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 second quarter of 2012 (i.e. 1 April 2012 to 30 June 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.

From a perspective of the areas which are normally covered in these tax udpates, it has been fairly quiet this quarter.

In the case of C:SARS v SACS, Johan Kotze represented SACS. This case should be studied by long-term contractors, who were given massive tax benefit therein, and the area of 'related finance charges' has been clarified by the Supreme Court of Appeal.

Enjoy reading on!

2. MEDIA STATEMENTS

2.1 C:SARS v Tradehold Ltd – Balance disturbed

The following media release by the Minister of Finance re. C:SARS v Tradehold:

'I note the Supreme Court of Appeal's judgment in the matter of *Commissioner for the South African Revenue Service v Tradehold Ltd* on 8 May 2012.

The capital gains tax (CGT) system has since its inception in 2001 been based on the principle that South African residents are taxed on all of their assets, irrespective of where these assets are located. Another principle has been that it would be unfair to tax a resident's capital gains accumulated before the taxpayer became a resident. Equally, not taxing capital gains accumulated while a taxpayer was a resident would be unfair.

Taxpayers are therefore deemed to have sold their assets, except those with a particularly close connection to South Africa, at market value on the day before the change in their residence. The tax payable on this basis is known internationally as an exit charge or exit tax. It is encountered in varying forms in, for example, Australia, Canada, the USA, the UK and a number of other European jurisdictions.

The Supreme Court of Appeal's judgment that a double taxation agreement (DTA) applied to a deemed disposal and thus did not allow for an exit charge appears to disturb the balance that has been achieved.

National Treasury and SARS are studying the judgment and, if necessary, I will propose amendments to further clarify that a DTA does not apply to deemed or actual disposals while a taxpayer is resident in South Africa. Measures such as the immediate termination of a taxpayer's year of assessment on the day before becoming non-resident, as is the practice in Canada, are being explored.

In order to maintain stability in the tax system, I will propose that any amendment take effect from 8 May 2012.'

2.2 Effective date of increased capital gains tax rates for long-term insurers and related matters

As part of the tax proposals announced by the Minister of Finance in the 2012 Budget review, capital gains tax rates will be increased. National Treasury hereby releases for public comment proposals relating to how these increased capital gains tax rates will be applied to long-term insurers in 2012. National Treasury also requests comment relating to the longer-term proposal of mark-to-market taxation of long-term insurer policyholder funds as well as longer-term proposed revisions that will simplify the four funds tax calculation.

2012 EFFECTIVE DATE CONSIDERATIONS

I. Corporate (shareholder) fund

Implementation of the increased capital gains inclusion rate from 50% to 66.6% will apply to the corporate (shareholder) fund for capital gains arising during years of assessment commencing on or after 1 March 2012. This effective date matches the effective date for all other companies.

II. Policyholder funds

A. Change in inclusion rates

Long-term insurers have three sets of policyholder funds for tax purposes – the individual policyholder fund, the company policyholder fund and the untaxed policyholder fund. The effective capital gains tax rate for individual policyholder funds will increase from 7.5% (i.e. the pre-existing 25% inclusion rate as applied to a tax rate of 30%) to 10% (the new 33.3% inclusion rate as applied to a tax rate of 30%). The effective capital gains tax rate for company policyholder funds will increase from 14% (the pre-existing 50% inclusion rate as applied to a tax rate of 28%) to 18.6% (the new 66.6% inclusion rate as applied to a tax rate of 28%). Untaxed policyholder funds remain fully exempt from the payment of income and capital gains tax. 2

B. Timing

The proposed changes in capital gains tax inclusion rates will take effect for all disposals of assets from 1 March 2012 without regard to the years of assessment at issue.

C. Deemed disposal and reacquisition

1. Need for special rules

Any change in effective capital gains tax rates for policyholder funds creates complications for insurers as trustees regardless of whether the change is triggered by disposals from a specified date or in respect of disposals occurring from a specified year of assessment. In particular, if the higher rates apply only from a later date, the policyholders notionally affected by the asset disposal bears the rate of increase not only for the period of that policyholder's notional ownership but also in respect of all prior periods of notional ownership by other policyholders.

EXAMPLE

Facts: Long-term Insurer purchases Share X for the benefit of Individual Policyholder A on 15 June 2011 at the price of R100. On 20 February 2012, notional ownership of Share X switches from Individual policyholder A to individual Policyholder B when the value of share X is R200. Long-term insurer sells Share X for the benefit of Individual Policyholder B on 10 August 2012 when the value of Share X is R250.

Result: Long-term insurer allocates R92.50 of post-tax gain to Individual Policyholder A on 20 February 2012. This gain is based on the R100 unrealised gain in respect of Share X less the reserve of R7.50 for the capital gains tax (i.e. effective rate of 7,5% on the notional gain of R100). Long-term insurer allocates R45 of post-tax gain to Policyholder B on 10 August 2012 (R50 realised gain less the capital gains tax of R5), less a further capital gains tax charge of R2.50 (2.5% on the initial R100 gain which is realised on 10 August 2012).

Because the effective capital gains tax rate increased from 7.5% to 10% by the date of disposal, an additional 2,5% charge is due in respect of the R100 prior notional capital gain allocated to Individual Policyholder A. However, this amount cannot be properly charged against individual Policyholder A as the actual disposal of Share X occurred after that individual ceased to be a policyholder. Therefore, the additional 2.5% charge will ultimately have to be borne by Individual Policyholder B because Individual Policyholder B is the only remaining policyholder that is notionally connected to Share X at the time of disposal.

