TAX UPDATE **PREPARED BY: JOHAN KOTZE**
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1. INTRODUCTION

The purpose of this update is to summarise the tax developments that occurred during the first quarter of 2012 (i.e. 1 January 2012 to 31 March 2012), specifically in relation to Income Tax and Value-Added Tax (VAT). Johan Kotze, Bowman Gilfillan's Head of Tax Dispute Resolution, has compiled this summary.

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

First quarters are always dominated by the Finance Minister's Budget speech. What will be interesting is how the Minister's proposals are eventually enacted, and indeed if they are eventually enacted. It certainly happens that certain proposals take many years before they are enacted and some others are never enacted.

Treasury has released technical corrections which are relatively important.

This update deals with a number of interesting cases, covering a variety of topics, published during this period. The writer does not agree with the Labat judgment and is at odds with the approach taken by the court in Capstone, given SARS' draconian powers collecting of outstanding tax.

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

Enjoy reading on!

2. NATIONAL BUDGET

2.1 Main tax proposals

The main tax proposals for 2012 include:

- Personal income tax relief of R9.5 billion
- Relief for micro and small businesses
- Implementing the dividend withholding tax at 15%
- An increase in effective capital gains tax rates
- Reforms to the tax treatment of contributions to retirement savings
- Further reforms of the tax treatment of medical scheme contributions
- Higher taxes on alcohol and tobacco products.

2.2 Individual's tax rates

The rates of tax for the 2012 tax year and those proposed for 2013 are set out below.

2012 year of assessment		**2013 year of assessment**	
Taxable Income	**Rates of tax**	**Taxable Income**	**Rates of tax**
R0 – R150 000	18% of each R1	R0 – R160 000	18% of each R1
R150 001 – R235 000	R27 000 + 25% of the amount above R150 000	R160 001 – R250 000	R28 800 + 25% of the amount above R160 000
R235 001 – R325 000	R48 250 + 30% of the amount above R235 000	R250 001 – R346 000	R51 300 + 30% of the amount above R250 000
R325 001 – R455 000	R75 250 + 35% of the amount above R325 000	R346 001 – R484 000	R80 100 + 35% of the amount above R346 000
R455 001 – R580 000	R120 750 + 38% of the amount above	R484 001 – R617 000	R128 400 + 38% of the amount above

	R455 000		R484 000
R580 001	R168 250 + 40% of the amount above R580 000	R617 001	R178 940 + 40% of the amount above R617 000
Rebates		**Rebates**	
Primary Secondary Third rebate	R10 755 R6 012 R2 000	Primary Secondary Third rebate	R11 440 R6 390 R2 130
Tax threshold		**Tax threshold**	
Below age 65 Age 65 and over Age 75 and over	R59 750 R93 150 R104 261	Below age 65 Age 65 and over Age 75 and over	R63 556 R99 056 R110 889

2.3 Implementation of dividend withholding tax

As announced previously, the dividend withholding tax comes into effect on 1 April 2012, bringing an end to the secondary tax on companies. Pension funds that are exempt from income tax will receive their dividends tax free. For equity reasons it is proposed that the dividend withholding tax come into effect at 15% – five percentage points higher than the previous secondary tax on companies rate. Income from capital can be derived as interest income, dividends or capital gains, all of which should be taxed equitably.

High-income individuals tend to receive a larger portion of their income in the form of dividends and capital gains. The higher rate will also help to mitigate some of the revenue losses when switching from the secondary tax on companies to the new tax. The estimated net loss as a result of these changes will be R1.9 billion.

2.4 Increase in effective capital gains tax rates.

Capital gains tax was introduced in 2001 at relatively modest rates and has remained unchanged for the past 10 years. This reform has helped to ensure the integrity and progressive nature of the tax system. To enhance equity, effective capital gains tax rates will be increased. The inclusion rate for individuals and special trusts will increase to 33.3%, shifting their maximum effective capital gains tax rate to 13.3%. The inclusion rate for other entities (companies and other trusts) will increase to 66.6%, raising the effective rate for companies to 18.6% and for other trusts to 26.7%. These changes will come into effect for the disposal of assets from 1 March 2012.

To limit the impact of capital gains taxation on middle-income households, the exemption thresholds for individual capital gains and for primary residences will be adjusted significantly. The following exemptions for individual capital gains are increased from 1 March 2012:

- The annual exclusion from R20 000 to R30 000
- The exclusion amount on death from R200 000 to R300 000
- The primary residence exclusion from R1.5 million to R2 million
- The exclusion amount on the disposal of a small business when a person is over age 55 from R900 000 to R1.8 million
- The maximum market value of assets allowed for a small business disposal for business owners over 55 years increases from R5 million to R10 million.

2.5 Medical deductions converted to medical tax credits

Medical tax credits are a more equitable form of relief than medical deductions because the relative value of the relief does not increase with higher income levels. As announced in the 2011 Budget, income tax deductions for medical scheme contributions for taxpayers below 65 years will be converted into such credits. Monthly tax credits will be increased from R216 to R230 for the first two beneficiaries and from R144 to R154 for each additional beneficiary with effect from 1 March 2012. From that date onwards (apart from those with disabilities), where medical scheme contributions in excess of four times the total allowable tax credits plus out-of-pocket medical expenses combined exceed 7.5% of taxable income, they can be claimed as a deduction against taxable income.

To ensure improved equity of the tax system and to help curb increases in health costs, additional medical deductions will be converted into tax credits at a rate of 25% for taxpayers aged below 65 years with effect from 1 March 2014. Also with effect from the same date, employer contributions to medical schemes on behalf of ex-employees will be deemed a taxable fringe benefit and such ex-employees will be able to claim the appropriate tax credits.

Taxpayers 65 years and older, and those with disabilities or with disabled dependants, can currently claim all medical scheme contributions and outof-pocket medical expenses as a deduction against their taxable income.

The tax credits will, as from 1 March 2014, apply to all taxpayers. However, taxpayers 65 years and older and those with disabilities or disabled dependants will be able to convert all medical scheme contributions in excess of three times the total allowable tax credits plus out-of-pocket medical expenses into a tax credit of 33.3%. Note that the 7.5% threshold will not apply in the case of taxpayers 65 years and older and those with disabilities or with disabled dependants.

2.6 Funding options for national health insurance

National health insurance is to be phased in over a 14-year period beginning in 2012/13. The new system will provide equitable health coverage for all South Africans. Plans to begin the first phase of national health insurance, and initial funding requirements, are discussed in some detail in Chapter 6. Over time, the new system will require funding over and above current budget allocations to public health. Funding options include an increase in the VAT rate, a payroll tax on employers, a surcharge on the taxable income of individuals, or some combination of the above.

Achieving an appropriate balance in the funding of national health insurance is necessary to ensure that the tax structure remains supportive of economic growth, job creation and savings. The role and implications of co-payments or user charges under certain circumstances (for example, to limit overuse and risky behaviours) will also be explored. A discussion paper will be published by end-April 2012.

2.7 Encouraging household savings

To encourage greater savings among South Africans, tax-preferred savings and investment accounts are proposed as alternatives to the current tax-free interest-income caps. This will encourage a new generation of savings products. Returns generated within these savings and investment vehicles (including interest, capital gains and dividends) and withdrawals will be tax exempt. Aggregate annual contributions could be limited to R30 000 per year per taxpayer, with a lifetime limit of R500 000, to ensure that high net-worth individuals do not benefit disproportionately. The design and costs (banking and other fees) of these savings and investment vehicles may be regulated to help lower-income earners to participate.

Government proposes to introduce tax-preferred savings and investment vehicles by April 2014. A discussion document will be published by May 2012 to facilitate consultation and refine these proposals.

2.8 Retirement reforms

To encourage South Africans to save for retirement, contributions by employees and employers to pension, provident and retirement funds will be tax deductible by individual employees.

Individual taxpayer deductions will be set at 22.5 and 27.5%, for those below 45 years and 45 and above respectively, of the higher of employment or taxable income. Annual deductions will be limited to R250 000 and R300 000 for taxpayers below 45 years and above 45 years respectively. A minimum monetary threshold of R20 000 will apply to allow low-income earners to contribute in excess of the prescribed percentages. Non-deductible contributions (in excess of the thresholds) will be exempt from income tax if, on retirement, they are taken as either part of the lump sum or as annuity income. Measures to address some of the complexities of defined benefit pension schemes will be considered. These amendments will come into effect on 1 March 2014.

A rollover dispensation similar to the current retirement annuity contributions will be adopted to allow flexibility in contributions for those with fluctuating incomes. Contributions towards risk benefits and administration costs within retirement savings will be included in the maximum percentage allowable deduction.

Lump sum withdrawals upon retirement from pension and retirement annuity funds are restricted to a maximum of one-third of accumulated savings. Consultations will be held with interested parties on a uniform approach to retirement fund withdrawals, taking into account vested rights and appropriate transitional arrangements.

2.9 Turnover tax for micro businesses

Several reforms of the turnover tax for micro businesses (with annual turnover below R1 million) were announced in 2011. Building on these reforms, micro businesses will be given the option of making payments for turnover tax, VAT and employees' tax at twice-yearly intervals from 1 March 2012. It is further envisaged that a single combined return will be filed on a twice-yearly basis from 1 March 2013. The number of returns required for these taxes will fall from about 18 per year to only two a year in 2013. The build-up of tax liability will require such taxpayers to ensure that funds are available when payment is due.

2.10 Small business corporations

To encourage the growth of small incorporated businesses, government proposes to increase the tax-free threshold for such firms from R59 750 to R63 556. Taxable income up to R300 000 is taxed at 10%; this threshold is now increased to R350 000 and the applicable rate reduced to 7%. For taxable income above R350 000, the normal corporate tax rate of 28%

applies. These amendments will come into effect for years of assessment ending on or after 1 April 2012.

2.11 Limiting excessive debt in businesses

Public debate on section 45 of the Income Tax Act (1962) and private equity acquisitions has highlighted the need to improve the classification of corporate financing. The main problem is the erroneous classification of certain instruments as ‘debt’ to generate interest deductions for the debtor, when such instruments more accurately represent equity financing. Similarly, in some private equity transactions, where creditors receive exempt interest income, the deductibility of interest payments deprives the fiscus of revenue. Excessive debt can also give rise to excessively risky transactions that may represent ‘credit risk’ for the domestic market.

To address these concerns, government will enact a revised set of reclassification rules deeming certain debt to be equivalent to shares. In 2013 government will also consider an ‘across-the-board’ percentage ceiling on interest deductions, relative to earnings before interest and depreciation, to limit excessive debt financing.

2.12 Debt used to fund share acquisitions

Unlike most countries, South Africa does not allow for interest to be deductible when debt is used to acquire shares. Section 45 has been used as an indirect acquisition technique to facilitate the deduction of interest payments by allowing debt to be formally matched against underlying assets as opposed to shares. Given the acceptance of section 45 as an indirect share acquisition tool, it is now proposed that the use of debt to directly acquire controlling share interests of at least 70% be allowed. However, the interest associated with this form of debt acquisition will be subject to the same controls applied to section 45 acquisitions.

2.13 Property loan stock companies and property unit trusts

Property unit trusts and property loan stock companies typically provide a commitment to distribute a minimum of 90% of their rental income to investors. The distribution of rental income is effectively tax-neutral in the hands of the property unit trust. Property loan stock companies appear to achieve roughly the same result but without official sanction. They issue investors a dual-linked unit that consists of a debenture and a share with the distribution in the form of interest.

The dual-linked structure needs to be eliminated so that other entities do not undertake the same structure to avoid tax by relying on excessive debt. The governance of property loan stock entities will be placed on par with property unit trusts. Rental income from these entities will fall under the pass-through regime that applies to property unit trusts.

2.14 Special economic zones

Legislation will introduce special economic zones, which will build on industrial development zone policy. The main aim is to improve governance, streamline procedures and provide more focused support to businesses operating within these zones. In support of this initiative, the following tax interventions will be explored:

- A possible reduction in the headline corporate income tax rate for businesses within selected zones (as determined by the Minister of Finance after consultation with the Minister of Trade and Industry).
- An income tax exemption for the operators of special economic zones.
- An additional deduction from taxable income for the employment of workers earning below a predetermined threshold.

2.15 Incentives for the construction of affordable housing

There is insufficient affordable housing stock for middle-income households above the income thresholds for RDP-type housing, but who cannot afford high mortgage finance. To address this ‘gap market’, a tax incentive for developers (and employers) to build new housing stock (at least five units in compliance with prescribed standards) for sale below R300 000 per dwelling is under consideration. Options include either a tax credit or a deduction at either a fixed rand amount per unit or as a percentage of the value of the dwelling. This proposal will be refined after public consultation. Policy alignment with existing housing incentives and attempts to unblock regulatory bottlenecks will also be considered.

Some low-income employees receive financial assistance from their employers to acquire a house. The current tax hurdles associated with such assistance will also be explored.

2.16 Dual-listed companies and other offshore reorganisations

In 2011, government introduced rollover rules for some offshore reorganisations. The purpose was to give South African multinationals more flexibility when restructuring offshore subsidiaries, and to curtail the use of the offshore participation exemption to avoid tax. Now that steps have been taken to bring misuse of section 45 under control, government proposes to introduce an offshore section 45 provision. It would also appear that unbundlings are used to facilitate dual-linked structures that allow for foreign operations to be shifted outside South Africa’s tax jurisdiction. The participation exemption will be curtailed if the transaction indirectly strips value from a South African multinational.

2.17 Rationalisation of withholding tax on foreign payments

International investors are subject to a final withholding tax when receiving royalties unless a tax treaty provides otherwise. They will also be subject to a final withholding tax on interest income as from 2013, subject to tax treaty exemptions. Government proposes to coordinate and streamline the procedures, rates and times for all of these withholding tax regimes, including the adoption of a uniform rate of 15%.

2.18 VAT - Square Kilometre Array

South Africa (in cooperation with other African countries) is bidding to host the Square Kilometre Array (SKA), an international collaboration to build the world's largest radio telescope. SKA is eligible for income-tax exemption under existing public-benefit provisions. Under consideration is providing VAT relief either in the form of a refund mechanism or the zero-rating of consideration received by the project and for imported goods and services if South Africa were to win the bid.

2.19 VAT - Financial services

Government will eliminate the VAT zero-rating of interest earned on loans to non-residents to level the playing field.

2.20 Review of VAT on indirect exports and temporary imports

The policy, legislation and administration of the VAT treatment of indirect exports of goods by road will be reviewed to ensure that exporters are not prejudiced and that the fiscus continues to be protected against potential abuses.

Government will review the VAT treatment of temporary imports to promote local processing and beneficiation, while protecting the fiscus.

2.21 Tax administration

During 2012/13, the South African Revenue Service (SARS) will increase its focus on cross-border cooperation. In addition, several other administrative areas will receive attention.

The bill has been approved by Parliament. It incorporates the common administrative elements of current tax law into one piece of legislation, and makes further improvements in this area. The bill is expected to be promulgated and most of its provisions brought into force in 2012.

2.22 Voluntary disclosure programme

By mid-February 2012, SARS had captured 17 938 applications for relief, concluded agreements to the value of R941 million and collected R718 million in related tax.

2.23 High net-worth individuals

There is room for improvement in the service offered to this segment and in compliance. This will be a focus area for SARS in the coming year.

2.24 Corporate income tax modernisation

Modernisation efforts now shift to corporate income tax. Over the next 12 months SARS will improve its audit capability and align declarations to International Financial Reporting Standards where possible.

2.25 Tax ombud

During 2012, South Africa will establish a dedicated ombud for tax matters. The office is intended to provide taxpayers with a low-cost mechanism to address administrative difficulties that cannot be resolved by SARS.

2.26 Tax policy research projects

The following tax policy research projects will be undertaken or completed during 2012/13:

- Reforms to the primary, secondary and tertiary rebates in the context of a review of the means testing for the old age grant and with the intention to introduce a child and/or dependant tax rebate/credit.
- Taxation of financial instruments (including derivatives).
- Long-term insurance companies – review of the taxation, accounting and regulatory practices of the four fund system.
- Taxation of income from capital (interest income, dividends, capital gains, rental) to be reviewed to ensure greater equity and minimise opportunities for tax arbitrage.
- VAT treatment of public passenger transport.
- The implementation and importance of user charges and other fees.

2.27 Employee share schemes

Many companies use employee share schemes to motivate employees and to meet black economic empowerment objectives. Most of these schemes are based on the use of employee share trusts. These trusts obtain funding from an employer-company, with a trust holding the shares for the benefit of the employees. While this legitimate practice is to be supported, these schemes are often mixed with executive share schemes that tend to undermine tax. This has resulted in audit controversy and legislative uncertainty. To address these concerns, it is proposed that the various types of employee share schemes be reviewed to eliminate loopholes and possible double taxation. The review will also consider the interrelationship between employer deductions and employee share scheme income. The incentive regime for low-income earner share schemes also needs to be reviewed and possibly merged into a single employee share scheme regime. These issues will be resolved over a two-year period.

2.28 False job terminations

Employees cannot withdraw funds from employer-provided retirement schemes before retirement unless an employee terminates employment with that employer. In some instances, employees terminate their employment solely to gain access to employer-provided retirement funds. In the most egregious circumstances, employees quit employment only to be rehired by the same employer shortly thereafter. Access to withdrawal under these artificial circumstances will no longer be permitted.

