme Court of Appeal did not consider that a declaration of invalidity would bring about inequitable results between the parties concerned. The severity of a declaration of invalidity is not out of all proportion to that of the prescribed penalty, namely a sentence of a fine, or to imprisonment for a period not exceeding five years.

The NWK case contains a number of tax legal nuances which will be used to distinguish this case from other structured finance, and in this regard the judge did say that it is not suggested that a taxpayer should not take advantage of a tax-effective structure.

The question is when is it falling foul? When is the intention to achieve a tax benefit outweighing the commercial reason? The answer can only be found if all the factors are holistically considered.

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