2. Deemed disposal / re-acquisition

In order to remedy this misallocation of additional capital gains tax among policyholders in an administratively viable manner (and without causing undue distortionary benefits vis-à-vis other classes of taxpayers), it is proposed that a deemed disposal and re-acquisition be applied to all policyholder fund assets. Under this approach, Long-term insurers would recognise all unrealised gains and losses arising before the 1 March 2012 effective date of the increased capital gains inclusion rates for policyholder funds (i.e. on the close of 29 February 2012). The new higher inclusion rates will then apply only from 1 March 2012 onward.

In essence, the higher inclusion rate will apply only in respect of post-effective date value changes at the cost of deemed taxable gain or loss in respect of unrealised gains and losses arising before the close of February 2012. The net result would be to trigger gain or loss for policyholders, but the practical tax impact would not undermine their savings because long-term insurers already charge policyholders with capital gains tax on a regular (i.e. daily, monthly or annual) mark-to-market basis due to the trustee nature of these holdings. Policyholders would then be freed from higher capital gains tax inclusion rates in respect of unrealised capital gains on assets acquired before 1 March 2012, even if the actual disposal of those assets occurs after the 1 March 2012 effective date.

3. Technical issues

The bulk of the assets within policyholder funds typically are held in the form of shares, bonds, derivatives and immovable property. Insurers also hold interests in collective investment schemes and similar investment schemes that invest in shares, bonds and immovable property for the benefit of policyholder funds. It is proposed that the deemed disposal / re-acquisition arising at the end of 29 February 2012 apply to all asset classes. However, collateral adjustments will be required to avoid distortions for these asset classes.

- *Shares:* The proceeds in respect of shares disposed of by taxpayers after being held for at least three years are automatically deemed to be of capital nature. It is proposed that the deemed disposal / re-acquisition be treated as having no bearing on this three year holding period (i.e. that the deemed disposal / re-acquisition be viewed as not triggering a new three-year start date for purposes of section 9C). In addition, it is proposed that losses in respect of these deemed disposals / re-acquisitions be fully recognised despite certain anti-avoidance rules to the contrary (e.g. paragraph 42 of the Eighth Schedule).
- *Bonds*: The tax yield to maturity calculation for bonds requires the holder to make a calculation of the yield based on the cost of acquisition as well as all future cash flows applying time-value of money principles. It is proposed that the deemed disposal / re-acquisition rule also triggers a new acquisition date for future bond yield to maturity calculations. In addition, it is proposed that these deemed disposals / re-acquisitions be fully recognised despite certain anti-avoidance rules to the contrary (e.g. 42 of the Eighth Schedule).
- *Derivatives:* Derivatives need to be taken into account on regular basis to avoid distortions (especially in the case of derivatives acting as hedges). A special rule will accordingly

be provided that will tax annual changes in fair values relating to derivatives.

- *Real estate:* Some immovable property is depreciable. For instance, qualifying commercial buildings are depreciable at a 5% rate over a 20-year period. Disposals and deemed disposals could potentially trigger recoupment of prior depreciation and distortions in depreciation calculations. It is accordingly proposed that the deemed disposal / re-acquisition rules should not trigger recoupment and the tax cost for future depreciation should remain without regard to deemed disposal / re-acquisitions.

D. Timing of collections

It is recognised that the deemed disposal / re-acquisition rule will trigger substantial amounts of capital gains at the end of February (i.e. immediately before 1 March 2012). These gains relate to amounts that have appreciated over many years (e.g. typically between 3 and 15 years). Given this long period of appreciation, the payment of tax in respect of all the unrealised gains may create a strain on liquidity for certain long-term insurers. It is accordingly proposed that aggregate capital gains resulting from the deemed disposal rule be spread over a period of four years (the current year and following three years of assessment). Similarly, any aggregate capital losses stemming from this deemed disposal rule should also be spread over a period of four years.

Secondly, provisional tax payments for years of assessment ending on or before 30 June 2012 may exclude the increased taxable income as a result of deemed disposals occurring on 29 February 2012. Insurers cannot be immediately expected to make this adjustment given the short-notice. However, these gains must be included by the third top-up provisional payment in respect of those same years of assessment.

III. Related matters for Long-term insurers

A. Annual mark-to-market proposal

Application of the deemed disposal / re-acquisition approach for the capital gains inclusion rate change raises the question of whether capital gains and losses should simply be taxed annually. This annual taxation would be consistent with the approach already taken by long-term insurers, most or all of whom are annually setting aside capital gains tax potentially payable in respect of policyholder assets. This amount should accordingly be paid over on an annual basis as capital gains tax is effectively being withheld by the long-term insurer in its role as trustee. A mark-to-market approach would also be consistent with the growing trend to shift towards applying a mark-to-market system for treating financial products for financial reporting purposes.

Like the initial set of deemed gains and losses arising on 29 February 2012, future annual capital gains and losses will be spread over a four-year period. The purpose of this spreading 5 rule is to effectively create an averaging mechanism so as to reduce excessive annual upswings and downswings. Without averaging, concerns exist that an extreme downswing could create liquidity problems if a long-term insurer must pay tax out of reduced assets existing in the downswing year when tax is owing in respect of prior-year gains.

B. Policyholder deduction formula

The deduction limitation associated with indirect expenses allocated to policyholder funds is governed by a complex formula. The formula seeks to ensure that indirect policy administration and policy related expenses are deductible only to the extent that these expenses are incurred to earn ordinary revenue as opposed to exempt amounts or capital gains/losses. Much of the complication of the formula is associated with the fact that the current formula is not based on actual taxable amounts or realised/unrealised capital

gains/losses arising during the year of assessment. The numerical formula is simply based on assumptions that may depart from economic reality.