2.29 Determination of the value of fringe benefits

In certain cases, the Income Tax Act prescribes the use of a formula to calculate the value of a fringe benefit to be taxed in the hands of the employee. However, in these cases, it is sometimes possible for the employer to determine or obtain the actual cost of providing the fringe benefit to the employee (for example, actual business and private kilometres travelled by an employee using a company vehicle, and employers that provide rented vehicles to their employees as 'company vehicles'). To create a better match between the employees' tax withheld and the tax calculation on assessment, it is proposed that, where possible and practical, the employer be allowed to use actual cost to determine the value of the fringe benefit for the employee.

2.30 Employer-owned insurance intended to cover a contingent liability

In 2011, the taxation of employer-provided insurance was rationalised. One of the aims of this rationalisation was to ensure that deferred compensation policies are not disguised as key person insurance. One unresolved issue relates to the purpose for which genuine key person insurance is intended. Insurance to cover against operating losses due to the loss of an employee clearly should be deductible for an employer if desired. On the other hand, deducting premiums for insurance to purchase ownership interests of an employee-shareholder or to repay the allocation of debt guaranteed by an employee-shareholder is questionable. The continued allowance of deductible premiums in these latter circumstances will be explored, along with other tax issues relating to this form of insurance. These issues will be resolved in 2012 or 2013 (depending on the press of other matters).

2.31 Taxation of payouts from South African or foreign retirement funds

There are currently a number of anomalies in the tax treatment of lump sum and annuity payouts from South African or foreign retirement funds, depending on whether a South African resident or a non-resident receives the payout. An important factor is whether the services that relate to the payout were rendered in South Africa or elsewhere. The issue will receive due consideration during the course of 2012 and 2013.

2.32 Taxation of divorce order-related retirement benefits

The 'clean-break' principle was introduced to private-sector funds in 2007 so that divorcing spouses could fully separate their pension interests without any ongoing connection. This principle will also form part of the Government Employees Pension Fund (GEPF). The National Treasury proposes that the taxation of retirement interests paid out as a result of divorce orders for the GEPF should roughly mirror private-sector funds:

- In the case of retirement fund payouts stemming from divorce orders issued on or after 13 September 2007, each individual spouse will be responsible for the tax on the portion that they receive.
- The transitional rules applicable to private-sector funds are extended to GEPF payouts, so that retirement fund payouts stemming from divorce orders issued prior to 13 September 2007 will not lead to any tax consequences for either spouse.
- Formula C, which preserves a public-sector fund member's right to a tax-free retirement benefit prior to 1 March 1998, will be extended to the non-member's portion of the pre-1 March 1998 interest.
- The proposed date of implementation is 1 March 2012.

Although the introduction of the 'clean-break' principle in private-sector funds has been largely successful, there are still some anomalies that result in continued engagement. It is proposed that these anomalies be addressed so that the overall tax treatment of all divorce-order retirement benefits paid out as a result of a divorce order will fully apply the clean-break principle from 1 March 2012.

2.33 Learnership allowances

Employers are eligible for an additional allowance for each registered learnership (in addition to the general deduction for employee expenses). Employers, however, do not qualify for this allowance if the learner did not complete a prior registered learnership. This prohibition will be re-examined. A further problem arises when registration is delayed owing to reasons outside the employer's control, but the allowance begins only upon official registration. The commencement date will be adjusted so that these delays do not undermine the benefit of the additional allowance.

2.34 Collateral amendments stemming from the implementation of the new dividend withholding tax

The dividend withholding tax becomes effective from 1 April 2012 at a rate of 15 per cent. This new tax necessitates the following collateral adjustments:

- Removal of the 33 per cent rate for foreign companies:

  Foreign companies with domestic income are subject to a 33 per cent rate of tax, while domestic companies are subject to a 28 per cent rate plus a 10 per cent secondary tax. The additional 5 per cent charge is a proxy for the lack of any secondary tax on foreign companies. This charge will be dropped in light of the repeal of the secondary tax on domestic companies.
- Removal of the 33 per cent rate for personal service providers:

  Personal service providers are similarly subject to a 33 per cent rate, which will also be reduced to 28 per cent.
- Removal of the higher gold formula rate:

  Gold companies have the choice of two gold formula rates – the standard formula or the higher formula. Companies choosing the higher formula are exempt from the secondary tax on companies. With the repeal of the secondary tax on companies, the higher formula will be removed as superfluous.

- Removal of the proposed passive holding company regime:

  Government initially proposed a passive holding company regime to come into effect with the implementation of the dividend withholding tax to correct potential arbitrage between different tax rates. With the dividend withholding tax coming into effect at a 15 per cent rate, these arbitration concerns are greatly reduced. The initially proposed passive holding company regime will be dropped.

- Shortened period for transitional credits:

  The dividends tax contains transitional credit relief stemming from the pre-existing secondary tax on companies. These credits are set to last for up to five years into the new regime. However, given the delayed implementation of the dividends tax (and the fact that the new regime has a higher rate), the transitional credit period will be reduced to three years.

2.35 Debt cancellations and restructurings

Given the weaker economic climate over the past several years, some taxpayers are at risk of becoming insolvent and are seeking to reduce or restructure their debt. In 2011, the National Treasury announced its intention to eliminate the unintended tax impact of debt reductions in the case of debt workouts (the treatment of debt cancellations or reductions as capital gain or ordinary revenue). The goal would be to create a simplified regime to determine the tax impact on the debtor when debt is unilaterally reduced or cancelled without full consideration, and to eliminate adverse tax consequences when the debt relief merely restores the debtor to solvency. Specific rules will also be required to address situations where creditors agree to convert their debt interests into an equity stake as partial compensation.

2.36 Company law reform and company restructurings

The comprehensive rewrite of the Companies Act (2008) has given rise to a set of anomalies in relation to tax, especially in the case of reorganisations and other share restructurings. As many of the tax rules relating to company reorganisations have been in place for 10 years, a review is appropriate. Government will hold a series of workshops to review the nature of company mergers, acquisitions and other restructurings to better understand their practical use. These workshops will lay the foundation for tax changes (and possibly changes to company law) over a two-year period. An immediate focus area will be share-for-share recapitalisations of a single company.

2.37 Mark-to-market taxation of financial instruments

The taxation of financial instruments on a mark-to-market basis has long been under consideration. This form of taxation aligns the tax treatment to financial accounting, which greatly simplifies audit and compliance. It is proposed that this project begin in earnest, using certain changes as pilot projects. First, the current system of mark-to-market taxation for foreign currency instruments should be moved closer to modern accounting standards. Second, the mark-to-market treatment of other financial instruments for tax purposes should be expanded and revised. Changes include expanding the elective regime to cover a wider set of financial assets and liabilities. However, the revised system will be subject to explicit SARS approval so that the regime can be fully controlled during the pilot phase. Ongoing changes can be expected in this area over the next few years based on practical experience.

2.38 Review of tax system for insurers

The global insurance industry is undergoing reforms associated with solvency assessment and management projects. These rules will change the way insurers determine their reserves. There are several related tax issues:

- In the case of short-term insurers, certain reserves form the basis for tax deductions while providing a safety cushion for the insurers. To date, the regulatory and tax impact of these reserves has not been fully coordinated, leading to anomalies that have both positive and negative effects for short-term insurers. Captive insurers have also raised longstanding issues for the fiscus.
- The principles of the four fund trustee system of taxation relating to long-term insurers has long been in need of review, Long-term insurers hold and administer assets on behalf of various categories of policyholders, in addition to managing assets for the benefit of shareholders. In recognition of these relationships, long-term insurance products are subject to the four funds system, with the insurer being taxed on return on assets as trustee for the policyholder. However, once the system moves beyond basic theory, it is often unclear whether issues should be determined from a policyholder perspective or a corporate shareholder perspective, and how the two perspectives can be combined. The system also lacks any correlation with the system of accounting, making factual verification and reconciliation difficult, if not impossible.

These concerns necessitate a comprehensive review of the tax system for insurers. To simplify the task, it is proposed that the tax system for calculating short-term insurance reserves be addressed in 2012, with long-term insurers being addressed in 2013. A short paper on long-term insurers will be circulated for comment by mid-2012.

2.39 Government grants

Unless a specific exemption exists, government grants are subject to tax when paid to a taxable entity. A comprehensive review is being undertaken to determine which grants should be exempt to avoid undue taxation (or unintended additional administration). This review will result in an explicit legislative list of exempt grants, updated annually, to improve transparency and ease of administration. The current regulatory regime will also remain in place in the interim. It should be noted, however, that tax expenditure related to tax-exempt grant funding will not be deductible, depreciable or allowed as any other tax offset against the grantee's taxable income, because government, not the grantee, bears these costs.

2.40 Sales of trading stock to connected persons

The tax system has rules to prevent character mismatches through related (connected) person sales. Under these rules, taxpayers purchasing assets from connected persons receive a tax cost that is the lower of the purchaser's or the connected person's tax cost. While this anti-avoidance rule can be supported from a capital gains tax perspective, it does not need to apply to trading stock because connected persons' sale of trading stock is unlikely to give rise to manipulation. Trading stock will accordingly be removed from the anti-avoidance connected-person sale rules.

2.41 Contingent liabilities associated with the sale of business operations

In 2011, concerns were raised about the tax effect of the sale of a business subject to potential contingent liabilities. These liabilities were giving rise to concerns of potential double taxation or double non-taxation. After much debate, the proposed legislation was withdrawn in favour of an interpretative approach. Interpretative guidance, with legislative refinements, is expected later in the year.

2.42 Share issue mismatches

The issuing of shares by a company does not give rise to ordinary or capital gain because any amounts received represent a cash contribution. However, it has come to government's attention that certain taxpayers are seeking to use this rule to shift value to new shareholders without paying the full tax due. Most of these schemes rely on the receipt of consideration in excess of the value of the shares issued. It is proposed that the exemption for the issue of shares be limited to their value, with the excess being subject to tax.

2.43 Share block conversions to sectional title

Company liquidations are generally subject to tax to preserve the company dual-level tax system (a tax on company income plus distribution of that income). The conversion of share block companies into sectional title schemes can create a tax problem. In form, this conversion is a company liquidation, but in substance it is merely a change to direct interest from an indirect interest in the underlying property. In these situations, the property owner has swapped interests in favour of a more modern approach. It is proposed that these liquidations receive tax-free rollover treatment.

2.44 Supporting structure for energy projects

Energy projects such as wind, solar and hydroelectric facilities are eligible for accelerated depreciation on a 50:30:20 basis. At issue are the foundations and supporting structures associated with these arrangements. Accelerated depreciation will be extended to these ancillary structures.

2.45 Extension of the urban development zone incentive

The incentive for buildings (new and renovated) in urban development zones is set to expire in 2014. Government is considering extending this incentive, subject to the receipt of current legislatively required municipal progress reports and a review of their effectiveness. In addition, the cut-off date poses a problem because it is based on when buildings are brought into use rather than the date of initial construction. It is proposed that the cut-off date be re-examined along with any other anomalies associated with the incentive.

2.46 Captive finance vehicles

Some taxpayers use artificial financing vehicles to eliminate income. In some of these schemes, the parent company transfers trade receivables at discounted rates, followed by the return of the discount via tax-free preference share dividends. Other schemes provide for the same manipulation through the artificial over-payment of insurance, services or other deductible payments. These schemes give rise to income tax concerns, and they may also be problematic for VAT. It is proposed that these schemes be reviewed for potential elimination.

2.47 Industrial policy incentives – section 12 (I)

Section 12 (I) of the Income Tax Act provides a tax incentive for qualifying companies in respect of investment and training. The experience gained thus far in administering the programme has revealed two areas in which legislative adjustments will result in a more streamlined process. First, the requirement for tax clearance certificates of all connected parties is an administrative burden. A relaxation of this requirement is under consideration. Second, it is proposed that companies should submit monitoring reports until the allowance is exhausted or until all requirements of the programme are met.

2.48 South African investment into Africa

Over several years, South Africa has introduced several initiatives to reduce potential double-tax costs when investing into Africa. Management services have been an issue, especially the question of whether foreign withholding taxes on these services are eligible for foreign tax credits. Besides clarifying further anomalies in this area, active South African management over controlled foreign subsidiaries may trigger dual-residence tax status, even though all day-to-day operational activities are being conducted abroad. This situation arises because there are practical difficulties associated with local conditions. It is proposed that this dual-residence tax status be removed if the tax of the foreign country is roughly on par with otherwise applicable South African tax. Alternatively, the issue can be resolved as a matter of interpretation.

Many South African loans to foreign African subsidiaries essentially operate as additional share capital contributions – their purpose is to provide for a more flexible use of capital, not to avoid South African tax. However, the formal use of a loan often gives rise to transfer pricing concerns because these loans do not generate annual interest. It is proposed that these loans be treated as shares in line with the decision to treat certain forms of debt as shares.

2.49 Local managers of foreign funds

Foreign investment funds often rely on active managers in South Africa for direction regarding African fund assets. However, this form of guidance often raises tax risks, especially the risk that this form of management will be viewed as South African effective management in tax terms, giving rise to a worldwide tax on all fund assets. This risk has deprived local fund managers of foreign investment fund business and has even forced certain local fund managers to relocate abroad. It is proposed that a legislative carve-out be created for foreign investment funds so that these funds are not inadvertently subject to worldwide taxation.

2.50 Ongoing refinements to headquarter company relief

Over the past two years, special rules have been enacted that provide tax and exchange control relief for South African headquarter companies. While most issues have been resolved, some outstanding problems are being uncovered as foreign investors seek to use the regime. These anomalies mainly focus on transfer-pricing concerns and headquarter companies that rely on foreign currency for their operations. These anomalies will be addressed to encourage regional headquarter company investment.

2.51 VAT - Clarification of the date of liability for registration

A person that becomes liable to register for VAT (on account of reaching the compulsory threshold of R1 million) must apply to SARS for registration as a vendor within 21 days. That person cannot charge VAT on supplies until they have been registered as a vendor by SARS. There are no transitionary rules in the VAT Act that address this issue. It is proposed that the liability date for VAT be clarified to streamline the transition from a non-vendor to a vendor.

2.52 VAT - Bargaining councils

Bargaining councils regulate collective agreements and conduct dispute resolution for their members. These councils levy an administration fee that is payable by employees. However, the activities of a bargaining council do not fall within the ambit of an employee organisation, and are arguably subject to VAT. These activities are similar to that of an employee organisation and should similarly be exempt from VAT.

2.53 VAT - Instalment credit agreements

Movable goods supplied through an instalment credit agreement take the form of a sale or a lease. Depending on the form, finance charges and/or insurance (the lessee accepts the full risk of destruction of the asset) is payable. Shariah law prohibits the charging of interest or the placing of risk or insurance responsibilities on the client, owing to the element of chance. It is proposed that the provisions governing instalment credit agreements in the VAT Act be amended to accommodate products that are compliant with Shariah law.

2.54 VAT - Debit and credit notes

The VAT Act contains specific scenarios that justify the issuing of a credit or debit note. For instance, if a vendor issues a tax invoice for an incorrect amount (for example, R100), the vendor cannot justify the issue of a credit note (the invoice amount was R50 and not R100) within the specified conditions in the VAT Act. It is also unlawful to issue more than one tax invoice for the same supply. It is proposed that the specified conditions in the VAT Act under which a vendor can issue credit or debit notes to correct incorrect tax invoices be extended.

2.55 VAT double charge for goods removed from an industrial development zone

Movable goods imported into a customs controlled area (CCA) of an industrial development zone are exempted from customs duty and VAT. A deemed VAT charge is triggered if the goods are temporarily removed from the CCA and not returned within 30 days. For customs purposes, the removal of the goods leads to a voucher of correction, processed by customs, and VAT on importation is payable. The result is that double VAT is charged. It is proposed that this double charge be eliminated.

2.56 VAT - Political parties

The receipts and accruals of any political party registered in terms of the Electoral Act (1998) are exempt from income tax. The VAT Act does not contain a specific provision for political parties, which results in uncertainty. As a result, it is unclear whether the receipts and accruals of a political party can be construed as ‘consideration’ for taxable supplies or a ‘donation’. The latter view seems more consistent with the nature and mandate of political parties as there is no reciprocal performance between the political party and the donor(s) concerned. It is proposed that the receipts and accruals of political parties be exempted from VAT.

2.57 VAT - Imported goods sold prior to entry for home consumption

A foreign company that sells goods that enter South African territorial waters may be required to register for VAT if this activity is continuous or regular. The recipient (buyer and vendor) is liable for import VAT on the clearance of the goods for home consumption. As a result, the recipient is liable for two VAT charges on the same amount. It is proposed that the VAT provisions relating to goods sold by foreign companies prior to entry for home consumption be reviewed.

3. DRAFT TAXATION LAWS AMENDMENT BILL, 2012 - MEDIA STATEMENT

While the attached draft legislation deals with a multitude of technical issues, the following items are worthy of note:

- Dividends Tax transitional rules:

  The proposed amendments clarify the transition from the Secondary Tax on Companies to the new Dividends Tax (as well as related rules involving capital distributions and general definitions).

  - The main points to note are newly added provisions to expressly prevent double taxation. More specifically, amounts subject to normal tax or the Secondary Tax on Companies will not be subject to tax again under the new Dividends Tax. The provisions also clarify that dividends subject to the Secondary Tax on Companies will generate credits against the new Dividends Tax even if timed shortly before the transition.
  - In addition, as per the 2012 Budget Review, STC transitional credits will only be available three years into the new regime (as opposed to the initially proposed five year period). This reduced time period is in recognition of the fact that the new Dividends Tax has been long-delayed, thereby mitigating the need for transitional credits given the advanced warning for taxpayers to plan their affairs.
  - Lastly, the rules relating to withholding certificates, exemption claims and refunds as well as collateral administrative issues may have to be revised to account for system implementation.

- Hybrid shares and third-party backed share guarantees:

  The draft website legislation contains revisions to the hybrid share and third-party backed share guarantee provisions. The main purpose of the initial anti-avoidance provisions is to ensure that the holder of the shares directly or indirectly bears some form of equity risk associated with the issuer. Without this indirect risk, the shares should not be viewed as generating exempt dividends but taxable interest. Equity risk is usually eliminated one of two ways: either the risk is shifted to third parties via third party guarantees or *via* secured third-party financial instruments. That said, the initial 2011 legislation recognised that the use of preference share funding to acquire shares in operating companies was necessary to avoid indirect double taxation (because debt used to acquire shares generally does not allow for deductible interest). It is further recognised that black economic empowerment transactions largely follow this paradigm.

The revised legislation essentially seeks to capture the original intent. However, intensive consultation with various key stakeholders suggests that the nature of the third party guarantees and security arrangements operate somewhat differently than initially believed when applied at a granular level. The revised legislation essentially adjusts both anti-avoidance provisions in light of these complexities. The details relating to the revised legislation are fully described in the draft explanatory memorandum attached. In closing, the other key points to note are as follows:

- Given extensive granular nature of these adjustments, it has been decided that the effective date of both anti-avoidance provisions be deferred until 1 October 2012 (applying only in respect of years of assessment commencing from that date).
- While it is understood that the rules closing down cession schemes should eliminate most collective investment schemes engaged in the practice of generating interest-like dividends via artificial preference share holdings, concerns exist that several schemes are trying to technically avoid the legislation through suspect means. Therefore, a second review of these schemes will be undertaken to ensure that the targeted schemes do not bypass the anti-avoidance legislation proposed.
- Requests were made to extend the exemption to include debt-like share financing in support of redemptions or in support of future dividends. However, it was decided that this extension raises

significant policy issues and could become an easy avenue for renewed avoidance. It was accordingly decided that the exemptions retain their sole focus of supporting equity share acquisitions of operating companies.

- Concerns also exist that derivatives can be used to shift risk to wholly unrelated parties so as to bypass the proposed anti-avoidance rules. The proposed legislation may accordingly have to be tightened to address this concern.

- Minimum 45-day holding period before disposal:

  The 2011 legislation was drafted with the intent of treating dividends as ordinary revenue (or additional capital gain) if the dividends arose 45 days before disposal. It is now proposed that this 45-day holding period be completely scrapped as impractical. Besides the burdensome reporting requirements associated with dividends received or accrued by various financial institutions (e.g. share dealers), it is questionable whether pre-sale dividends for regularly traded shares gives rise to the potential for avoidance initially believed. We also note that the main avoidance was terminated with the closure of cession schemes.

- Headquarter company regime:

  The proposed amendments eliminate certain anomalies associated with the newly established Headquarter regime. For instance, the purchase of headquarter company shares will no longer be subject to the Securities Transfer Tax. Many of the requirements associated with the exemption for the disposal of shares by a headquarter company will also be dropped to allow for more flexible disposals as initially intended. More substantive aspects of the regime will be reviewed later in the year to further facilitate the regime’s intended use.

- Delayed effective date for the revised research and development incentive:

  It was initially intended that the revised incentive regime (i.e. the additional allowance system) for research and development was initially set to take effect as from 1 April 2012. This date has now been delayed until 1 October 2012 to facilitate enhanced implementation.

- Temporary Expanded Brokerage exemption from the Securities Transfer Tax:

In 2011, the brokerage exemption from the Securities Transaction Tax became the object of an interpretative challenge from SARS due to certain practices that shifted the economic risks and rewards to related parties. Without going into the merits of the issue, it was decided that the exemption be temporarily expanded so as not to disrupt the business of market making on the JSE nor the business of offering derivatives. It appears now that the technical language contained within that amendment may itself be suspect. Hence, it is proposed that the language associated with the temporary expansion be adjusted to provide for full temporary protection from the Securities Transaction Tax (as initially intended).

- Deductible foreign dividends:

  The 2011 legislation effectively treats foreign dividends as ordinary revenue if the dividend is deductible in the foreign home country. The purpose of this legislation was to prevent the use of hybrid instruments as a means of bringing exempt funds into the country (which often stem from local amounts paid offshore in deductible form). Nonetheless, several commentators contend that deductible foreign dividends are often not an indicator of avoidance and should be allowed. The proposed legislation remains silent on the matter. Further information will be required before any policy decision can be taken in this regard.

- Oil and gas incentive:

  Oil and gas companies are eligible for special tax incentives within South Africa, including a fiscal stability clause against certain increased rates and other base broadening measures. Transition of these regimes in light of the new Dividends Tax will be conducted later in the year.

4. DRAFT TAXATION LAWS AMENDMENT BILL, 2012

4.1 Section 8E – Dividends on certain shares deemed to be interest in relation to the recipient thereof

Section 8E is proposed to be substituted by the following substitution and to come into operation on 1 October 2012 and applies in respect of dividends and foreign dividends received or accrued during years of assessment commencing on or after that date:

(1) For the purposes of this section—

'date of issue' in relation to a share in a company means—

(a) the date on which it is issued by that company;

(b) the date on which the company at any time after the share is issued undertakes the obligation to redeem that share in whole or in part; and

(c) the date on which the holder at any time after the share is issued obtains the right to require that share to be redeemed in whole or in part, otherwise than as a result of the acquisition of that share by that holder;

'financial instrument' means any—

(a) interest bearing arrangement; or

(b) financial arrangement based on or determined with reference to the time value of money;

'hybrid equity instrument' means—

(a) any share other than an equity share if—

(i) the issuer of that share is obliged to redeem that share in whole or in part; or

(ii) that share may at the option of the holder be redeemed in whole or in part,

within a period of three years from the date of issue of that share;

(b) any share other than a share contemplated in paragraph *(a)* if—

(i) *(aa)* the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share ;

(bb) that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or

(cc) at any time on the date of issue of that share, the existence of the company issuing that share—

(A) is to be terminated within a period of three years; or

(B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time; and

(ii) *(aa)* such share does not rank *pari passu* as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes; or

(bb) any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value of money; or

(c) any share if—

(i) any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value of money; and

(ii) such share is—

(aa) secured by a financial instrument; or

(bb) subject to an arrangement in terms of which a financial instrument may not be disposed of (other than an arrangement in terms of which that financial instrument may be distributed as a dividend or return of capital), unless the consideration received by or

accrued to the issuer of that share was applied directly or indirectly solely—

(A) for the purpose of acquiring a share in an operating company, other than a share—

(AA) in an operating company that forms part of the same group of companies as that issuer; and

(BB) that constitutes a share contemplated in paragraphs *(a)* or *(b)* without regard to any three year period requirement contemplated in those paragraphs;

(B) in partial or full settlement of any debt incurred for the purpose of directly or indirectly acquiring a share as contemplated in subparagraph (A) or in partial or full settlement of any interest accrued on such debt; or

(C) for the purpose of acquiring or redeeming any preference share as defined in section 8EA(1) if—

(AA) that preference share was issued for any purpose contemplated in subparagraph (A) or (B); and

(BB) that consideration does not exceed the amount outstanding in respect of that preference share, being—

(AAA) the capital subscribed for the issue of; and

(BBB) any amount of dividends or interest accrued in respect of,

that preference share.

(2) Any dividend or foreign dividend received by or accrued to a person during any year of assessment in respect of a share must be deemed in relation to that person only to be an amount of interest accrued to that

person if that share constitutes a hybrid equity instrument at any time during that year of assessment.

4.2 Section 8EA - Dividends on third-party backed shares deemed to be income in relation to recipients thereof

The Income Tax Act is proposed to be amended by the insertion after section 8E of section 8EA, to come into operation on 1 October 2012 and applies in respect of dividends and foreign dividends received or accrued during years of assessment commencing on or after that date:

(1) For the purposes of this section—

'enforcement obligation' in relation to a share means any obligation, whether fixed or contingent, of any person other than the issuer of that share to—

(a) acquire the share from the holder of that share;

(b) make any payment in respect of that share in terms of a guarantee, indemnity or similar arrangement; or

(c) procure, facilitate or assist with any acquisition contemplated in paragraph *(a)* or the making of any payment contemplated in paragraph *(b)*;

'enforcement right' in relation to a share means any right, whether fixed or contingent, of the holder of that share or of any person that is a connected person in relation to that holder to require any person other than the issuer of that share to—

(a) acquire that share from the holder;

(b) make any payment in respect of that share in terms of a guarantee, indemnity or similar arrangement; or

(c) procure, facilitate or assist with any acquisition contemplated in paragraph *(a)* or the making of any payment contemplated in paragraph *(b)*;

'equity share' means an equity share as defined in section 1, other than an equity share that would have constituted a hybrid equity instrument, as defined in section 8E(1), but for any three-year period requirement contemplated in the definition of 'hybrid equity instrument' in that section;

'operating company' means—

(a) any company that carries on business continuously, and in the course or furtherance of that business provides goods or services for consideration;

(b) any company that is a controlling group company in relation to a company contemplated in paragraph *(a)*; or

(c) any company that is a listed company;

'preference share' means any share other than an equity share; and

'third-party backed share' means any share in respect of which an enforcement right is exercisable or an enforcement obligation is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share not being received by or accruing to the person holding that share: Provided that, where the consideration received by or accrued to the issuer of a share (which, but for this proviso, would have constituted a third-party backed share) was applied directly or indirectly solely—

(a) for the purpose of acquiring an equity share in an operating company, other than an equity share in an operating company that forms part of the same group of companies as that issuer;

(b) in partial or full settlement of any—

(i) debt incurred for the purpose of directly or indirectly acquiring an equity share in an operating company, other than an equity share in an operating company that forms part of the same group of companies as that issuer; or

(ii) interest accrued on any debt contemplated in subparagraph (i); or

(c) for the purpose of acquiring or redeeming any preference share if—

(i) that preference share was issued for any purpose contemplated in paragraphs *(a)* or *(b)*; and

(ii) that consideration does not exceed the amount outstanding in respect of that preference share, being—

(aa) the capital subscribed for the issue of; and

(bb) any amount of dividends or interest accrued in respect of,

that preference share,

in determining whether—

(A) an enforcement right is exercisable in respect of that share, no regard must be had to any arrangement in terms of which the holder of that share has an enforcement right in respect of that share and that right is exercisable only against—

(AA) that operating company or any person that directly or indirectly holds at least 20 per cent of the equity shares in that operating company;

(BB) any person that directly or indirectly holds at least 20 per cent of the equity shares in—

(AAA) that issuer; or

(BBB) any other issuer of a preference share if the consideration received by or accrued to that other issuer as consideration for the issue of that preference share by that other issuer is applied solely for the purpose of acquiring an equity share in an operating

company and that equity share in that operating company was acquired indirectly by that issuer in the circumstances contemplated in paragraph *(a)* or *(b)*; or

(CC) any company that is a controlled group company in relation to—

(AAA) that operating company;

(BBB) the issuer contemplated in subparagraph (BB)(AAA); or

(CCC) the other issuer contemplated in subparagraph (BB)(BBB),

if other enforcement rights are exercisable against the controlling group company in relation to that controlled group company and those other enforcement rights are of equivalent or greater strength than the enforcement right against that controlled group company; and

(B) an enforcement obligation is enforceable in respect of that share, no regard must be had to any arrangement in terms of which—

(AA) that operating company or any person that directly or indirectly holds at least 20 per cent of the equity shares in that operating company is subject to an enforcement obligation in respect of that share and that obligation is enforceable by the holder of that share; or

(BB) any person that directly or indirectly holds at least 20 per cent of the equity shares in—

(AAA) that issuer; or

(BBB) any other issuer of a preference share if the consideration received by or accrued to that other issuer as consideration for the issue of that preference share by that issuer is applied solely for the purpose of acquiring an equity share in an operating company, and that equity share in that operating company was acquired indirectly by that issuer in the circumstances contemplated in paragraph *(a)* or *(b)*,

is subject to an enforcement obligation in respect of that share and that obligation is enforceable by the holder of that share; or

(CC) any company that is a controlled group company in relation to—

(AAA) that operating company;

(BBB) the issuer contemplated in subparagraph (BB)(AAA); or

(CCC) the other issuer contemplated in subparagraph (BB)(BBB),

is subject to an enforcement obligation in respect of that share and that obligation is enforceable by the holder of that share, and if other enforcement obligations are enforceable against the controlling group company in relation to that controlled group company and those other enforcement obligations are equally or more burdensome than the enforcement obligation against that controlled group company.

(2) Any dividend or foreign dividend received by or accrued to a person during any year of assessment in respect of a share must be deemed in relation to that person only to be an amount of income received by or accrued to that person if that share constitutes a third-party backed share at any time during that year of assessment.

5. TAX CASES

5.1 MTN Holdings (Pty) Ltd v C:SARS

MTN Holdings (Pty) Ltd (MTN Holdings) was a wholly-owned subsidiary of the MTN Group Ltd and had five wholly-owned subsidiaries and the collective business of the MTN Group was the provision of mobile telecommunication networks and related services.

It was common cause that MTN Holdings had carried on a trade during the years of assessment in issue in that it had been an investor in shares and a lender of funds, primarily in the context of a debenture scheme arrangement which existed in relation to companies within the group and their staff members.

MTN Holdings had claimed deductions of certain expenses, being audit fees and professional fees, for the relevant years of assessment, 2001-2004.

The audit fees in issue incurred by MTN Holdings related to revenue from dividends as well as revenue from interest.

The professional fees had been incurred when the services of KPMG were provided in order to train staff on the computer accounting system known as the Hyperion system.

The issues to be determined in the appeal were:

- whether SARS was entitled to disallow MTN Holdings' expenditure incurred in respect of audit fees for the relevant years of assessment;
- whether the expenditure incurred by MTN Holdings in respect of professional fees charged by KPMG for the training of staff on a new accounting package was wholly deductible.

The evidence revealed that MTN Holdings had lent money to its subsidiaries and had also earned dividends from investments made and the total dividend income represented the largest portion of its income of between 89% and 99% during the years in question.

The audit fees had been incurred by MTN Holdings for the purposes of complying with its statutory obligations to have its accounts audited as well as for the purpose of trading.

Although dividends constituted the bulk of MTN Holdings' revenue for each of the four years of assessment, the auditors estimated that only about 6% of the audit had been devoted to auditing the revenue from dividends and, in contrast, much work had been done in respect of MTN Holdings' interest income.

The Hyperion computer management system had been introduced in the 2004 tax year in order to capture, record and index certain aspects related to MTN Holdings' financial affairs and the system assisted in the conduct of its business and, in particular, it assisted in the consolidation of financial results and the reporting of its results.

The professional fees were incurred with MTN Holdings' auditors in respect of their rendering services in regard to the implementation, adjustment, fine tuning and user operation of the system.

SARS had apportioned the audit fees in accordance with the ratio between dividends received and interest earned and had disallowed the portion allocated to dividends received and, in the result, had disallowed the bulk of the expenditure for audit fees and had also disallowed the aforementioned professional fees as the expense was, inter alia, of a capital nature.

MTN Holdings had appealed SARS' finding to the South Gauteng Tax Court (see ITC 1842 per Gildenhuys J) which had apportioned a deduction of 50% in respect of the auditing fees for the relevant years of assessment and had referred the matter back to SARS to issue new assessments but the court had refused MTN Holdings a deduction for the full cost to it of the training of staff for the new Hyperion accounting package as the fees paid to the consulting auditors constituted an expense of a capital nature and in the light of this finding it was not necessary to decide whether the expense had been incurred in the production of 'income' or in carrying on any trade.

The court a quo did not accept that the cost of statutory compliance necessarily meant that such costs amounted to expenditure incurred in the production of income. It found further that the expenditure on the audit fee had been for a dual purpose and in the circumstances was thus entitled to apportion the expenditure between two purposes and had considered various formulae for the apportionment and had arrived at the 50% apportionment.

On appeal to a full bench of the South Gauteng High Court MTN Holdings contended that it was entitled to deduct its full expenditure incurred in respect of audit fees for the relevant tax years and was entitled to deduct in full the professional fees incurred by it for the training of staff on a new accounting package.

SARS contended that the audit services in issue did not advance MTN Holdings' trade and the production of its income and submitted that all audit fees should be disallowed.

SARS cross-appealed in respect of the audit fees and contended that the deduction of 50% ordered by the court a quo in respect of the audit fee was incorrect and had to be considered.

Judge Victor held the following:

<u>As to the deductibility of the audit fee</u>

(i) That the applicable legal principles were clear but their application to the facts introduced the complexities; in order for the expenditure to be deducted it must have been incurred in the bona fide performance of the operation, must have been incurred in the production of income and need not be causally related to the income and regard had to be had to the purpose of the expenditure and to what it actually affected.

(ii) That the acceptance by the parties that it was common cause that MTN Holdings had been a trading entity constituted an essential element in determining the issue and, in addition, the undisputed contention of MTN Holdings that on average only 6% of the entries in its books of account such as the cash book, and ledger related to dividends was an important consideration.

(iii) That having placed the emphasis on the primary role of an auditor in company law as not being related to the generation of income but as being in the vanguard of protecting the interests of investors, potential investors and creditors and whilst the evolution of the statutory role of an auditor in auditing a company may involve non-income producing aspects, in this case the evidence revealed the necessity of the auditor's role in MTN Holdings' income generating activities and the application of the aforementioned evolving jurisprudence had no application in this case since the factual matrix was clear.