However, if the taxation of capital gains/losses shifts to a mark-to-market approach, many of the reasons for the complexity relating to the deduction limitation formula are no longer required. It is accordingly proposed that the formula be adjusted to simply require a ratio of taxable income (before selling and indirect overhead expenses) over economic income (taxable income (before selling and indirect overhead expenses) plus dividend receipts and fully included capital gains)).

3. TAX CASES

3.1 C:SARS v South African Custodial Services (Pty) Ltd (SACS)

Respondent (SACS) was a joint venture between a South African company and an American entity that specialised in the operation of correctional, detention and health facilities throughout the world and SACS concluded a concession contract with the Minister of Correctional Services in terms of which it would design, construct and operate a prison in Louis Trichardt with a duration of twenty-five years.

The concession contract that SACS concluded with the Minister was a public private partnership – a PPP – for purposes of the Treasury Regulations.

The preamble to the concession contract stated that the object of the contract was to give effect to the Department of Correctional Services' wish to 'provide the public with cost-efficient, effective prison services, and to provide prisoners with proper care, treatment, rehabilitation and reformation in accordance with the provisions of the Correctional Services Acts.

To this end the concession contract provided that SACS would design and construct the prison and a road on land provided by the Department and SACS would have the right to occupy the land for the duration of the concession but would have 'no title to, or ownership interest in, or *liens*, or leasehold rights or any other rights in the land' and the State would 'at all times remain the owner of the land'.

SACS entered into a sub-contract (the construction contract) with CGM in terms of which the latter was appointed to 'undertake the design, construction and commissioning of the prison at Louis Trichardt in accordance with the provisions of this contract'. In terms of the construction contract all the terms and conditions of the concession contract 'applicable to the design, construction, installation and commissioning of the prison are incorporated into and form part of' the construction contract.

In terms of the contract CGM accepted responsibility 'for the provision of' and bore 'all risks in relation to all goods, materials and labour necessary for the provision of the works'. The contract required 'materials and goods' to meet prescribed standards and CGM undertook to provide SACS on request 'with all the necessary supporting documentation to prove that the materials and goods comply with clause 17.1 hereof'.

The contract provided for a contract price of R303 000 000 for 'the performance and delivery of the works' and the term 'works' was defined to mean 'all the construction services and activities associated with or necessary to provide the prison'.

In order to finance the project and to meet its other obligations in terms of the concession contract, SACS entered into various agreements with banks for loans of R384 000 000 and these banks required security which was provided in the form of guarantees given by the South African Government and the shareholders of SACS.

SACS, in addition, was required to pay various fees including guarantee fees, introduction fees, financial advisory and margin fees and commitment, administration and legal fees incurred in connection with the contract.

SACS in addition, incurred expenses of R228 821 436 in respect of the building of the prison and the total amount involved, made up of the construction and equipping costs and the financial costs amounted to R464 376 824.

The prison was designed and built in accordance with the specifications contained in the concession contract and was brought into use during February 2002.

The court on appeal was concerned with three issues:

- The validity of SACS' objection to the assessment for the 2002 year of assessment;
- The deductibility of the cost of constructing and equipping the prison; and
- The deductibility of interest and other costs.

SACS had successfully appealed to the court *a quo* (see *ITC 1845*) against the disallowance by SARS of its objection to the assessments of its tax liability for the 2002, 2003 and 2004 years of assessment and that found that all of the expenditure in issue was deductible.

SACS contended that, in the construction of the prison, it carried out a trade; the materials that were used to construct the prison constituted its trading stock; those materials, when they were built into the prison, acceded to the prison – and hence became the property of the State – and that, as a result, the materials were deemed to be trading stock held and not disposed of by it in terms of section 22(2A) of the Income Tax Act and that consequently, being expenditure actually incurred, and not being of a capital nature, the cost of the construction of the prison was a permissible deduction from SACS' income in terms of section 11(a) of the Act.

The crisp issue to be decided was whether SACS' activities fell within the terms of section 22(2A) of the Act.

Furthermore, in order to bid for the tender and to raise the loans that it required to finance the construction of the prison, SACS incurred a number of fees payable to various parties and also incurred interest on its loans.

SACS contended in this regard that it was entitled to a deduction in respect of the various fees and the interest in terms of section 11(bA) of the Act.

In the court *a quo* SACS raised a point *in limine* (see *ITC 1855*) contesting SARS' view that his original 2002 assessment dated 1 June 2004 had become final on 31 May 2007.

After the issue of the aforementioned assessment SACS 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.

SACS contended that SARS had thereafter, by way of a letter dated 4 May 2007, revised its assessment with the effect that the original 2002 assessment had not become final.

SARS contended that the aforementioned 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 aforementioned letter had been headed 'Income Tax: Revised Assessments for the years of assessment 2001 to 2004'. The letter responded to a number of issues that had been raised by SACS, such as the deductibility of the construction costs of the prison in terms of section 11(a) of the Act, and whether the materials used to build the prison qualified as trading stock for purposes of section 22(2A).

Judge Plasket held the following:

<u>As to the deductibility of the cost of constructing and equipping the prison</u>

(i) That the crisp issue to be decided was whether SACS' activities fell within the terms of section 22(2A) of the Act and in giving consideration to the purpose of the section it is necessary to deem materials to be trading stock for purposes of the benefit provided by the section because, having acceded to the land upon which they have been built, the materials in question ceased to be owned by the

person who had acquired them. The trading stock is deemed to have been 'held and not disposed of' by the person who had acquired it for purposes of effecting improvements to the fixed property of another: the deeming provision qualifies this phrase and not the term 'trading stock' and it does not 'override' section 11(a) by deeming expenditure of a capital nature to be expenditure of a revenue nature.

(ii) That the question to be answered was whether SACS ever held trading stock in the form of materials and equipment that were built into the prison or, put slightly differently, did it ever effect improvements to the fixed property of the State by delivering materials and equipment to that property which it then built into the prison, thus losing ownership of the materials and equipment?

(iii) That, in terms of the construction contract, CGM, being SACS' sub-contractor, undertook to build and equip the prison – to perform 'all the construction services and activities associated with or necessary to provide the prison' – on land owned by the State, for which SACS undertook to pay a set price and the relationship between SACS and CGM was expressly stated not to be an employment relationship and it was evident that CGM was not SACS' agent either as it acted as an independent contractor and it stood in relation to SACS as any construction company would in relation to a client for whom it had undertaken to construct a building and from this it could be concluded that SACS never provided the materials or the equipment that were built into the prison, and never owned them at any stage but that CGM did.

(iv) That, accordingly, SACS did not fall within the parameters of section 22(2A) as it never carried on 'any construction, building, engineering or other trade in the course of which improvements' were effected by it to the fixed property of the State and it never effected any improvements and never delivered materials to the State's fixed property; accordingly, it never held any trading stock for purposes of the section that could be deemed to be trading stock that was held and not disposed of by it and it seemed, rather, that CGM would have

been entitled to a deduction in terms of section 22(2A) because its activities appeared to fall squarely within the terms of the section and to correspond to the purpose of the section.

(v) That, accordingly, SACS was not entitled to the deduction contended for by it in terms of section 22(2A), read with section 11(a) of the Act and SARS' appeal has succeeded to this extent.

As to the validity of Respondent's objection to the 2002 assessment

(vi) That SARS' letter of 4 May 2007 purported to be a determination as envisaged by the definition of 'assessment' in section 1 of the Act: it called itself a revised assessment; it responded to the issues raised by SACS when it requested a reduced assessment in terms of section 79A; it spoke, in the body of the document, of the 'revised assessment below', in explaining the decisions encapsulated in it; and it purported to make an adjustment under a heading 'Revised assessment' and it was apparent from these features that the letter recorded a determination.

(vii) That the only indication that ran counter to the indications listed in (vi) above was the sentence 'Tax assessment will be issued to you in due course' which was simply intended to convey to SACS that, the determination having been made, the appropriate computer-generated IT 34 form would in due course be completed and sent to SACS.

(viii) That the overwhelming impression created by the letter of 4 May 2007 was that it was, indeed, an assessment and it determined, in a reasoned manner, the request made by SACS for a reduced assessment in terms of section 79A of the Act.

(ix) That, accordingly, there was no merit in the point that the original assessment for the 2002 year of assessment had become final in terms of section 79A(2) of the Act.

As to the deductibility of interest and other costs

(x) That the interest that SACS had incurred was deductible in terms of section 11(bA) of the Act as it had been 'actually incurred' by SACS on its loans from BoE Merchant Bank and First Rand Bank to pay CGM for the construction of the prison.

(xi) That the various fees were also deductible in terms of section 11(bA) of the Act because of their close connection to the obtaining of the loans and the furtherance of SACS' project and they qualified as 'related finance charges' for purposes of the section.

(xii) That the assessment is referred back to SARS for him to determine the precise amount that is deductible from the the taxpayer's income in terms of section 11(bA) of the Act in the light of the principle set out in *Caltex Oil* (*SA*) *Ltd v SIR* that the interest and fees had to have been actually incurred during the year of assessment in which the deduction was sought.

Appeal upheld in part.

SACS is directed to pay the costs of the SARS, including the costs of two counsel.

3.2 ITC 1856

The deferred delivery share option scheme

Appellants (identified as 'ABC' and 'DEF') had been participants in a deferred delivery share option scheme (the 1997 scheme) in which the purpose of the scheme was to give employees an incentive to increase the growth of the company (TXYZG Share Incentive Trust) and the scheme operated on the basis that options would first be granted before shares could be bought.

Options granted by TXYZG were exercisable within 21 days of the Notice Date and once the option was exercised those shares became known as 'sale shares' and shares that had been delivered were known as 'scheme

shares' and a participant did not have to pay the purchase price upon the exercise of the option, but only on delivery to the participant of the scheme shares. Moreover, the participants could only take delivery against payment of the scheme shares in three equal tranches on the second, fourth and sixth anniversaries of the Notice Date or on such later date to which delivery was further deferred.

Each of the second, fourth and sixth anniversaries of the relevant Notice Date was known as the 'Implementation Date' and prior to the delivery of the scheme shares to a participant, the participant could not alienate, transfer, cede, pledge or encumber his or her rights in terms of the scheme, including the right to delivery of the shares.

The risks and benefits of the shares did not pass to the participant until they were registered in the name of the participant and the participant could not acquire or have accrue to him or her any cash dividends declared in respect of the shares.

From time to time TXYZG and later the Trust, acting in terms of the scheme, granted options to certain employees to acquire scheme shares at stipulated prices, being either the middle market price of the scheme shares on the relevant Notice Date or such price less a discount of up to 10%.

The Notice Dates in respect of options granted by TXYZG relevant to appellants' appeals were 14 August 1998 and 2 December 1998. The Notice Dates in respect of options granted by the Trust relevant to the Appellant's appeals were 19 March 2001 and 1 April 2003 and Appellant (ABC) exercised all of the options.

Appellants accepted that shares were delivered to them on the Implementation Date by means of constructive delivery, despite the fact that, instead of being transferred into their names, the shares were sold and the net proceeds were paid to those who elected to have the shares sold.