(iv) That the parties accepted that MTN Holdings' business constituted trading and therefore fell within the purview of section 1 of the Income Tax Act, which defined 'trade', which is given a wide definition and 'is intended to embrace every profitable activity' and MTN Holdings' evidence that it embraced 'every profitable activity' was not undermined.

(v) That it was common cause that the amount of work undertaken by the auditors extended beyond the verification of interest income and the receipt of dividends, but these additional tasks did not detract from MTN Holdings' main submission that the costs incurred related to its income earning activities.

(vi) That MTN Holdings' evidence could not be rejected as the facts as proven, i.e. the amount of work done must remain the yardstick or benchmark and not the value of the dividend payments; moreover, only 5% or 6% of the auditor's time was spent on the dividends and the rest was utilised in respect to the interest which was its income-producing activity and hence the expenditure was incurred to directly facilitate the carrying on of its trade not only in a legally compliant manner but to generate income.

(vii) That MTN Holdings did not have to show a direct causal link or connection but a closeness of connection between the expenditure and the income, e.g. cost price of expenditure incurred for a product which is later sold by MTN Holdings for profit and such direct causal link is not the only link required in terms of section 11(a) of the Income Tax Act and there are instances where expenditure does not causally produce the income but is still deductible in terms of section 11(i) of the Act.

(viii) That in determining the causal connection between the expenditure and the income regard must be had to the purpose of the expenditure and what it actually affects and in this regard the court a quo placed importance on the role of the auditor in the context of company law statutory requirements as suggested by Professor Pretorius but the facts in this case are not probative of the learned Professor's work and the court a quo's finding cannot be upheld.

(ix) That, accordingly, the only fair basis upon which to treat the deductibility of the audit fees was to remit the issue to SARS to issue new assessments for the relevant tax years in accordance with the apportionment of 94% being deductible in respect of the audit fee, having regard to the applicable principles in ITC 1589 as in this case the bulk of the auditor's fee should be apportioned to the operating and income producing section of MTN Holdings' business.

(x) That SARS' cross-appeal is to be dismissed with costs including the costs of two counsel as the finding of the 50% apportionment by the court a quo had to fail since it was unchallenged that the audit functions and their concomitant cost related to the interest-producing operations and not the dividend-producing operations.

<u>As to the deductibility of the professional fee</u>

(xi) That the Hyperion Computer Management System enabled MTN Holdings to consolidate its financial statements and took care of 90% of the accounting work that would otherwise have had to be performed manually and it could not perform its accounting consolidation requirements without such a tool; moreover, the majority of transactions in MTN Holdings' financial records related to interest income and therefore the System had to be used and it was not used in relation to the dividend income.

(xii) That the professional fees incurred by MTN Holdings in respect of the System were closely connected to the earning of the interest income and should properly be regarded as a cost incurred in order to generate the income and hence the System was directly related to MTN Holdings' trading activities.

(xiii) That the fact of trading more effectively as a benefit from the System did not undermine the primary purpose of the System and the fact of trading more effectively did not convert expenditure into a capital item; moreover, the fact that the System aids in assisting MTN Holdings to report its trading results is not a justifiable reason to disallow the expenditure.

(xiv) That MTN Holdings was obliged in terms of its business arrangements to report its results to other companies within the MTN group and such a function was in the ordinary course of business and related to its trading activities and this function necessarily related to the ongoing production of its income in a manner consistent with its obligations to other companies in the group.

(xv) That the System constituted a tool in MTN Holdings' business as a trader and its trade was based on the fact that its activities were that of a money-lender and the scale of the investment by MTN Holdings in the shares of its subsidiary companies was such as to amount to the carrying on of a trade.

(xvi) That the audit opinion and the production of audited financial statements and the consolidation thereof where there is a group of companies must be regarded as expenditure necessarily attached to the carrying on of a trade where the trading vehicle is a company.

(xvii) That, accordingly, the expenditure incurred by MTN Holdings in respect of professional fees for the training on the System was necessary for it to conduct its income-earning business, i.e. the interest, and was deductible irrespective of whether or not there was also a non-income-earning advantage for MTN Holdings.

5.2 C:SARS v Labat Africa Ltd

Labat Africa Ltd (Labat) had acquired the trade mark ‘Labat-Anderson’ through assignment during the relevant tax year and sought to claim a deductible allowance in terms of section 11(gA) of the Income Tax Act in respect of the ‘expenditure actually incurred’ on the acquisition of the trade mark in its 2000 year of assessment.

Labat, under its former name of Acrem Holdings Ltd, had purchased ‘the entire business operations’ of Labat-Anderson (South Africa) (Pty) Ltd in terms of a written agreement dated 15 February 1999 and its effective date was 1 June 1999.

The business operations of Labat-Anderson were defined to include all its tangible and intangible assets including, more particularly, the trade mark.

In terms of clause 6 of the aforesaid agreement, under the heading ‘sale’, Labat ‘purchased’ the business ‘for a consideration’ of R120 million, ‘discharged by the issue to Labat-Anderson’ of 133 333 333 Acrem shares ‘at an issue price of 90 cents per share’.

Clause 6 of the aforesaid agreement further provided that the ‘purchase price’ was to be apportioned as to the net tangible assets at the values reflected in the accounts, then to the value of the trade mark and name in an amount as determined by an independent and suitably qualified valuator, and the balance was to be apportioned to goodwill.

An increase and subdivision of the authorized share capital of Labat was necessary in order to create these shares and the terms of the agreement were approved and the necessary special resolutions were taken to give effect to the transaction. The shares were issued and transferred in terms of the agreement and their value, at the time of transfer, was in excess of the issue price. The trade mark was valued at R44 462 000 and the allowance claimed was based on this valuation and its correctness was not in dispute.

The sole issue between the parties was whether, within the context and meaning of the statutory provision, ‘any expenditure’ had ‘actually’ been ‘incurred’ by Labat.

SARS had disallowed Labat’s claim in terms of section 11(gA) of the Act on the ground that no expenditure had actually been incurred by Labat in acquiring the trade mark in issue as required by section 11(gA) of the Act and Labat then appealed to the Pretoria Tax Court (see ITC 1801) which upheld its appeal whereupon SARS then appealed to a full bench of the North Gauteng High Court (see C: SARS v Labat Africa Ltd per Sapire AJ) which dismissed SARS’ appeal against the judgment of the Tax Court which resulted in the present appeal with special leave of the Supreme Court of Appeal.

The Tax Court found that the issuing of the shares with a value equal to the value of the trade mark meant that Labat did actually incur expenditure in obtaining assignment of the trade mark.

The court a quo was of the view that if the agreement for the acquisition of the trademark had been that the seller would purchase an agreed number of the unissued shares of the purchaser at an agreed price, and that the proceeds of such sale would be applied to payment of the purchase consideration of the asset, there could be no doubt that the transaction would constitute or involve an expenditure by the company of a portion of its share capital and hence it confirmed the conclusion of the Tax Court that the issue of shares by a company for the acquisition of an asset constituted expenditure for the purposes of section 11(gA) of the Act.

Judge Harms held the following:

(i) That although called a sale, the agreement in issue had not been a sale because a sale requires payment in money and not consideration in kind.

(ii) That the sole issue between the parties was whether, within the context and meaning of the statutory provision, i.e. section 11(gA) of the Act, ‘any expenditure’ had ‘actually’ been ‘incurred’ by Labat and the Tax Court, in coming to its conclusion that Labat did actually incur expenditure in obtaining assignment of the trade mark, relied on Edgars Stores Ltd v CIR which, in turn, was based on Nasionale Pers Bpk v KBI in holding that the expression ‘expenditure actually incurred’ meant in the present context that Labat must have incurred an unconditional legal obligation in respect of the amount concerned and it was not required that the obligation be discharged and once the obligation had been incurred the expenditure became deductible.

(iii) That although the Tax Court stated the principle to be deduced from these judgments correctly, the problem was that they did not deal with the meaning of ‘expenditure’ but with the question when the expenditure was actually incurred and it was never an issue in the instant case as to when liability arose as the transfer of the shares took place against the assignment of the trade mark and Labat sought to claim the allowance in the year the obligation was incurred.

(iv) That the question the Tax Court should have posed was whether the issuing of shares by a company amounted to ‘expenditure’ and not whether the undertaking to issue shares amounted to an obligation, which it obviously does; the terms ‘obligation’ or ‘liability’ and ‘expenditure’ are not synonyms and this was apparent from what was said by Botha JA in Caltex Oil (SA) Ltd v SIR, namely that the expression ‘any expenditure actually incurred’ meant ‘all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not’; in other words, the liability or obligation must be discharged by means of expenditure – timing is not the question.

(v) That, however, the Tax Court did seek to pose the correct question when it referred to some English judgments that dealt with the effect of a transaction in terms of which a company acquires assets ‘in consideration’ of the issue of fully-paid shares and the High Court likewise asked whether the issue of a company’s own authorized share capital in exchange for a trade mark ‘represents real consideration given by the company’ but it escaped the court how these decisions had any bearing on the meaning of 'expenditure' as used in section 11 of the Act.

(vi) That the term 'expenditure' was not defined in the Income Tax Act and since it is an ordinary English word and, unless context indicates otherwise, this ordinary meaning must be attributed to it.

(vii) That the ordinary meaning of the term 'expenditure' referred to the action of spending funds; disbursement or consumption; and hence the amount of money spent – the Afrikaans text, in using the term 'onkoste', endorses this reading and in the context of the Income Tax Act it would also include the disbursement of other assets with a monetary value.

(viii) That expenditure, accordingly, required a diminution (even if only temporary) or at the very least movement of assets of the person who expends but this did not mean that Labat will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.

(ix) That Labat-Anderson had assigned the trade mark as consideration for the shares and Labat did not 'expend' any money or assets in acquiring the trade mark and, as Goldblatt J said in ITC 1783, an allotment or issuing of shares does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders, and that it can therefore not qualify as an expenditure; it would have been more correct if he had said that it did not involve a shift of assets of the company even though it might, but not necessarily, dilute or reduce the value of the shares in the hands of the existing shareholders.

(x) That if authority is needed for the self-evident statement of Golblatt J that an allotment of shares does not diminish a company's assets, one may refer to CIR v Estate Kohler and Others which was followed by Estate Furman and Others v CIR.

(xi) That the full court in C: SARS v Labat Africa Ltd had stated that if the agreement had been that Labat-Anderson would have purchased the shares at an agreed price and that the proceeds of the sale would be applied to the purchase price, there could be no doubt that the transaction would constitute an expenditure by the company of its share capital, and that it is difficult to see the difference between this construction and the present agreement; however, whether or not the premise of the full court is correct, the conclusion misses the point. Because there is no suggestion that the contract is in any way simulated we have to take it as we find it and the fact that the parties may have constructed their agreement differently and tax-efficiently is entirely beside the point.

(xii) That, accordingly, no expenditure had actually been incurred by Labat in obtaining assignment of the trade mark and it was therefore not permitted an allowance in terms of section 11(gA) of the Act.

5.3 C:SARS v Van Kets

SARS had sought orders in the Western Cape High Court declaring that sections 74A and 74B of the Income Tax Act may be invoked by it for the purpose of obtaining information from Van Kets and any other person in the Republic of South Africa in respect of an Australian taxpayer in order to comply with its obligations under a double taxation agreement or treaty which had been concluded between South Africa and Australia (the 'DTA') and which contained a provision for the exchange of information.

SARS had received a letter which contained a request from the Australian Tax Office ('ATO') for information in terms of the DTA between South Africa and Australia and this request and subsequent requests had been made by the ATO pursuant to Article 25 of the applicable DTA.

The request related to an investigation of the income tax affairs of a Mr Duncan Paul Saville and, in particular, his possible offshore wealth and his involvement with a Labuan, Malaysian entity which had transferred approximately 62 million Australian Dollars into Australia during the period 2004 to 2007.

The information provided to SARS by the ATO indicated that Van Kets had resided in South Africa and had been a director of the aforementioned Malaysian entity, a fact which had been confirmed by Van Kets.

It was not disputed that Van Kets possessed information which ATO had requested from SARS and that such information could not be obtained as Van Kets had refused to disclose such information on the basis that it was confidential, that he was not so authorised, nor had he permission to so disclose.

Van Kets contended that he was not obliged to furnish the information requested on the ground that the Australian taxpayer (Saville) in relation to whom the information was requested was not a 'taxpayer' as envisaged in sections 74A and 74B of the Act.

The crisp issue for determination was whether the words 'any taxpayer' which are employed in sections 74A and 74B of the Act could be interpreted to include a person who is not a taxpayer as defined in section 1 of the Act, but who, in terms of the DTA, has been identified as the person who can provide the information pursuant to the request which, in this case, had been initiated by the ATO.

Sections 74A and 74B, to the extent that they are relevant to this dispute, provide that SARS may, for the purposes of the administration of the Act in relation to any taxpayer, require such taxpayer or any other person to furnish such information (whether orally or in writing) documents or things as SARS may require and SARS may require such taxpayer or any other person, with reasonable prior notice, to furnish, produce or make available any such information, documents or things as SARS may require to inspect, audit, examine or obtain.

The definition of 'taxpayer' in section 1 of the Act is as follows:

> 'taxpayer' means any person chargeable with any tax leviable under this Act and includes every person required by this Act to furnish any return.'

Article 25(1) of the DTA, headed ‘Exchange of Information’ provides, inter alia, for the exchange of information between the two countries as is foreseeable relevant for carrying out the provisions of the Agreement.

Article 25(2) of the DTA provides that any information received under par. (1) by a contracting state shall be treated as secret in the same manner as information obtained under the domestic law of that state.

Article 25(3) provided that ‘in no case shall the provisions of paragraphs (1) and (2) be construed so as to impose on a contracting state the obligation:

(a) to carry out administrative measures at variance with the law and the administrative practices of that or of the other Contracting State; or

(b) to supply information which is not obtainable by the competent authority under the law or in the normal course of the administration of that other contracting state; or . . .’

SARS contended that sections 74A and 74B were the means by which it invoked the power to obtain information requested by foreign tax authorities, pursuant to agreements that South Africa had concluded and, in terms of which, it was obliged to provide this information and in many cases information would not relate to a South African taxpayer.

SARS contended further that sections 74A and 74B can be invoked for the purpose of the administration of the Act and, to that end, they include the power to obtain information for the purposes of meeting South Africa’s obligation under the applicable DTA.

Van Kets contended that the words ‘any taxpayer’ as employed in sections 74A and 74B of the Act refer to persons who are liable for South African income tax or other taxes levied in terms of the Act or are required to furnish any return relating to South African income tax or other taxes levied in terms of the Act.

Van Kets, in other words, contended that section 74A and section 74B only apply to information which is possessed by a taxpayer as defined in terms of section 1 of the Act and, on this basis, SARS would have no legal means at its disposal to provide any information to foreign authorities, pursuant to a request made for information so long as it did not relate to a South African taxpayer.

It was accepted that the Australian taxpayer in issue (Saville) was not a ‘taxpayer’ as defined in section 1 of the Act.

Judge Davis held the following:

(i) That the crisp issue for determination was whether the words ‘any taxpayer’ which are employed in sections 74A and 74B of the Act could be interpreted to include a person who is not a taxpayer as defined in section 1 of the Act, but who, in terms of the DTA, has been identified as the person who can provide the information pursuant to the request which, in this case, had been initiated by the Australian Tax Office (‘ATO’).

(ii) That section 108(1) of the Income Tax Act provides that the national executive may enter into an agreement with the government of any other country, whereby arrangements are made with such government with the view to the prevention, mitigation of discontinuance of the levying, under the laws of South Africa and of such other country, of tax in respect of the same income, profits or gains, or tax imposed in respect of of the same donation, or to the rendering of reciprocal assistance in the administration and the collection of taxes under the laws of South Africa and of such other country; section 108(2) of the Act provides that, after the approval by Parliament of any such agreement, as contemplated in section 231 of the Constitution, the arrangement thereby shall be notified by publication in the Gazette and the arrangement so notified shall thereupon have effect as if enacted in the Act.

(iii) That the South African legal system has followed a dualist approach to international law and for this reason section 231(2) of the Constitution provides that an international agreement binds South Africa only after it has been approved by a resolution in both the National Assembly and the National Council of Provinces, unless it is an agreement referred to in subsection (3), being an agreement of a technical, administrative or executive nature or an agreement which does not require ratification or accession.

(iv) Section 231(4) of the Constitution provided that any international agreement became law in the Republic when it was enacted into law by national legislation but a self-executing provision of an agreement that has been approved by Parliament is law in the Republic unless it was inconsistent with the Constitution or an Act of Parliament.

(v) That the effect of section 108 of the Act was thus to ensure that domestic statutory obligations were created and these obligations, within the context of this dispute, were set out in Article 25 of the DTA, headed 'Exchange of Information'.

(vi) That the question for decision could be refined to the following: whether the provisions of Article 25, which provided that 'the competent authorities of the Contractual States shall exchange such information as is foreseeable relevant for carrying out the provisions of the Agreement or to the administration and enforcement to the domestic law' could be enforced in terms of South African law; in other words, absent the provisions of sections 74A and 74B of the Act there would be no legal basis by which SARS would have the legal means to acquire the information which is 'foreseeable relevant' for the administration or enforcement of Australian domestic tax law.

(vii) That the essential dispute therefore hones down further to whether the provisions of the DTA in general and Article 25 thereof in particular broaden the scope of section 74A and section 74B beyond the strict meaning of the definition of 'taxpayer' in section 1 of the Act.