Shortly before each of the Implementation Dates, the Trust offered appellant the choice of having the shares transferred into her name against payment of the consideration or selling them on her behalf and paying to her the net proceeds and in each instance she asked the Trust to sell the

shares on her behalf and the parties reached a formal agreement as to the manner in which such sales were effected.

The Trust calculated the net amounts payable to appellant, based upon the number of scheme shares to which she had been entitled pursuant to the sale agreements, as a proportion of the net proceeds of the sale of shares and paid such amounts to her and the relevant scheme shares were never registered in Appellant’s name.

The issue before the court was whether the gains made on the difference between the value of the shares purchased by appellants and the price paid should be taxable and, if so, should it be in terms of section 8A, section 8C or par. 2(*a*) of the Seventh Schedule to the Income Tax Act.

In terms of the scheme the appellant, ABC, had entered into various agreements in terms of which she purchased specified shares at stipulated prices.

The Additional Assessments

Both appellants ABC and DEF had not made disclosure to SARS of their participation in the scheme during the 2001 year of assessment (ABC) and the 2003 year of assessment (DEF).

It was common cause that when SARS initially assessed ABC to tax on income under the Income Tax Act in respect of the 2001, 2003, 2005 and 2006 years, she did not include in her taxable income the difference between the cost of shares to her when she exercised options under the Scheme and their market value on the delivery dates.

In the case of DEF, he had been assessed to tax in December 2003 and he had conceded that he did not disclose the delivery of the shares in question in his income tax return for the 2003 year. His appeal was ancillary to the appeal of ABC in respect of the 2003 year of assessment.

DEF had exercised two sets of options which resulted in deliveries to him of shares in the 2003 year of assessment.

SARS had become aware of the share scheme in the course of an audit of the Appellant’s employers and, following a review of their returns for the

2001 and 2003 years of assessment, proceeded to issue additional assessments imposing tax on the amounts identified.

In the case of ABC SARS issued additional income tax assessments in 2008 for the 2001, 2003, 2005 and 2006 years of assessment and then issued further additional assessments on alternative grounds to which ABC had objected on a number of grounds.

In the case of DEF SARS, on 1 November 2007, had issued an additional assessment for the 2003 year of assessment in which SARS had assessed DEF for further tax on income.

The crucial grounds of the appeal relating to the additional assessments were as follows:

- whether SARS was precluded from issuing the first additional assessments for the 2001 and 2003 years of assessment by the first proviso to section 79(1) of the Income Tax Act, i.e. SARS was precluded from issuing an additional assessment more than three years after the date of the original assessment unless it was satisfied that the failure to raise an assessment was due to fraud, misrepresentation or non-disclosure of material facts;
- whether SARS was precluded from issuing the first additional assessments for the 2001 and 2003 years of assessment by the third proviso to section 79(1) of the Act, i.e. an additional assessment may not be raised after a lapse of three years if the assessment was made in accordance with the practice generally prevailing at the time it was issued;
- whether SARS was precluded from issuing the first additional assessment for the 2001 and 2003 years of assessment by virtue of the appellant's legitimate expectation that she would be taxed solely on the basis that the exercise of an option or acceptance of an offer to sell shares was the only relevant event for the purposes of section 8A of the Act and that the gain in terms of that section was the difference between the consideration payable and the value of the shares at the date of such exercise or acceptance.

The three-year period mentioned in section 79(1) ran from the due dates of the original assessments for the 2001 and 2003 years of assessment. The original assessment in respect of appellant, ABC, for the 2001 year was issued with a due date of 1 December 2001 and the original assessment in respect of appellant, ABC, for the 2003 year was issued with due date of 1 January 2004.

The first additional assessments were issued in June 2008 and the three-year period referred to in section 79(1) had accordingly expired by then.

In the case of appellant, DEF, as the original assessment for the 2003 year of assessment was 1 December 2003 and the date of issue of the first additional assessment was 1 November 2007, the three-year period referred to in par. (i) of the proviso to section 79(1) of the Act had expired before the first additional assessment was issued.

Therefore, SARS could only justifiably issue the first additional assessment if the requirements of par. (i)(*aa*) were met, namely he was 'satisfied that the fact that the amount which should have been assessed to tax was not so assessed or the fact that the full amount of tax chargeable was not assessed, was due to fraud or misrepresentation or non-disclosure of material facts'.

The *onus* of proving that he was so satisfied before issuing the additional assessments rested upon SARS.

The court, therefore, had to consider whether SARS had proved the presence of fraud, misrepresentation or non-disclosure of material facts.

In terms of the proviso to section 79(1) of the Act, SARS was precluded from raising the additional assessments outside the three year period, unless he was satisfied:

- that there was fraud or misrepresentation or non-disclosure of material facts; and
- it was not sufficient that SARS was satisfied that there was fraud, misrepresentation or non-disclosure of material facts. He must have been satisfied that 'the fact that the amount which should have been

assessed to tax was not so assessed . . . was due to such fraud, misrepresentation or non-disclosure of material facts.'

SARS contended that there was misrepresentation or non-disclosure of material facts by ABC and pointed out that appellant had failed to disclose to SARS, in the relevant years of assessment, that she had taken delivery of the shares in that year and/or had made or realised any gain of an income nature.

In regard to the issue of whether SARS was precluded from issuing the additional assessments for the 2001 and 2003 years of assessment by proviso (iii) to section 79(1) of the Act, the question was whether at 1 December 2001 and 1 January 2004 it was the practice generally prevailing to assess taxpayers, who purchased shares in terms of share incentive schemes on the terms on which the Appellants purchased the relevant scheme shares, on the grounds relied upon by SARS in the first additional assessments.