(viii) That it thus appeared as if the DTA provisions become part of domestic income tax laws and given the manner in which the DTA stands to be treated in terms of section 231 of the Constitution, its provisions must rank at least, equally with domestic law, including the Act and for this reason the provisions of the DTA and the Act, should, if at all possible, be reconciled and read as one coherent whole.

(ix) That it followed that, if sections 74A and 74B stood to be interpreted on the basis of Van Kets's argument, there would be an inconsistency, to the extent that SARS would not be able to comply with the request from its contracting partner, in this case the ATO and the definition of 'taxpayer' in section 1 of the Act would represent an insurmountable obstacle to compliance. However, if the DTA is interpreted as part of domestic tax legislation, then it behoved the court to interpret sections 74A and 74B so as to render them compatible with the very provisions of the DTA and, in particular, Article 25 thereof.

(x) That Article 25 of the DTA clearly provided that the competent authority of either Contracting State may request information from the other Contracting State in order that it may impose any of the taxes 'to which the agreement applies insofar as the taxation under that law is not contrary to the agreement' and the purpose of the exchange of information clause was to ensure, for example, that a resident of Australia did not escape Australian tax which may be imposed in circumstances where income, profits or gains have accrued to that resident but are from a South African source and, absent an exchange of information, the ATO would be unable or find it extremely difficult to impose the legitimate amount of tax on such income, profits or gain.

(xi) That within the aforementioned context, the question arises as to whether the exchange of information provision caters for a third party who may have information with regard to income profits or gains of a resident of Australia in circumstances where the income, profit or gain could be sourced anywhere in the world and in this case the investigation concerns the income tax affairs of Mr Duncan Saville and in particular the accretion of his offshore wealth.

(xii) That in this case Van Kets on his own version had information regarding the tax affairs of an Australian resident (Saville) and in such circumstances he could be compelled to provide such information pursuant to the exercise by SARS of its powers in terms of sections

74A and 74B of the Act; moreover, once the DTA was read together with the Act, this reading would imply that the word ‘taxpayer’ should include those taxpayers who do not fall within the scope of the Act but fall within the scope of the DTA, which would thus include an Australian resident and once the Australian resident, in this case Mr Saville, is considered to be a taxpayer, manifestly Van Kets would fall within this section because he would be classified as ‘any other person’ who would be able to furnish information regarding a taxpayer, in this case Mr Saville.

(xiii) That, accordingly, when the DTA is read together with the Act so as to render the one congruent with the other, SARS was entitled to act in terms of sections 74A and 74B and SARS was entitled to require another person, in this case Van Kets, to furnish such relevant information in relation to this particular Australian taxpayer and in this manner the relevant provisions of the DTA and the Act would then be reconciled.

5.4 Capstone 556 (Pty) Ltd v C:SARS

Two applications were heard together in the Western Cape High Court and in each application the substantive relief sought by the respective Capstone 556 (Pty) Ltd and another (Capstone) – both of whom were taxpayers with an assessed tax liability under the Income Tax Act – was aimed at interdicting and restraining First Respondent, SARS, from taking any steps to enforce payment of the tax amount in accordance with section 91(1)(b) of the Income Tax Act, including but not limited to:

(i) taking judgment against the Capstone and filing a certificate with the Registrar of the court in order to attach their assets;

(ii) attaching their bank accounts and removing monies therefrom; and

(iii) taking any steps against their public officers, pending the determination of appeals against their assessments in the Tax Court.

Capstone had sought the aforementioned relief because for SARS had refused their request that he should direct that the obligation on them to pay the assessed tax should be suspended pending the determination of the appeals noted against their assessments in which their objections to the assessments in question had already been dismissed.

Section 88 of the Income Tax Act provided, inter alia, prior to its amendment on 1 February 2011 by section 13(1) of the Taxation Laws Second Amendment Act (No. 18 of 2009), that the obligation to pay any tax chargeable under the Act shall not and the right to receive and recover any tax chargeable under the Act, shall not, unless SARS so directs, be suspended by any appeal or pending the decision of a court of law.

The concept of ‘pay now, argue later’, as enshrined in section 88 of the Act, did not rest easily with taxpayers who found themselves in dispute with the revenue authorities in respect of the amount of tax which the authorities were determined was extractable from them but it was a concept applied in the taxation dispensations of many countries in the world and its legality survived scrutiny by the Constitutional Court in the context of this country’s Value-Added Tax Act in the case of Metcash Trading Ltd v C: SARS and Another.

SARS’ powers in terms of section 88 were ameliorated by the fact that he could suspend the operation of the ‘pay now, argue later’ provision in circumstances considered by him or her to be appropriate and the exercise of the power to grant a suspension in terms of section 88 which conceptually includes any decision by SARS to refuse a request by a taxpayer to exercise it, or to cancel any suspension previously granted, constituted administrative action within the meaning of section 33 of the Constitution and of the Promotion of Administrative Justice Act (‘PAJA’) and any decision by SARS in the exercise of the power was accordingly susceptible to judicial review in terms of section 6 of PAJA.

SARS powers in terms of section 88 of the Act were supported by section 91(1)(b) of the Act which provided that if a person failed to the pay the tax or interest when it became due or payable by him, SARS could file a statement certified by him as being correct and setting out the taxes or interest due or payable with the Clerk of the Court and this statement then had all the effects of a civil judgment for a liquid debt of the amount in favour of SARS and in terms of section 92 the taxpayer was precluded from questioning the correctness of any assessment on which such a statement was based.

There were certain relevant differences between the factual circumstances in which the two applications were brought and it is therefore necessary to summarise them individually.

The facts in case no 26078/10 were that Applicant had been informed by SARS that, consequent upon a tax audit, he proposed to re-assess its income tax liability and then issued a notice of assessment on 31 March 2010 imposing certain tax adjustments which resulted in an amount of income tax becoming payable.

Applicant then lodged an objection to the assessment in terms of section 81 of the Act and included a request for suspension in terms of section 88 of its obligation to pay the assessed tax in its letter of objection. The objection was disallowed and there was no response from SARS of any kind to the request made for a suspension in terms of section 88.

Applicant then noted an appeal in terms of section 83 of the Act to the Tax Court against the assessment and the appeal had yet to be heard.

SARS then wrote to Applicant informing it that unless the tax in dispute, including interest thereon at the prescribed rate was paid within 14 days a statement would be filed in terms of section 91(1)(b) of the Act and a warrant of execution issued against applicant without further notice.

When SARS failed to give applicant the assurance that it would not enforce payment pending the determination of the pending appeal to the Tax Court it instituted proceedings as a matter of urgency for interim prohibitory interdictal relief.

The facts in case no 8274/11 were that the applicant had lodged an objection to the revised assessments in issue and had requested a suspension of its obligation to make payment until the objection, or, if necessary, any subsequent appeal had been determined.

SARS had granted a suspension in terms of the existing provisions of section 88 of the Act on 20 December 2010 (i.e. before the section was amended with effect from 1 February 2011) pending the determination of the matter on appeal but subject to the lodging of the appeal within the prescribed time and also subject to the condition that it might ‘be reviewed at any time.’

However, on 29 March 2011, SARS informed applicant that upon review the decision to suspend payment had been denied and the tax in issue became payable and hence applicant approached the High Court urgently for interim relief.

Judge Binns-Ward held the following:

<u>As to the issues in case no. 26078/10</u>

(i) That a request for the suspension of the obligation to make payment did not detract from the nature of the assessed tax in question as payable and if the amount in question were not payable an obligation to make payment would not exist and any request for its suspension would be nonsensical; moreover, the mere submission of a request for a suspension did not alter the position.

(ii) That it might well be that pending the determination by SARS of a bona fide request for the suspension of an obligation to make payment, it would be grossly unreasonable, and therefore unlawful, for SARS to avail of any of the enforcement measures available under the Act to exact payment, but even so, as such contingent fetter on SARS right to enforce payment would not detract from the fact that the assessed tax had become payable on the date determined in terms of the Act, and remained so.

(iii) That any suspension granted by SARS, whether under the previous, or under the current, version of section 88, could, and can, be unilaterally withdrawn highlights that a suspension goes to exigibility, not payability.

(iv) That the new version of section 88 is, in the respects that are relevant, just a more explicitly expressed iteration of SARS powers under the previously subsisting version of the section and the itemised prescription of the factors to which SARS is enjoined to have regard in the new version makes the manner in which the power must be exercised more transparent and thereby, if anything, potentially facilitates the taxpayer's ability to challenge the exercise of the power on review, if so advised.

(v) That the previous version of section 88 did not expressly enjoin SARS to have regard to the merits of the appeal when determining a request for a suspension of payment and, by contrast, the new version of the section expressly refers to the merits of the appeal as a relevant consideration.

(vi) That, for the reasons discussed, the alternative argument that the determination of the request – made as it was in terms of the new provisions of section 88 – was invalid because the request fell properly to be decided under the earlier version of the provision must also fail and the substitution of the new section 88 for its predecessor was, in the respects currently relevant, merely expositionary in effect.

(vii) That in regard to applicant's reliance on the judgment in Mokoena v C: SARS 2011 (2) SA 556 (GSJ) – reported as Sepataka v C: SARS – the court was unable to agree with the statements at par. 16 of Mokoena and the view expressed therein that SARS could not have resort to section 91(1)(b) of the Act when an appeal is pending was not supported by a proper construction of the pertinent provisions of the statute, or by relevant precedential authority.

(viii) That the point of departure must be an acceptance that the tax in issue is payable on the date fixed in terms of section 89 of the Act and the effect of section 88 is that the noting of an appeal did not suspend the taxpayer's obligation to make payment.

(ix) That the Act contains a number of provisions of which SARS may make use to extract the payment which the taxpayer is obliged to make and one such provision is section 91(1)(b) and although a statement filed by SARS in terms of section 91(1)(b) has all the effects (i.e. consequences) of a judgment, it is nevertheless not in itself a judgment in the ordinary sense as it does not determine any dispute or contest between the taxpayer and SARS. However, it has the effect of a judgment in enabling SARS to obtain a writ to attach and sell in execution the taxpayer's assets to exact payment of an amount that is payable.

(x) That the existence of any pending appeal by the taxpayer against its assessed liability had no effect on its obligation to pay the tax and it thus could not constitute any bar to SARS resort to section 91(1)(b) to extract from a taxpayer the payment that the taxpayer is obliged by the Act – notwithstanding any appeal – to make.

(xi) That once it is accepted that the filing of a statement in terms of section 91(1)(b) is nothing more than an enforcement mechanism, as distinct from a means of determining liability, there was no basis for distinguishing it from any of the other recovery mechanisms.

(xii) That the court in Mokoena v C: SARS, supra, went awry by apparently regarding the filing of a statement in terms of section 91(1)(b) as having the rights-determining character of a judicially delivered judgment as it plainly did not and that much was confirmed by the Supreme Court of Appeal in Singh v C: SARS.

<u>As to the issues in case no 8274/11</u>

(xiii) That the primary object of section 88 was the implementation of the 'pay now, argue later' policy and that object was evidently conceived by the legislature as a necessary incidence of efficacious tax recovery and the achievement of the object would be frustrated if SARS power to grant a dispensation relieving the taxpayer from the undeniably rigorous effect of the provision did not include the right to make the grant of the dispensation subject to appropriate conditions and even revocation, including in a case in which it subsequently appeared, on a reconsideration of the relevant material, that it had not been appropriate, after all, to have given the dispensation in the first place.

(xiv) That the proper approach was to determine whether an authority to review and revoke was a necessary implication of the provisions of section 88 in the form it existed when the decision to grant the suspension had been made.

(xv) That the obligation to make payment and the right of the fiscus to recover assessed tax pending an appeal against an assessment was subject to the power of SARS to direct otherwise and the word ‘direct’ was not specially defined in the Income Tax Act and therefore bore its ordinary meaning within the context in which it was used.

(xvi) That it was clear that the power to direct necessarily included the power to formulate the content of the relevant order or instruction and there was no reason why the content of the direction should not include a reservation of the right to revisit its terms; particularly having regard to the factors that would have to weigh with SARS in determining upon it.

(xvii) That, accordingly, it was within the power of SARS to impose the condition that the direction suspending the taxpayer’s obligation to make payment of the assessed tax pending its appeal against the assessment was subject to revision.

Both applications dismissed.

5.5 ITC 1854

The taxpayer, during the years of assessment, owned three goldmines, namely, B Mine, C Mine and D Mine. B Mine and C Mine, for the years under consideration, made a profit while D Mine made a loss and the taxpayer also derived an income from non-mining activities.

The main question for determination was whether the loss suffered by D Mine could be set-off against the taxable income derived by the taxpayer from its non-mining activities, or whether the loss, being a current or operating loss of D Mine, had to be deducted (and on a pro rata basis) from the income of the profitable mines, namely B Mine and C Mine before any capex deductions (capital expenditure) in respect thereof.

There were no factual disputes before the court and the issues between the parties were further narrowed by the time the matter was presented in court and the only issues remaining for determination were questions of law.

The taxpayer, in its income tax returns for the years in question did not deduct the loss from the income of C Mine and B Mine, but deducted the loss from the taxable income derived by it from its non-mining activities, thus substantially reducing the taxable income in respect of its non-mining activities.

The taxable income of B Mine and C Mine, respectively, was taken up by the redemption of capital expenditure (capex), which was deducted from such income up to the limit of such income, effectively leaving the profitable mines with no taxable income for the respective years and the only taxable income the taxpayer had was the reduced income from its non-mining activities and the effect of the taxpayer's approach was to effectively reduce the tax payable by it and to maximise the amount of capex it redeemed in respect of C Mine and B Mine.

SARS in his assessment applied a different approach in that he deducted D Mine's operating loss from the income of the B Mine and C Mine on a pro rata basis, before redeeming capex against the respective taxable incomes of those mines.

SARS did not set-off D Mine's loss against the taxable income derived from the non-mining activities, but left that income intact. The effect of SARS' assessment was to reduce the capex that the taxpayer could redeem in the relevant years in respect of the B Mine and C Mine and to, effectively, increase the taxpayer's tax liability in respect of its income from non-mining activities.

Central to the differences in approach was the interpretation of, inter alia, sections 11(a), 15(a), 20(1)(b), 36(7E) and 36(7F) of the Income Tax Act.

Much of the argument presented by the parties related to the interpretation of sections 36(7E) and 36(7F) of the Act which applied to mining and introduced a ring-fencing in respect of mining income and, in particular, to whether the approach of either the taxpayer, or that of SARS, resulted in the mischief which those sections were intended to overcome.

The taxpayer had contended that its approach had been in accordance with sections 36(7E) and 36(7F) of the Act and that SARS had wrongly read requirements into the Act regarding the deduction of operating losses. It submitted that a distinction had to be drawn between a current year loss (or operating loss) and an 'assessed loss'. An 'assessed loss' was a loss incurred in a previous year and such a loss carried over from a previous year was ring fenced in terms of sections 36(7E) and 36(7F) in that it was the assessed loss of a particular mine carried over from the previous year that could be deducted from the taxable income of that mine and before redemption of the capex of that mine against its taxable income but the ring fencing did not apply in respect of current losses.

SARS contended that the taxpayer's method of calculation had to be rejected on four grounds:

- all mining operating expenses or losses had to be deducted from mining income before any capex is redeemed;
- section 11(a) of the Act distinguished between trades and required the operating loss of a trade to be firstly deducted from the income derived from that trade, if any;
- the intention of the Legislature in enacting sections 36(7E) and 36(7F) was to prevent the erosion of the non-mining tax base; and
- to allow the deduction of expenses from the trade of mining for gold from non-mining trades (and vice versa) carried on by the taxpayer, 'would distort and dilute the graduating tax rate applicable to the gold mining trade.'

Judge Coppin held the following:

(i) That the fear of potential losses to the fiscus as a result of various schemes prompted the introduction of sections 36(7E) and 36(7F) into the Income Tax Act and those provisions were intended to prevent erosion of the mining tax base, in particular, by the use, or potential use, by mining companies, of capex to generate losses which would result in a substantial reduction, or total elimination of the mining income as a source of taxation.

(ii) That section 36(7E) prohibited the redemption of capex relating to mine activities against income derived from other sources and provided that such capex could only be redeemed against the taxable income from mining and it also limited the amount of capex that may be redeemed to the amount of such taxable income.

(iii) That section 36(7F) governed the situation where the mining company (the taxpayer) had more than one mine and it prohibited the capex of one mine from being redeemed against the taxable income of another mine and provided that the capex of a mine may only be redeemed against the taxable income of that mine. The section further limited the amount of capex that can be redeemed in a particular year of assessment by providing that it could only be redeemed against a taxable income from mining after set-off of any balance of assessed loss incurred by the taxpayer in respect of a mine in a previous year of assessment.

(iv) That arguably section 36(7E), by ring-fencing income from mining, also ring fenced, to an extent, the income derived by the taxpayer from other sources, in that the capex relating to its mining operations may not be redeemed against the income from those other sources, but may only be redeemed against the mining income.

(v) That the ring fences imposed by sections 36(7E) and 36(7F) rendered the income from mining impervious to the redemption of capex, but did not render those incomes impervious to the deduction of, say, current losses and section 36(7E), where it dealt with the deduction of assessed losses carried over from preceding years of assessment, implied that such losses may only be deducted from the mine or mines that incurred them.