Appellants therefore relied on s 79(1)(iii) of the Act which precluded SARS from raising an additional assessment if the amount which is sought to be taxed was 'in accordance with the practice generally prevailing at the date of the assessment, not assessed to tax'.

The date at which the practice is ascertained is the due date of the original assessment, and the taxpayer bears the *onus* of establishing a practice generally prevailing.

Judge Allie held the following:

<u>As to the taxation of gains resulting from the deferred delivery share scheme</u>

(i) That in terms of section 82 of the Income Tax Act Appellants had to prove that the gains derived by them from the deferred delivery share scheme were not taxable and they had to prove that they and not SARS were correct as to the interpretation and true meaning and effect of the scheme and agreements.

(ii) That conventional option schemes were until October 2004 taxable under section 8A of the Act and conventional purchase schemes were taxable under par. 2(*f*) of the Seventh Schedule to the Act. XYZ's 1997 scheme was an attempt to avoid both provisions and there was, of course, nothing sinister in seeking to avoid tax provided that tax avoidance is not the only 'real and sensible commercial purpose' of the scheme, see *C: SARS v NWK Ltd*.

(iii) That, in the context of section 8A of the Act, it was not the mere right but the acquisition pursuant to the grant of that right which brought with it the possibility of financial gain; moreover, having regard to the environment in which section 8A was introduced, the clear purpose of section 8A was to tax employees who bought shares at less than their market value by either accepting offers for the sale of the shares, or by accepting options to purchase the shares. It is the intended result of the exercise of the right to acquire which section 8A, and failing that section, par. 2(*a*) of the Seventh Schedule, sought to regulate for income tax purposes.

(iv) That section 8A is triggered when a gain is made and in the case of deferred delivery schemes, the gain can only be finally quantified once delivery occurs as that is when acquisition of the shares is complete and, accordingly, it must be that section 8A can be triggered on delivery.

(v) That it was clear from the scheme and the way Appellants understood its purpose, that it was the right to take delivery against payment at a later date at a price less than the market value of the shares at that later date that created the substantial financial gain which served as an incentive to employees.

(vi) That the services rendered by employees were a *sine qua non* for the coming into existence of the rights to take delivery inasmuch as delivery could only take place if the participant was still employed with the company and, in practice, a set off operated without actual delivery occurring if a participant was no longer employed. Accordingly, there did indeed exist a sufficient causal relationship

between the delivery of the shares and the services rendered by Appellants to their employee.

(vii) That, having determined that section 8A applies to the transactions *in casu*, clearly par. 2(*a*) of the Seventh Schedule to the Act could not also apply.

(viii) That in view of the finding that section 8A applied to the transactions relevant to the 2001 and 2003 years of assessment and that those shares were acquired by virtue of appellants' employment, the only outstanding issue for consideration was whether the relevant shares pertaining to the 2005 and 2006 years of assessment were acquired after 26 October 2004, in which case section 8C would apply.

(ix) That the gains made under the XYZ Share Option Incentive Scheme prior to 26 October 2004 were taxable under section 8A of the Act and those gains made after 26 October 2004 were taxable under section 8C of the Act.

(x) That appellants therefore failed in proving that neither section 8A, nor section 8C nor par. 2(*a*) of the Seventh Schedule of the Income Tax Act applied to the relevant gains made by them by participating in the Share Option Scheme under consideration in this matter.

(xi) That section 8A applied to the gains made on delivery of the relevant scheme shares during the 2001 and 2003 years of assessment as it constituted the exercise of the right to acquire marketable security for the purposes of section 8A of the Act.

(xii) That section 8C applied to the gains made on delivery of the relevant scheme shares after 26 October 2004 during the 2005 and 2006 years of assessment as it constituted the vesting of equity instruments acquired during the relevant years of assessment as contemplated by the provisions of section 8C of the Act.

(xiii) That the gain made by Appellant, ABC on 26 August 2004 in the amount of R61 099 fell to be taxed under section 8A of the Act and the gains made by appellant, ABC on 9 December 2004 in the amount of R58 400, on 31 March 2005 in the amount of R102 710

and on 19 April 2005 in the amount of R105 818 fell to be taxed under section 8C of the Act.

(xiv) That the additional assessments of ABC for the 2005 and 2006 years of assessment were confirmed.

(xv) That the gains made by appellant, GHI in the 2005 year of assessment fell to be taxed, in respect of the August 2004 one, under section 8A and in respect of the December 2004 gain, under section 8C and, accordingly, the additional assessment of GHI for the 2005 year of assessment was confirmed.

As to the issue of additional assessments by SARS

(xvi) That the proviso to section 79(1) did not expressly say that the disclosure must be made by the taxpayer personally. The rationale for the proviso is that, if SARS was aware of the material facts at the time when he issued the original assessment, but did not assess the taxpayer on the correct basis, then he should be precluded from issuing a revised assessment; moreover, section 79(1) and its provisos must be read with section 8A in this case as section 8A clearly places the *onus* of disclosure on the taxpayer who should include such gains in his/her income for the year of assessment and, as such, reliance cannot be placed on the corporate disclosure referred to.

(xvii) That the non-disclosure or alleged misrepresentation by Appellants in the 2001 and 2003 years of assessment did not afford SARS the right to raise additional assessments once three years from the due date of the original assessments had lapsed because SARS did not state that its failure to assess the appellants' gains under section 8A or 8C was due to appellants' alleged non-disclosure or misrepresentation and at the stage when the right to additionally assess had expired, SARS had adopted a practice which generally prevailed of not raising assessments on the basis which it now contends it was entitled to.

(xviii) That Appellant, ABC's additional assessment for the 2001 year of assessment is set aside because, although appellant acknowledged

her non-disclosure, the practice of the SARS generally prevailing was not to assess to tax the gains made on delivery of the relevant scheme at that stage.