(vi) That one of the main purposes of section 36(7E) was to limit the amount of capex redeemed in any particular year and if the taxpayer was free to deduct the assessed loss from the preceding year from any other income it could undermine this purpose of the subsection; section 36(7F) also provided that capex can only be redeemed against the taxable income of that mine after set-off of any assessed loss incurred by the taxpayer in relation to that mine in any previous year which has been carried forward from the preceding year of assessment.

(vii) That, however, the main issue raised in this matter was whether the Income Tax Act prohibited the current loss incurred by the taxpayer in respect of a particular mine from being deducted from the income derived by the taxpayer from a source other than mining and the related issue, namely, whether the current year's operating loss from such a mine could only be deducted from the incomes of other mines of the taxpayer and, if so, whether the deduction should be pro rata from the incomes of the other mines.

(viii) That sections 36(7E) and 36(7F) do not prescribe what was to be done to current year losses as they only dealt specifically with the balance of assessed losses from a previous year which were carried over from that year, but they made no express mention of the losses referred to in sections 20(1)(b) of the Act, namely, assessed losses incurred by the taxpayer during the same year of assessment in carrying on any other trade. In terms of section 20, for the purposes of determining taxable income, those kind of losses are to be set-off against income derived by a taxpayer from any trade and the current year losses are not subject to the ring fencing envisaged in those subsections.

(ix) That in enacting sections 36(7E) and 36(7F) the Legislature did not regard the deduction of current operating losses as a mischief to be regulated by means of a ring-fencing provision in those subsections, in all probability because that was dealt with elsewhere in the Act.

(x) That but for what was held in ITC 1420, it was apparent from section 20(1)(b) of the Act that a loss incurred by a taxpayer in respect of one trade may, subject to exceptions, be written off against the income the taxpayer derived from another trade but it had to be a loss incurred in respect of the trade and not only in respect of a unit or units in respect of that trade.

(xi) That in this case and in respect of the relevant years of assessment the taxpayer had incurred an operating loss in respect of only one of its mines and not in respect of its entire gold mining operation as B and C Mines turned a profit and, accordingly, the provisions of section 20(1)(b) were not applicable here.

(xii) That the applicable provision was section 11(a) of the Act and while sections 36(7E) and 36(7F) ring-fence mining and individual mines, respectively, and in particular in respect of the redemption of capex and the deduction of the balance of the assessed losses from the previous year, section 11(a) distinguishes between trades and allows certain expenses and losses (current or operating) to be deducted from the income derived by the taxpayer from a particular trade.

(xiii) That section 11(a) did not allow such expenses, or losses, incurred in respect of one trade to be deducted from the income derived by the taxpayer from another trade and in the case of a taxpayer who derived an income from mining and an income from another trade, the taxpayer was not allowed to deduct an operating loss incurred in the mining trade from the income derived from another trade and vice versa and the loss can only be deducted from the income derived from the same trade as the one in which the loss had been incurred and the same would apply whether the taxpayer had one or more mines and also derived an income from another trade.

(xiv) That the wording of section 11(a) was clear and unambiguous and the view expressed in the previous paragraph was consistent with the legislative intention to preserve the tax bases of the different trades, which was also the intention behind the enactment of sections 36(7E) and 36(7F).

(xv) That the taxpayer's approach, namely, to deduct the current, or operating, loss of D Mine (a loss in the mining trade) from the income derived from its other trade, is not allowed by section 11(a) or any other provision of the Income Tax Act. The fact that the ring fences introduced by sections 36(7E) and 36(7F) are not impervious to the deduction of current, or operating losses from another mine, or another trade, did not legally justify the taxpayer's approach and the taxpayer's contention that its approach was supported by the decision in ITC 770 was flawed as the facts of that case were distinguishable; on the other hand, SARS' approach, namely, of deducting the D Mine loss from the incomes of the other mines, was consistent with the provisions of the Act.

(xvi) That, other than the decision in ITC 770, the court was not referred to any other authority for deducting the D Mine losses from the respective incomes of B Mine and C Mine on a pro rata basis and it appeared to be a practice or method of SARS to apportion the set-off of such loss on that basis to the profitable mines but there was no obstacle in the Act to this method or practice and such an apportionment also appeared to be appropriate.

Appeal dismissed and no costs order was made.

5.6 ITC 1855

The taxpayer, on 5 June 2006, had written to SARS requesting a reduced assessment in terms of section 79A of the Act on the basis that certain expenses that qualified for deduction had not been claimed as deductions in its tax returns for the 2001 to 2004 years of assessment.

SARS, on 4 May 2007, had sent a letter to the taxpayer which was headed 'Income tax: revised assessments for the years of assessment 2001 to 2004' which had responded to a number of issues that had been raised by the taxpayer.

The issue before the court was whether the taxpayer's original assessment for the 2002 year of assessment had prescribed on 31 May 2007 or had been replaced by a 'revised assessment' dated 4 May 2007, to which the taxpayer had objected.

SARS contended that the letter of 4 May 2007 was not a revised assessment and that, three years after the date of assessment (1 June 2004), the assessment for the 2002 year of assessment had become final.

The taxpayer, on the other hand, had argued that the letter of 4 May 2007 was indeed a revised assessment and consequently that the assessment for the 2002 year of assessment had not become final.

The aforementioned letter dated 4 May 2007 was sent to and received by the taxpayer and, in fine, it was stated that tax assessments would be issued in due course. The taxpayer was also informed that he had the right to lodge an objection in terms of section 81 of the Income Tax Act. He was also informed that the objection had to be lodged within 30 calendar days of the date of the assessment.

SARS usually used set forms for its various functions and so used the form IT 34 for assessments but in this case did not, in fact, issue the necessary IT 34 forms to Appellant.

Judge RD Claassen held the following:

(i) That it was so that SARS used set forms for its various functions and so too it used form IT 34 for assessments but these were not prescribed by law and it was common cause that respondent did not in fact issue such assessments because by the time they had to be issued, the 31st May 2007 had come and gone.

(ii) That it had been authoritatively stated that what was required as 'a purposeful act, one whereby the document embodying the mental act is intended to be an assessment' – ITC 1740.

(iii) That in Irvin & Johnson (SA) Ltd v CIR the court stated that, subjectively, an assessment was an abstraction which had no real existence until it was published by being expressed in symbols which conveyed a meaning to others and it seemed, therefore, that in most places in the Income Tax Act the word 'assessment' did not mean the unexpressed thoughts of the assessing officer, but the written representation of those thoughts; similarly, an assessment must have resulted in a figure, it is an 'amount' which has to be determined and it is that 'amount' or figure which the Commissioner may 'reduce' or 'alter' under section 77(6) of the Act.

(iv) That, accordingly, from the authorities quoted, it was abundantly clear that the said letter (dated 4 May 2007) did indeed constitute an intentional published act of assessment, giving the required 'amount' i.e. a zero tax liability and for those reasons it was found that the assessment for the tax year 2002 had not prescribed.

6. INTERPRETATION NOTES

6.1 Income Tax – Exemption: Body corporates – No. 64

This Note replaces Practice Note No. 8 issued on 26 March 2001, and provides guidance on the application and interpretation of section 10(1)(e).

Section 10(1)(e) exempts from income tax the levy income of a body corporate, a share block company and an association of persons. It also provides an exemption for these entities of an amount up to a maximum of R50 000 for all their receipts and accruals other than levy income (the basic exemption).

In conclusion –

- only the levy income of share block companies, bodies corporate and qualifying associations of persons referred to in section 10(1)(e)(i) is fully exempt from income tax;
- the sum of other income received by those entities is subject to a basic exemption limit of R50 000;

- share block companies, bodies corporate and qualifying associations of persons referred to in section 10(1)(e)(i) are exempt from the payment of provisional tax and are not required to submit provisional tax returns;
- share block companies and bodies corporate do not have to apply to SARS in order to enjoy exemption from income tax under section 10(1)(e); and
- the qualifying associations of persons referred to in section 10(1)(e)(i)(cc) (for example, home owners' associations) are required to apply for exemption to the SARS Tax Exemption Unit in order to qualify for exemption from income tax under section 10(1)(e).

6.2 Income Tax – Trading Stock: Inclusion in income when applied, distributed or disposed of otherwise than in the ordinary course of trade – No. 65

This Note provides guidance on the application and interpretation of section 22(8) which deems an amount to be included in income when trading stock is applied, distributed or disposed of in specified circumstances otherwise than by sale at market value in the ordinary course of trade.

The cost of acquisition of trading stock should in principle not be deductible if it is:

- withdrawn for private consumption;
- donated;
- sold otherwise than in the ordinary course of the taxpayer's trade for less than its market value; or
- distributed to a shareholder in specie.

A deduction results from these events because there would be no inclusion in income of closing stock while the cost price would have been allowed as a deduction. In these circumstances the purpose of the expenditure has changed to one that is not productive of income and it accordingly becomes necessary to redress the situation. This task is taken care of by section 22(8) which provides for a deemed inclusion in the taxpayer's income. The amount of the inclusion (for example, at cost, written-down value or market value) will depend on the manner in which the trading stock has been applied, distributed or disposed of.

The deduction could be under section 11(a) (trading stock disposed of in the same year of assessment in which it was acquired), section 22(1)(a) (write-down of closing stock) or section 22(2) (opening stock).

Section 22(8) deems an amount to be included in a taxpayer's income when trading stock is:

- applied for private or domestic use or consumption;
- donated;
- disposed of otherwise than in the ordinary course of trade for a consideration less than its market value;
- distributed by a company in specie;
- used or consumed in the course of trade or disposed of at market value otherwise than in the ordinary course of trade; or
- no longer held as trading stock.

In situations in which the taxpayer receives an amount of consideration that is below market value section 22(8) excludes the amount of consideration received, which would already be included in gross income, from the required inclusion in income under section 22(8). A taxpayer that uses or consumes trading stock for the purposes of trade is deemed to incur an amount of expenditure equal to the income inclusion under section 22(8) and may qualify for a tax deduction or allowance if the requirements of the relevant provision are met. Section 22(8) does not apply to:

- livestock or produce; or

- any assets the receipts or accruals from the disposal of which are included in gross income under paragraph (jA) of the definition of the term ‘gross income’.

6.3 Income Tax– Scholarships and bursaries – No. 66

This Note provides clarity on the tax implications of any bona fide scholarship or bursary granted to enable or assist any person to study at a recognised educational or research institution. Practice Note No. 17 of 12 March 1993 is hereby withdrawn.

Generally, any bona fide scholarship or bursary granted to enable or assist any person to study at a recognised educational or research institution is exempt from normal tax. This exemption is, however, subject to certain conditions, particularly where the scholarship or bursary is granted by an employer (or an associated institution in relation to that employer) to an employee or to a relative of such employee.

7. DRAFT INTERPRETATION NOTES

7.1 Connected persons

This Note provides guidance on the interpretation and application of the definition of a ‘connected person’ in section 1 of the Income Tax Act.

The Income Tax Act No. 113 of 1993 introduced the definition of a ‘connected person’ into section 1. This definition is central to specific anti-avoidance provisions which regulate the tax consequences of transactions entered into between related taxpayers. Such related-party transactions are more likely to be open to manipulation

The definition became effective as from 21 June 1993. It replaced the previous definition of a ‘connected person’ in section 12C(6) which was only relevant in the context of that section.

The definition of a ‘connected person’ in section 1 identifies those persons that connected person in relation to:

- an individual;
- a trust;
- a member of a partnership;
- a company; and
- a close corporation

The definition also establishes the reverse relationship between the persons, that are connected persons in relation to the above persons.

The wording of a particular provision of the Act will determine the time at which the existence of any ‘connected person’ relationship must be determined. It will also determine whether an expanded or restricted meaning of the term as defined in section 1 must be applied.

7.2 Game Farming

This Note:

- provides guidance on the application of selected sections of the Act and paragraphs of the First Schedule to persons carrying on game farming operations, with its primary focus being the provisions applicable to livestock;
- is not intended to deal with farming in general; and
- replaces Practice Note No. 6 dated 30 July 1999.

Section 26(1) stipulates that the taxable income of any person carrying on pastoral, agricultural or other farming operations shall, in so far as the income is derived from such operations, be determined in accordance with the Act, but subject to the First Schedule. The First Schedule deals with the computation of taxable income derived from pastoral, agricultural or other farming operations.

The taxable income from farming operations is combined with the taxable income from other sources to arrive at the taxpayer's taxable income for the year of assessment.

The First Schedule applies regardless of whether a taxpayer derives an assessed loss or a taxable income from farming operations. The Schedule may further apply even after farming operations have been discontinued [section 26(2)].

Section 26 and the First Schedule are applicable to game farming since it comprises farming operations.

The same principles used to determine whether a person carries on farming operations apply to game farmers. The test for this purpose is a subjective one, that is, one based on the taxpayer's intention.

Income from the sale of game, game carcasses, skins and so forth constitutes farming income and is included in gross income. But income from accommodation, catering, admission charges and fees for providing guides and trackers is not farming income. This will be relevant when applying the ring-fencing provisions of paragraph 8 to game livestock.

The rules governing the deduction of expenditure, including capital development expenditure, are similar to those which apply to normal farming operations.

A farmer is required to bring to account the value of game livestock in opening and closing stock. No standard values have been prescribed by regulation for game livestock, but SARS accepts that game livestock may be allocated a standard value of nil. Game livestock which is acquired by donation or inheritance is included in opening stock in the year of acquisition at market value.

The deduction under section 11(a) for the cost of livestock is ring-fenced under paragraph 8, while an assessed loss or balance of assessed loss from farming is subject to potential ring-fencing under section 20A.

A farmer who ceases to carry on game farming operations must generally continue to deal with any game livestock under the First Schedule.

Special rules apply for income tax and CGT purposes upon the death or sequestration of a farmer.

7.3 Allowances, advances & reimbursements

This Note provides clarity on the tax treatment of allowances, advances and reimbursements granted to employees.

The Note updates and replaces Issue 2 which was published on 8 January 2008 and incorporates relevant legislation changes up to and including the Taxation Laws Amendment Act No. 24 of 2011.

In line with the 2002 Budget Review proposal to simplify the system of employment income taxation, the provisions relating to allowances, advances and reimbursements were previously consolidated in section 8(1). Section 23(m) was also previously enacted to limit the deductions available to employees and office holders.

Since Issue 2 of this Note, substantial amendments have been made to the travel allowance system. These include the removal of the 'deemed kilometre' method of calculating the allowable deduction as well as amendments to the employees' tax withholding requirements on allowances and advances.

The update to this Note includes these amendments and also clarifies what constitutes business travel and private travel.

Section 8(1)(a)(i):

- deals with all allowances and advances paid by a 'principal' to a 'recipient' (for example, travel, subsistence, public office, cell phone and housing allowances); and
- provides that all such allowances and advances must be included in the recipient's taxable income to the extent that it was not expended as specified in section 8.

Section 8 only permits a deduction for expenditure incurred in relation to travelling on business, expenditure incurred for accommodation, meals and incidental costs while such office holder or employee is obliged to spend at least one night away from his usual place of residence as a result of business or official purposes and expenditure incurred by reason of the duties attendant upon public office. The method of calculating the amount of the allowable deduction is specified in section 8. This Note discussed the methods of calculating the allowable deduction which, in the case of the travel allowance, included actual business kilometres and an actual rate per kilometre or a deemed rate per kilometre as determined by the Minister of Finance in the Gazette. The allowable deduction for subsistence expenses may, depending on the circumstances, be based on a deemed rate per the Gazette or on actual expenditure.

Employers are required to calculate and withhold employees' tax on a monthly basis. With effect from 1 March 2011 employers must include 80 per cent of the travel allowance in remuneration. However, in the event that an employer is satisfied that at least 80 per cent of the use of the motor vehicle for a year of assessment will be for business purposes, only 20% of the travel allowance or advance is included as remuneration and is subject to employees' tax.

Subsistence allowances are generally not subject to employees' tax. If an employee receives a subsistence allowance but does not spend the anticipated time away from home, the amount of the subsistence allowance must be included in remuneration in the month following the month in which the allowance was paid to the employee.

7.4 Documentary proof for VAT input taxes and other deductions

This Note provides guidelines on the documentary proof that must be obtained and retained under section 16(2) to substantiate a vendor's entitlement to 'input tax' as defined in section 1, or a deduction as contemplated in section 16(3).

VAT is aimed at taxing final consumption. As a result, where a VAT vendor acquires goods or services for purposes of consumption, use or supply in the course of making taxable supplies, that vendor is entitled, subject to the provisions of sections 16(2), 16(3), 17(1), 17(2) and 20 to deduct from the amount of output tax:

- the VAT paid in respect of a taxable supply made to that vendor;
- an amount equal to the tax fraction of any payment made by the vendor in respect of second-hand goods. For the period prior to 10 January 2012, the deduction of input tax was, in respect of second-hand goods which consist of 'fixed property' as defined, limited to the amount of transfer duty or stamp duty paid;
- an amount equal to the tax fraction of the outstanding cash value in respect of goods repossessed by the vendor under an instalment credit agreement; or
- a deduction as contemplated in sections 16(3)(c) to (n).

Input tax or any deduction under section 16(3) should be claimed in the VAT return in the period during which the time of supply occurs, or for imported goods, the period during which the VAT on importation is paid.

Input tax or a deduction may be claimed in a later period if the vendor is unable to make a claim for input tax or a deduction in the aforementioned period (because evidence is not received in time). In terms of the first proviso to section 16(3) of the VAT Act, this later period may not be more than five (5) years after the date when the input tax or special deduction should have been claimed. If SARS is satisfied that the deduction was not permissible in accordance with the practice generally prevailing, the five (5) year period is limited to six (6) months.