(xix) That Appellant ABC's additional assessment for the 2003 year of assessment is set aside for the following reasons: SARS had failed to prove that his failure to assess her to tax within three years from the due date of her original assessment was due to non-disclosure on the part of Appellant; in the 2003 tax return, appellant, ABC, completed Schedule 5 of the tax return by stating that she received the proceeds of scheme shares sold in the 2003 tax year and accordingly it could not be said that she did not disclose the relevant information for that year of assessment in her tax return; it was the practice generally prevailing at the time when the original assessment was made not to assess gains of the nature under consideration on the bases now sought to assess.

(xx) That Appellant, DEF did not disclose sufficiently, the gains made in his tax return for the 2003 year of assessment and the corporate disclosures did not exonerate him from the duty to so disclose, where section 8A applied.

(xxi) That Appellant, DEF's additional assessment for the 2003 year of assessment is set aside for the following reasons: SARS had failed to prove that its failure to assess him to tax within three years from the due date of the original assessment was due to non-disclosure on the part of Appellant; and it was the practice generally prevailing at the time when the original assessment was made not to assess gains of the nature under consideration on the bases now sought to assess.

(xxii) That it was clear from the evidence that the reason why Appellant was not assessed for the tax in the original assessments, on the grounds currently raised by SARS, was that SARS, at the time, was of the view that, in the case of this type of share incentive scheme, the event giving rise to a liability for tax took place upon the exercise of the option or the conclusion of the agreement for the purchase of the shares, as the case may be, and not upon the subsequent delivery of

the shares; moreover, it was only much later, in 2004 long after the original assessments for the 2001 and 2003 years had been issued, that SARS held the opinion that a right to acquire shares for the purpose of section 8A, or the acquisition of a share for the purposes of par. 2(*a*) of the Seventh Schedule, occurred on delivery of the share.

As to the existence of a legitimate expectation

(xxiii) That, further, Appellants were not exempt from paying tax on the basis of an alleged substantive legitimate expectation as no such expectation had been proved nor had it been established to exist on a substantive basis.

(xxiv) That for an expectation to be legitimate the aggrieved person must have held the expectation subjectively and ABC did not allege that she held any expectation regarding the taxation of the gains, she simply followed the advice of the accountants of her employer.

(xxv) That, furthermore, there was no evidence that an expectation was created by any representation of SARS; moreover, if appellants wished to rely on the doctrine of legitimate expectation, they surprisingly did not seek to prove an undertaking or promise on the part of SARS.

(xxvi) That the application of the doctrine of legitimate expectation under South African law has been recognised by the courts but to date, however, the doctrine has only been applied to the determination of procedural fairness.

(xxvii) That although Appellants have shown a practice generally prevailing, the court was not persuaded that they had shown a legal right to expect that practice to continue without a change in the tax treatment of deferred delivery schemes; moreover, our courts have held that it is insufficient to prove an expectation. What must be shown is the legitimacy of that expectation which led the person whose expectation was so raised to believe that it would receive a procedural benefit.

3.3 ITC 1857

The taxpayer was a foreign currency exchange dealer and had been awarded a tender in 1999 to operate two bureaux de change in the duty-free area of the departure hall at the OR Tambo International Airport.

The taxpayer had for four years paid the standard VAT rate on the services rendered by it but had thereafter altered this practice to zero-rating the services for the reasons advanced in this appeal.

Prior to 1999 the South African Reserve Bank did not allow South African residents to trade in the duty-free area of the airport but, pursuant to a request by the taxpayer to the Reserve Bank, it granted the taxpayer permission to trade with South African residents in the duty-free area.

The two branches in the duty-free section of the airport could deal only in travel related transactions. The taxpayer would 'sell' foreign currency and add on a fee and there would also be a fee per transaction and a commission fee on each transaction.

Rennies was one of the taxpayer's shareholders and when the taxpayer was awarded the tender it continued to utilise the same 'point of sale' software system that automatically provided for VAT.

For the four years prior to 2003 the taxpayer charged VAT but thereafter the VAT calculation function could be turned on and off.

The evidence revealed that the taxpayer then took the decision to turn off the VAT calculation function and this meant that both residents and non-residents were not paying VAT on the services rendered by it in the duty-free area. Moreover, the taxpayer did not consider it necessary to take legal advice or obtain a directive from SARS at the time it turned off the VAT function key.

The auditors, KPMG, raised a query regarding the levy of VAT in the duty-free area and, as a result, a request was made to SARS on 10 November 2004 for a directive and in January 2005 SARS directed that VAT was payable on the transactions in issue at the standard rate in terms of s 7(1)(*a*) of the Act.

SARS issued VAT assessments at the standard rate of 14% in respect of the period October 2003 to January 2005 on commission and fees charged by the taxpayer amounting to R1 473 009.

SARS, on 7 January 2005, issued VAT Ruling 440 in respect of the purchasing and selling of foreign currency in duty-free areas of the airport and directed that such transactions would not be zero-rated.

The taxpayer contended that the services rendered by it in the exchange of currency were zero-rated in terms of the exclusions contained in section 11(2)(l)(ii)(aa) and 11(2)(*l*)(iii) of the Value-Added Tax Act.