7.5 Taxable benefit – use of employer provided cellphones, computer equipment and telecommunication services

This Note provides clarity regarding:

- the determination of the value of the taxable benefit arising from the private or domestic use by an employee of employer-provided or employer-owned telecommunications equipment (for example, a cellular telephone) or computer equipment (for example, a laptop) and employer-funded telecommunications services; and
- the taxability of any allowance or reimbursement granted by the employer to the employee in respect of the employee's privately-owned equipment or service contract which is used by the employee for purposes of the employer's business.

Employers often provide employees with cellular telephones (cell phones) or computer equipment. The intention is that the employee will use the assets for work purposes, however given that the assets are often used outside of the office, some private or domestic use of these items is inevitable.

Previously, the Seventh Schedule treated almost all private or domestic use by employees of employer-owned cell phones and computer equipment and employer-provided line rentals and call charges as a taxable benefit in terms of paragraphs 2(b) or 2(e).

The associated compliance and enforcement costs were potentially prohibitive and in 2008 the legislation was amended to provide that in certain circumstances an employee's private or domestic use will not be taxed. This Note discusses the circumstances when an employee's private or domestic use of these benefits will not be subject to taxation.

The Note focuses primarily on the following scenarios:

- Employer-owned (or leased) equipment and related services

In this scenario the employer provides the employee with equipment[1] or related services and incurs the associated cost. Two potentially taxable benefits arise, namely:

- the private or domestic use of an employer-owned or provided asset [paragraph 2(b)]; and
- access to and use of a telecommunications network (line rental and call charges) for private or domestic purposes at the employer's cost [which constitutes the provision of free or cheap services in terms of paragraph 2(e)].

- Employee-owned (or leased) equipment and related services:

  In this scenario the employee would typically have entered into a contract with a service provider in terms of which the employee (and not the employer) has acquired the right to, for example, a cell phone or laptop and access to a telecommunications network. The contract with the service provider could take the form of a standard 24-month (or similar) contract between the employee and the service provider or a 'prepaid' (or similar) contract.

  The employer may require the employee to use his or her private contract or equipment during the course of the employee's employment for work purposes. Typically an employer would grant the employee an allowance or a reimbursement in order to defray the expenditure incurred for business purposes.

The facts and circumstances of a particular employee's case will determine whether the use of an employer-provided cell phone, computer equipment or employer-funded telecommunications service gives rise to a taxable fringe benefit.

If the facts and circumstances indicate that the employee uses the asset or communication service mainly for the purposes of the employer's business then a taxable fringe benefit will not arise. 'Mainly' in this context means that more than 50% of the total use of the asset or service is for business purposes.

If the asset or service is not used mainly for business purposes then the employer will have to calculate the value of the taxable fringe benefit. In the case of -

- the use of an asset, the value of the taxable fringe benefit is, depending on the facts, equal to either the rental cost or the 15% calculated amount or the cost to the employer, less any consideration payable by the employee for such use; or
- the use of a communication service, the value of the taxable fringe benefit is the cost to the employer of rendering or having the service rendered but only to the extent it is used for private or domestic purposes less any consideration payable by the employee for such service.

8. BINDING PRIVATE RULINGS

8.1 BPR 108 – Issue of redeemable preference shares from reserves available for distribution

This ruling deals with the question as to whether the issuing of redeemable preference shares from the reserves of a company will constitute a 'dividend' as defined in section 1 of the Act.

In this ruling legislative references to sections are to sections of the Income Tax Act applicable as at 8 November 2011 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act. This ruling has been requested under the provisions of section 1, the definition of 'dividend'.

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

The Applicant: A company that is incorporated in and a resident of South Africa

The Shareholders: The holders of a specific class of redeemable preference share

Description of the proposed transaction

The Applicant intends to issue a specific class of redeemable preference share (the shares) from its reserves available for distribution. These shares will be issued to Shareholders in proportion to their trading ratio with the Applicant. The rights that will be attached to the shares can be summarised as follows:

- the shares will be non-convertible;
- will have no voting rights; and
- holders of the shares will not be entitled to any preference dividend in respect thereof.

The Shareholders will also only be allowed to redeem the shares if the Applicant is liquidated or its business is sold, whichever event takes place first.

Condition and assumption

This ruling is made subject to the condition and assumption that the redemption of the shares will constitute a 'dividend' as defined in section 1.

Ruling

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

- The issue of the redeemable preference shares, from the reserves available for distribution to the shareholders, will not constitute a 'dividend' as defined in section 1 and as such will not be subject to secondary tax on companies.

8.2 BPR 109 – Loan granted with embedded option

This ruling deals with the income tax consequences for a taxpayer who grants a loan with an embedded option to subscribe for shares in the borrower.

In this ruling legislative references to sections are to sections of the Income Tax Act applicable as at 1 February 2012 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of:

- section 1, the definition of 'gross income';
- section 22(2) read with 22(4);
- section 24J; and
- paragraphs 18, 20(1)(a), 20(c)(ix), 35, 43 and 58 of the Eighth Schedule.

Parties to the proposed transaction

The Applicant: A company that is incorporated in and a resident of South Africa

The Co-Applicant: The Holding company of the Applicant, that is incorporated in and a resident of South Africa

The Borrower: An unconnected third party

Description of the proposed transaction

The proposed transaction will entail a loan agreement and a subscription agreement, which will be interdependent.

The Applicant will raise funds to be advanced as a loan to the Borrower. The interest chargeable on the funding will be less than the interest that will be charged on the loan to be granted.

In terms of the proposed loan agreement the full amount so advanced will be repayable in three years time.

In terms of the proposed subscription agreement, the Applicant will have the right but will not be obliged to subscribe for a fixed number of shares in the Borrower at a future date and at an agreed price. The subscription agreement will indicate that no premium will be payable for the option rights receivable on day one.

The subscription rights will be sold by the Applicant to the Co-Applicant after the agreements are entered into, but before the Applicant's financial year end.

Conditions and assumptions

This ruling is made subject to the assumption that the subscription rights will be sold by the Applicant at market value to the Co-Applicant. In the event that the said rights are sold for less than market value a portion of the interest allowed as a deduction under section 24J(2) will be disallowed as that portion will be deemed to have not been incurred for the Applicant's trade but for that of the Co-Applicant.

Ruling

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

- The Applicant will be entitled to claim all interest incurred by it, in order to raise the funds to be advanced as a loan to the Borrower, under section 24J.
- The subscription rights received on day one will constitute an amount received and will, in terms of the definition of 'yield to maturity' as contained in section 24J(1), be regarded as part of the amounts receivable under the loan agreement. Consequently, the deemed accrual to the Applicant from an interest perspective will be greater than the interest receivable as set out in the loan agreement.
- The amount received from the sale of the subscription rights will be included in the gross income of the Applicant. The Applicant will be entitled to claim opening stock in respect of subscription rights, calculated at the market value of the subscription rights, under section 22(2) read with section 22(4).
- If the subscription rights are acquired on capital account then the payment made by the Co-Applicant in relation to the acquisition of the said subscription rights will result in either:
    - a capital loss if the entitlement to subscribe for the shares is not exercised; or

  - be added to the base cost of the shares if the entitlement to subscribe for shares is exercised.

- No additional amount will be included in the gross income of the Applicant or the Co-Applicant should the entitlement to subscribe for the shares be exercised notwithstanding the fact that the value of the shares may exceed the subscription price at that point in time.

8.3 BPR 111 – Toll manufacturing agreement and the attribution of the global sales of South African manufactured products to a foreign business establishment

This ruling deals with the question as to whether:

- a toll manufacturing agreement (an agreement under which one entity, that is a resident and has specialized equipment, processes raw material or semi finished goods into manufactured products on behalf of another entity that is a controlled foreign company) will be regarded as a service agreement or a sale agreement; and
- the global sales of the manufactured products will constitute outbound sales. (Outbound sales exist when a South African resident sells products to a controlled foreign company which on sells the same products to a person other than a connected person in relation to the controlled foreign company who is a South African resident). Outbound sales may not be attributed to a foreign business establishment.

In this ruling legislative references to sections are to sections of the Income Tax Act applicable as at 1 January 2011 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of section 9D(9)(b)(ii)(bb).

Parties to the proposed transaction

The Applicant: A resident company owning more than 50% of the participation rights in the Controlled Foreign Company

The Controlled Foreign Company: A foreign company selling the South African manufactured products to the global market from a foreign business establishment

The Contract Manufacturer: A resident company which is wholly owned by the Applicant and which manufactures the products on behalf of the Controlled Foreign Company

Description of the proposed transaction

The Controlled Foreign Company intends to enter into a toll manufacturing agreement with the Contract Manufacturer.

The ownership and risks in relation to the manufactured products will at all times be that of the Controlled Foreign Company. The Controlled Foreign Company will provide the principal materials for the manufacturing of the products. The other materials and the packaging for the manufactured products will be provided by the Contract Manufacturer.

The Controlled Foreign Company will own all intellectual property in relation to the manufactured products. The Controlled Foreign Company will provide the Contract Manufacturer with the know-how and a manufacturing license to manufacture the products. The manufactured products will be shipped directly to the end client. All global sales and marketing in relation to the manufactured products will be performed by the employees of the Controlled Foreign Company from a foreign business establishment.

Conditions and assumptions

This ruling is made subject to the conditions and assumptions that:

- the ruling does not, in any way, deal with or provide any opinion or certainty as to whether a foreign business establishment exists or whether the requirements in the Act are adhered to in this regard; and

- the attribution of the net income amounts to the so called ‘foreign business establishment’ was not evaluated and no opinion or ruling is issued in this regard.

<u>Ruling</u>

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

- The proposed toll manufacturing agreement will be a service agreement as opposed to a sale agreement to be entered into between the Controlled Foreign Company and the Contract Manufacturer. As such, the Applicant, in relying on the foreign business establishment exemption under section 9D(9)(b) (provided all the other requirements thereof are met), may disregard the exclusion to the foreign business establishment exemption in section 9D(9)(b)(ii)(bb) in the context of the proposed toll manufacturing agreement.

8.4 BPR 112 – Interposing a co-operative between a South African holding company and its foreign subsidiary

This ruling deals with the income tax consequences arising from the sale of the shares held by a holding company in its foreign subsidiary to a Co-Operative to be incorporated, for an interest in that Co-Operative.

In this ruling legislative references to sections and paragraphs are to sections of the Income Tax Act and paragraphs of the Eighth Schedule to the Act applicable as at 7 October 2011 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of:

- section 10(1)(k)(ii)(dd);
- section 24B; and

- paragraph 64B of the Eighth Schedule.

Parties to the proposed transaction

The Applicant: A company that is incorporated in and a resident of South Africa

The Co-Operative: A Co-Operative to be incorporated in and a resident of a foreign country

Subco: A wholly owned subsidiary of the Applicant and a resident of the same foreign country as the Co-Operative

Description of the proposed transaction

The Applicant currently holds 100% of the shares issued by Subco and has held these shares for more than 18 months. Subco currently holds the foreign interests of the Applicant.

The Applicant intends to interpose a Co-Operative between itself and Subco, which will then act as the holding vehicle for the Applicant's foreign interests. The Co-Operative will be established as part of the proposed transaction.

The Applicant will sell its 100% shareholding in Subco to the Co-Operative in return for the issue of 99% of the contributed capital of the Co-Operative to the Applicant.

The Applicant will, therefore, hold 99% of the interest in the Co-Operative whereas the Co-Operative will hold 100% interest in Subco. The remaining 1% interest in the Co-Operative will be held by another foreign company which is 100% held by the Applicant. This is a statutory requirement in the foreign jurisdiction where the Co-Operative is registered.

The Co-Operative will not be effectively managed in South Africa and it is not the intention of the group to dispose of its interest in the Co-Operative or Subco within the next five (5) years.

Conditions and assumptions

This binding private ruling is subject to the conditions and assumptions that:

- no opinion, conclusion or determination is expressed or made in this ruling in relation to the application or interpretation of the laws of the foreign jurisdiction concerned;
- the ruling is issued on the assumption that the profit to be distributed by the Co-Operative will be treated by the Co-Operative as a dividend or similar payment for purposes of the laws relating to tax on income in the foreign jurisdiction concerned;
- Subco is not a 'foreign financial instrument holding company' as defined in section 41; and
- the participating members of the Co-Operative will have an unlimited right to distributions when declared, and return of capital on the winding-up of the company.

Ruling

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

- Any capital gain or capital loss arising on disposal by the Applicant of its shares in Subco to the Co-Operative will be disregarded under paragraph 64B(2) of the Eighth Schedule.
- The Co-Operative will be deemed to have actually incurred an amount of expenditure in respect of the acquisition of Subco's shares, which will be equal to the lesser of the market value of Subco's shares immediately after acquisition or the market value of the Applicant's interest in the Co-Operative immediately after the acquisition.
- The Applicant will, under section 24B(1)(b), be deemed to have disposed of the shares in Subco for an amount equal to the market value of its interest in the Co-Operative immediately after the acquisition.
- The Co-Operative will be a 'foreign company' as defined in section 1.
- The Applicant's interest in the Co-Operative will constitute equity shares as defined in section 1.

- Any distributions by the Co-Operative to the Applicant in the form of dividends will be exempt under section 10(1)(k)(ii)(dd).
- The shares in Subco, which the Applicant will sell to the Co-Operative, will be considered to be contributed tax capital as defined in section 1.
- Any capital gain or loss arising on a return of contributed tax capital, as contemplated in paragraphs 76 and 76A of the Eighth Schedule, will be disregarded under paragraph 64B(5) of the Eighth Schedule.

8.5 BPR 113 – Expenditure associated with broad based black economic empowerment

This ruling deals with the deductibility of expenditure incurred in attaining the requisite points per the scorecard prescribed in association with Broad Based Black Economic Empowerment.

In this ruling legislative references to sections are to sections of the Act applicable as at 24 August 2011 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of:

- section 11(a);
- section 23(g); and
- section 23H.

Party to the proposed transaction

The Applicant: A private company that is incorporated in and a resident of South Africa

Description of the proposed transaction

From a compliance and commercial perspective the Applicant requires Black Economic Empowerment (BEE) points in order to conduct business in the South African environment. As a multinational, however, the Applicant is bound by the policies of its principals, one of which states that equity will not be sold in any of its subsidiaries.

In order to address the ownership component of the BEE scorecard prescribed by the Broad Based Black Economic Empowerment Act the Applicant proposed an alternate approach by means of an Equity Equivalent programme (EE programme).

The proposed EE programme entails the investment of 4% of the Applicant's annual turnover, over a period of seven years, into selected qualifying small black owned Independent Vendors (the Vendors). This investment includes financial, infrastructure, dedicated personnel, marketing, sales and intellectual support to these Vendors. The implementation of the EE programme will enable the Applicant to receive the full 20 BEE points per annum for the ownership component of the BEE scorecard, subject to the Applicant meeting annual agreed milestones with the Department of Trade and Industry (DTI). The attainment of the 20 BEE points will enable the Applicant to attain level 2 compliance as per the said BEE scorecard.

The necessary approval for the EE programme was granted by the DTI and the Applicant entered into its first Equity Equivalent Investment Agreement with the DTI in 2011 and received the relevant BEE points upfront. This agreement with the DTI expires eight to nine months after the Applicant's year-end and may be renewed on an annual basis. The BEE points for the ownership component will in future be granted by the DTI on an annual basis following a review of the Applicant. The BEE points for ownership are, therefore, only valid for a year and future agreements need to be signed in order for the Applicant to qualify for the BEE points.

The proposed transaction involves the selection of a minimum of five black owned and black managed Independent Vendors that will meet a set of pre-determined criteria. They will not necessarily form part of the Applicant's existing value chain.

The programme consists of the Vendors incurring expenditure in respect of infrastructure, recruitment and employment of black graduates, relevant sales and marketing, software development, training and skills development, travelling and other external services that will include but will not be limited to legal, accounting, tax, advertising, public relations and management consulting expenditure.

These Vendors will be reimbursed for the agreed and approved expenditure incurred (the Applicant's EE expenditure), by requesting purchase orders via the Applicant's global accounting system, and upon presentation of the relevant invoices, the Applicant will settle such expenditure. The EE expenditure will be incorporated under a separate cost centre and paid for via the Applicant's normal payment processes. The budget allocated to the separate cost centre will be the agreed 4% of the Applicant's annual turnover.

The management and governance of the EE programme will thus be incorporated within the Applicant's accounting framework to leverage the current internal control infrastructure and system resources.

The Applicant will appoint managers for each Vendor, namely, a technology specialist, a finance manager and a programme manager, to manage the Vendor and implement the EE programme.

The Applicant will not subscribe for equity in the companies of these Vendors.

A separate contract will be drafted and entered into with each Vendor.

The terms of the contracts with these Vendors will be reviewed annually based on the renewal or granting of the annual BEE ownership point allocation by the DTI.

Conditions and assumptions

This ruling is subject to the conditions and assumptions that:

- the ruling is only made in respect of the EE expenditure incurred in years two to seven; and

- the contracts to be entered into between the Applicant and the DTI, for years two to seven, will be on the same terms and conditions as the Equity Equivalent Investment Agreement entered into in 2011 (year one) between the Applicant and the DTI.

Ruling

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

- The Applicant may claim the EE expenditure in years two to seven as a deduction under section 11(a), read with section 23(g).
- The deduction of the EE expenditure, in years two to seven, will be spread in terms of section 23H.

8.6 BPR114 – Loan facilities raised by a foreign permanent establishment from which deposits and advances are made

This ruling deals with the income tax consequences for a resident company arising from the raising of loan facilities by a foreign branch of the company from international banks and the subsequent placement by the branch of these funds on deposit with various other international banks.

In this ruling legislative references to sections, paragraphs and Parts are to sections of the Income Tax Act, paragraphs of the Eighth Schedule to the Act and Parts of the Eighth Schedule to the Act applicable as at 21 July 2011 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of:

- section 24I;
- paragraph 43(1) of the Eighth Schedule; and
- Part XIII of the Eighth Schedule.

Parties to the proposed transaction

The Applicant: A company incorporated in South Africa

The Branch: A branch of the Applicant, operating in a foreign country as a permanent establishment

Description of the proposed transaction

The Applicant established branch operations in a foreign country with the approval of the South African Reserve Bank and conducts branch operations from premises located there.

The functional currency of the Branch for the Applicant's financial reporting purposes is US Dollars (USD) as the Applicant primarily operates its business in the foreign country in USD, this being the currency in which it predominantly generates and expends cash.

The Applicant is in the process of negotiating a term loan facility (the facility) through the Branch which is in turn negotiating through a foreign Bank as co-ordinator. The funding will therefore be raised from the coordinating foreign Bank and potentially other international banks.

Pending utilization of these funds by the Applicant through the provision of loans to its clients, the funds will be placed on deposit by the Branch with various international bank counterparties. The deposits or advances will be denominated in USD.

Once granted the facility will represent a liability for the Applicant's annual financial statement purposes whilst the deposit or advances to client(s) will represent an asset.

Conditions and assumptions

This binding private ruling is subject to the condition that the Branch situated in the foreign country is a 'permanent establishment' as defined in section 1.

Ruling

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

- The facility to be raised and the deposits or advances to be made by the Branch will fall within the scope and application of section 24I. However, the facility, deposits and advances will be considered to be denominated in the 'local currency' of the Branch. The result is that no 'exchange item' and accordingly no 'exchange difference' will arise for the Applicant in the determination of the taxable income derived by it from the Branch operations.
- Paragraph 43(1) of the Eighth Schedule will apply to the proposed transaction, but will result in a no gain no loss situation.
- Part XIII of the Eighth Schedule will neither apply to the facility, deposits or advances to be made by the Branch.

8.7 BPR115 – Incentive rewards paid to independent sales persons

This ruling deals with incentive cash rewards to be paid by a company to independent sales persons not in the employment of the company.

In this ruling references to paragraphs are to paragraphs of the Fourth Schedule to the Act applicable as at 27 July 2011 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of paragraph 1, definition of 'remuneration', 'employer' and 'employee'; and paragraph 2(1)(a) of the Fourth Schedule.

Parties to the proposed transaction

The Applicant: A company incorporated in and a resident of South Africa

Independent sales persons: The employees, of various wholesalers and retailers, who participate in the Reward Programme referred to below

Description of the proposed transaction

The Applicant manufactures products which it sells to various wholesalers and retailers and intends launching a Reward Programme (the Programme) as a marketing initiative to increase the sales of its products.

The Programme will be directed at the Independent sales persons who sell the Applicant's products to the customers of the wholesalers and retailers. Wholesalers and retailers may, however, direct that their staff will not be entitled to participate in the Programme and the Applicant will not enjoy any form of employment relationship with the sales persons.

The Applicant will, furthermore, have no supervision or control over these sales persons and no service will be rendered by them on the premises of the Applicant.

The sales persons will be required to register for the Programme with the Applicant, after which a recognised prepaid card will be issued to each of them. The reward to be earned by a sales person will be calculated with reference to the amount of the Applicant's products sold and the equivalent Rand value will be credited to his/her prepaid card.

The term 'prepaid' means the card can only be utilised to the extent that it has a positive balance and cannot be overdrawn as is the case of normal credit cards. The sales persons will be entitled to spend the Rand value of their rewards at their discretion but only by utilising the prepaid card to purchase certain goods and services.

The prepaid accounts will be under the control of the Applicant and administered by an independent third party. The physical cash to be used to credit these accounts will be held in a separate bank account in the name of the Applicant. The prepaid card account will be credited to a maximum value of R5 000, which will be supplemented as and when a portion or all of the maximum value has been utilised and further reward credits are available.

Ruling

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

- The amounts payable into the prepaid card accounts for the benefit of the Independent sales persons will not constitute ‘remuneration’ as defined in paragraph 1 for employee’s tax purposes.
- The amounts payable will fall outside the ambit of paragraph 2(1).

General note

This ruling does not mean that incentive cash rewards received by the Independent sales persons under the circumstances as described in this ruling are not taxable. The incentive cash rewards received constitute ‘gross income’ as defined in section 1 of the Act and will, therefore, be subject to income tax in their hands. The incentive cash rewards as described above will not constitute ‘remuneration’ as defined in the Fourth Schedule which merely releases the Applicant from the obligation to withhold employees’ tax from these amounts but does not release the sales persons from the obligation to declare such incentive cash rewards for income tax purposes.

9. BINDING CLASS RULINGS

9.1 BCR 32 – Distribution of certain shares to certain foreign shareholders as a result of restructuring

This ruling deals with the tax consequences that will arise from:

- the distribution of shares to shareholders in terms of an unbundling transaction; and
- the disposal of certain of the shares available for distribution in terms of the unbundling transaction on behalf of certain foreign shareholders as well as the distribution of the net proceeds thereof to such foreign shareholders.

This ruling also deals with the question as to whether the transfer of the shares to shareholders will be exempt from securities transfer tax.

In this ruling legislative references to sections are to sections of the relevant Acts applicable as at 02 February 2011 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the relevant Act.

This ruling has been requested under the provisions of section 46 of the Act and section 8(1)(a)(iv) of the STT Act.

Class

The class members to whom this ruling will apply will be the Class A shareholders as described below.

Parties to the proposed transaction

The Applicant: A wholly owned subsidiary of the Holding Company mentioned as one of the Co-Applicants below

The Co-Applicants: The Holding Company of the Applicant, a private company in which the Applicant holds shares

The Class A shareholders: Certain foreign shareholders of the Holding Company

Description of the proposed transaction

The Applicant and its Holding Company form a group of companies (the Group). The Applicant owns three businesses, (A, B and C) in South Africa. The Applicant intends to incorporate Newco as a wholly owned subsidiary of the Applicant and to move the business of C as a going concern (including all assets and liabilities of C) to Newco in exchange for additional shares in Newco.

The businesses of A and B are neighbouring operations and have the same operational methods and standards. The business of C is located a few hundred kilometres away from A and B. C adopts different operational methods and support standards from those tailored to A and B and its productivity is generally higher.

Given the particular requirements of C and the operation of the business of C, it is envisaged that it will be necessary to address the particular operational requirements of C separately from those of A and B. In particular, it is highlighted that:

- from an operational perspective, C requires a specific skill set and management aligned with the operational requirements of C;
- from a geographic perspective, C requires regional services appropriate to its specific needs; and
- from a commercial perspective, there is significant potential for C to grow production through the acquisition of businesses of a similar nature to that of C and undeveloped business properties in the area in which it is located.

Based on the above information it is clear that C will commercially be in a better position as a separate entity.

The introduction of a Black Economic Empowerment (BEE) consortium will further benefit both C and the rest of the Group. It is proposed that the BEE consortium subscribes for a certain percentage shareholding in Newco.

From the perspective of C and Newco the introduction of a BEE consortium will:

- introduce capital of hundreds of millions of rands into C; and
- provide a BEE shareholder which will significantly enhance the ability of C to do further transactions in its business area and will enhance the relationship between C and other stakeholders.

The following steps are envisaged in order to execute the proposed transaction:

- Step 1: The Applicant will incorporate Newco as a wholly owned subsidiary.
- Step 2: The Applicant will transfer the business of C as a going concern (including all assets and liabilities of C) in exchange for additional shares in Newco under section 42 of the Act.

- Step 3: The Applicant will transfer all ancillary assets comprising 100% of the shares held by the Applicant in a private company (mentioned as one of the Co-Applicants) in exchange for additional shares in Newco under section 42 of the Act.
- Step 4: The BEE partner will subscribe for a certain percentage shareholding in Newco for a cash consideration.
- Step 5: Newco will issue an effective percentage of its issued share capital to a newly incorporated C Management Trust.
- Step 6: The Applicant will distribute its shareholding in Newco to its Holding company under section 46 of the Act.
- Step 7: As part of the Holding Company's unbundling, it will distribute its shareholding in Newco to its shareholders under section 46 of the Act.
- Step 8: Newco will be listed on the JSE on the day of distribution as contemplated in Step 6 above.
- Step 9: Newco shares that will be due to the shareholders in a specific foreign country [other than that specific foreign country's qualified institutional buyers (QIBs)] will be retained by the Applicant or delivered, following the unbundling, to a third party in South Africa nominated by the Applicant, who will coordinate the disposal of the Newco shares due to that specific foreign country's shareholders for cash in South Africa and distribute the cash (net of costs) due to the specific foreign country's shareholders in proportion to their entitlement to the Applicant's shares.

  In addition, the specific foreign country's depository will dispose of the Newco shares due to the Applicant's specific foreign country's depository receipt (DR) holders (other than DR holders that qualify as QIBs) for cash in South Africa either independently or in combination with the disposal of the Newco shares due to the specific foreign country's shareholders and any other ineligible foreign shareholders. The specific foreign country's depository will distribute the cash proceeds (net of costs) to the Applicant's relevant DR holders in proportion to their respective entitlements to Newco shares.

Conditions and assumptions

This ruling is made subject to the conditions and assumptions that:

- Newco will be a resident company.
- On the date of disposal, the market value of the assets will be equal to or exceed the cost of the assets to be disposed of.
- The Applicant holds the assets (that is, the business of C and the shares mentioned in Step 3 above) as capital assets and not trading stock as the Applicant's main business.
- Newco will hold the assets in the business of C in the same capacity as it was previously held by the Applicant.
- Newco will acquire the ancillary assets, that is, the shares mentioned in Step 3 above as capital assets and not as trading stock.
- The proposed disposal of the shares mentioned in Step 3 above and the business of C in exchange for Newco shares will constitute an asset-for-share transaction under section 42 of the Act.

Ruling

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

- The distribution of Newco shares by the Holding Company to the Holding Company's shareholders will constitute an unbundling transaction under section 46 of the Act.
- The disposal by the Holding Company, acting as an agent on behalf of certain foreign shareholders, of relevant shares in Newco available for distribution to those shareholders and the distribution of the net proceeds thereof, will comply with section 46 of the Act.

- The transfer of Newco shares by the Applicant to its shareholders, in terms of the constituted unbundling transaction under section 46 of the Act, will be exempt from securities transfer tax under section 8(1)(a)(iv) of the STT Act.

Other issues

The securities transfer tax exemption will not be applicable to the transfer of Newco shares to be sold on behalf of the shareholders (other than the specific foreign country's shareholders mentioned above) who are resident in other foreign jurisdictions and are unable to take delivery of the shares.

9.2 BCR 33 – Conversion of a public company to a private company

This ruling deals with the capital gains tax consequences for a public company on conversion (in terms of the Companies Act, No. 71 of 2008) to a private company.

In this ruling legislative references to paragraphs are to paragraphs of the Eighth Schedule to the Income Tax Act, applicable as at 31 January 2012 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act. This ruling has been requested under the provisions of paragraphs 1, 11, 31 and 33 of the Eighth Schedule.

The class members to whom this ruling will apply are the Shareholders as described below.

Parties to the proposed transaction

The Applicant: A public company incorporated in and a resident of South Africa

Shareholder A: A company that holds 50% of the shares in the Applicant

Shareholder B: A company that holds the other 50% of the shares in the Applicant

Description of the proposed transaction

The Applicant has authorised and issued share capital of 100 ordinary shares with a par value of R1 each. Shareholders A and B each hold 50% of the issued share capital. The Applicant was classified as a public company in terms of the Companies Act, No. 61 of 1973. The Applicant retained its classification as a public company in terms of the Companies Act, 2008, but now wishes to convert to a private company. In terms of the proposed conversion from a public company to a private company, the shareholding in the Applicant will remain unchanged immediately before and after the conversion, that is, Shareholders A and B will each retain their 50% shareholding in the Applicant, with the same amount of shares. The conversion will entail limited amendments to the Applicant's Memorandum of Incorporation, restricted to the following:

- inserting provisions prohibiting the offering of the Applicant's securities to the public and restricting the transferability of its securities;
- deleting the provisions dealing with share warrants;
- removing the power of the directors of the Applicant to apply for a stock exchange listing of the company's securities; and
- removing provisions anticipating the securities of the Applicant being listed on a stock exchange.

Ruling

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

- For purposes of the Eighth Schedule to the Act, the conversion of the Applicant from a public company to a private company will amount to a part-disposal of the shares held by Shareholders A and B. The part-disposal of the shares held by Shareholders A and B will not result in any capital gain or capital loss as a result of paragraph 33(1) read with paragraph 31(3) of the Eighth Schedule.

10. GUIDES

10.1 Tax Guide for Share Owners (issue 3)

This guide provides general guidance on the taxation of share owners. It does not go into the precise technical and legal detail that is often associated with tax, and should not, therefore, be used as a legal reference. It is not a binding ruling under Part IA of Chapter III of the Income Tax Act.

The guide examines:

- the tax consequences of holding shares as trading stock compared to holding them as capital assets;
- how to distinguish between profits of a capital and revenue nature using common law principles and statutory rules;
- the determination of a taxpayer's liability for capital gains tax;
- how dividends are taxed; and
- various corporate actions that can impact on the determination of a person's liability for tax.

10.2 VAT Guide

The VAT 404 is a basic guide where technical and legal terminology has been avoided wherever possible. Although fairly comprehensive, the guide does not deal with all the legal detail associated with VAT and is not intended for legal reference.

The information in this guide is based on the VAT legislation (as amended) as at the time of publishing and includes the amendments contained in the Taxation Laws Amendment Act 24 of 2011 which was promulgated on 10 January 2012 (as per GG 34927).

Below is a brief synopsis of some of the most important changes affecting the administration of VAT since the previous issue of this Guide:

- Tax Administration Bill (TAB):

  The TAB has been passed by Parliament and it is expected to become an Act of Parliament during the course of 2012. The TAB seeks to provide a single body of law that outlines common procedures, rights and remedies. Once in effect the TAB will have a major impact on the administration of all taxes in general. The effect from a VAT perspective is that a number of administrative type provisions which are currently in the VAT Act will be deleted.

- Exemption for imported services:

  The VAT Act currently provides for a minimum threshold exemption of R100 in respect of books, newspapers and journals imported by post. A similar exemption of R100 was introduced for imported services (e.g. electronic books) for imports into South Africa on or after 10 January 2012.

- Conversion and renewal of mining rights:

  The law was clarified to make it clear that only the conversion of so-called old order mining rights held by a person into 'new order' mining rights as required by the Mineral and Petroleum Resources Development Act 28 of 2002 (the MPRD Act) qualify for the zero rate of VAT.

  The zero-rating does not apply to the transfer of mineral rights to third parties outside of the conversion or renewal process. The zero-rating which applied for mineral rights renewals has also been deleted. The zero-rating merely protects existing mineral rights holders from being subject to VAT on the compulsory conversion of old rights to new rights as prescribed in terms of the MPRD Act.

- Redemption of manufacturer discount tokens, vouchers and stamps (coupons):

  Manufacturers often issue coupons which may be redeemed by customers in the form of a discount allowed on the retail price of the manufacturer's products at certain retail outlets. A manufacturer that reimburses a retailer for a discount allowed to a customer, may deduct input tax equal to the tax fraction of the amount reimbursed. The law has now been amended to clarify that input tax in such cases may only be deducted by the manufacturer when the supply by the retailer to which the coupon relates, was subject to VAT at the standard rate.

- Temporary letting of dwellings by property developers:

  Section 18B was inserted to provide some temporary relief for the change in use adjustment required by a vendor when newly developed units are temporarily let as residences (exempt supplies) whilst they are also being marketed for sale (taxable supplies). The relief is in the form of a suspension of the liability to declare output tax on the change in use adjustment for a maximum period of 36 months. It is intended to apply in cases where developers experience difficulties in selling their newly developed properties due to the depressed property market where they have found it necessary to temporarily let the properties as dwellings until the property market improves. The relief will expire on the earlier of 1 January 2015 or the date of any permanent change in intention or use of the properties from taxable to non-taxable purposes.

- Delinking VAT from transfer duty:

  The limitation of the notional input tax credit to the transfer duty payable in respect of the purchase of fixed property from a non-vendor has been removed. The input tax which may be deducted on the acquisition of fixed property from a non-vendor on or after 10 January 2012 is now subject to largely the same rules applicable for the deduction of notional input tax in respect of other second-hand goods. This includes limiting the input tax to the extent that there has been actual payment of the purchase price of the property. The amendment is not retrospective and does not have the effect of allowing the input tax previously denied to be deducted on properties held which were acquired before 10 January 2012.

- Adjustments for unpaid debt on inter-company loan accounts:

  Vendors who are registered on the invoice basis are required to pay back input tax previously deducted which relate to credit purchases which have not been paid within a 12-month period. Relief from this adjustment is now available to members of a group of companies under certain conditions.

- Intra-warehouse transfers:

The valuation of goods entered for home consumption should reflect the value of the goods in terms of any intra-warehouse sales that occurred before the goods were entered for home consumption instead of their original value on entry into the warehouse.

11. INDEMNITY

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