Section 11(2) provided at the relevant time—

'*Where, but for this section, a supply of services would be charged with tax at the rate referred to in section 7(1), such supply of services shall, subject to compliance with subsection(3) of this section, be charged with tax at the rate of zero% where—*

(l) *the services are supplied to a person who is not a resident of South Africa, not being services which are supplied directly—*

(i) *in connection with land or any improvement thereto situated inside South Africa;or*

(ii) *in connection with movable property (excluding debt securities, equity securities or participatory securities) situated inside South Africa at the time the services are rendered, except movable property which—*

(aa) *is exported to the said person subsequent to the supply of such services; or*

(bb) *. . .*

(iii) *to the said person or any other person, other than in circumstances contemplated in subparagraph (ii)(bb), if the said person or such other person is in South Africa at the time the services are rendered . . .*

and not being services which are the acceptance by any person of an obligation to refrain from carrying on any enterprise, to the extent that

the carrying on of that enterprise would have occurred within South Africa; or'

The taxpayer contended that the services rendered by it were zero-rated in terms of the above provisions as once the currency is exchanged it 'is exported to the said person subsequent to the supply of such services.' In addition, the services supplied were in connection with 'movable property' which was subsequently exported by way of removal from South Africa to an export country within the meaning of the word set out in par. (*d*) of the definition of 'exported' in section 1 of the Act and should therefore be zero-rated.

The taxpayer further contended that non-residents whilst in the duty free area of the airport were not in South Africa when the services in issue were rendered and therefore the words 'in South Africa' should be given a restrictive meaning.

SARS contended that the service was consumed by the non-residents in South Africa and therefore section 11(2)(*l*)(iii) applied.

The taxpayer, in order to succeed in its attempt to zero-rate the transactions in issue, bore the *onus* of proving that it was subject to the exemptions contained in section 11 of the VAT Act.

SARS contended that the taxpayer had not discharged the *onus*.

Judge Victer held the following:

(i) That, upon a proper interpretation of section 11 of the Act, there was no room for contradiction in the interpretation and application between the concept of allowance and disallowance of zero-rating of services between s 11(2)(*l*)(ii)(*aa*) and the wording of s 11(2)(*l*)(iii) of the Act.

(ii) That it was clear from the definition of 'Republic' in section 1 of the Act that it is defined as the geographical territory of South Africa including territorial waters and hence the duty-free area within an airport would be within South Africa unless the President or some other statute which has application to the Value-Added Tax Act or that Act itself determines otherwise.

(iii) That section 1 of the Act defines ‘goods’ as ‘corporeal movable things . . . but excluding money’ and ‘services’ are defined as ‘anything done or to be done . . . but excluding a supply of . . . money’ and goods and services as defined in section 1 of the Act can only be zero-rated in terms of the instances referred to in section 11 of the Act.

(iv) That ‘goods’ as defined in the Act meant corporeal movable things but not money and the statutory interpretation of the supply of ‘services’ in connection with money could not be interpreted within the statutory framework of ‘goods’ as the relevant definitions were clear.

(v) That section 11(2)(*l*)(iii) prohibited the zero-rating of services where the recipient, whether a non-resident or not, was in South Africa at the time when the services were rendered and the services were consumed in South Africa and therefore SARS directive that VAT was payable must succeed.

(vi) That, as it was common cause that the taxpayer had supplied money, this took the taxpayer’s services, being the exchange of money, out of the application of s 11(2)(*l*)(ii)(*aa*), *i.e.* ‘is exported to the said person subsequent to the supply of such services;’.

(vii) That the export of goods meant goods exported in terms of a sale and/or instalment credit agreement and in order for the taxpayer to succeed it had to show that the services were supplied to a non-resident in connection with movable goods exported subsequent to the supply of the services but once money falls outside the ambit of movable goods and services then the taxpayer could not rely on a zero-rating.

(viii) That currency was excluded from the definition of ‘exported’ in section 1 of the Act and the taxpayer’s services were clearly supplied in connection with money; moreover, the taxpayer had failed to demonstrate that its services fell within the two categories provided for in the definition and money or currency did not fall into either of the two exemptions as if reliance is being placed on currency being

exported then there had to be the requisite documentary evidence and, furthermore, in terms of section 2(1)(*a*) of the Act the definition of 'financial services' included an exchange of currency and not a 'sale' of currency.

(ix) That the taxpayer's reliance on the export scheme for its services had to fail and in terms of s 7(2)(*d*) of the Act the provisions of the Customs and Excise Act relating to the clearance of goods applied and, accordingly, if money was to be regarded as an export it must be regarded as an export incentive scheme approved by the Minister.

(x) That the exchange of currency did not constitute an export as to qualify for export there had to be a sale or credit agreement or an instalment sale agreement and the exchange of money did not qualify as a sale.

(xi) That, accordingly, the services supplied by the taxpayer were services in connection with money and did not constitute movable property with a zero-rating of VAT; furthermore, the services were consumed in South Africa and were not exported as envisaged in the Act.

Appeal disallowed and Commissioner's assessment confirmed.

4. INTERPRETATION NOTES

4.1 Circumstances in which certain amounts received or accrued from the disposal of shares are deemed to be of a capital nature

This Note provides clarity on the interpretation and application of section 9C, which deems the amount derived from the disposal of certain shares held for a continuous period of <u>at least three years</u> to be of a capital nature. Interpretation Note No. 43 (Issue 2) 'Circumstances in which Amounts Received or Accrued on Disposal of Listed Shares are Deemed to be of a Capital Nature' (31 August 2010) deals with section 9B, the predecessor to section 9C. Section 9B applies to the disposal of JSE-listed shares before 1

October 2007, and issue 2 therefore remains relevant to such disposals. It can be found on the SARS website under Legal & Policy/Interpretation Notes/Archive. Section 9C was inserted into the Act by section 14(1) of the Revenue Laws Amendment Act No. 35 of 2007. It was deemed to have come into operation on 1 October 2007, and applies to any disposal of a 'qualifying share' on or after that date.

The first step in determining a person's income tax liability in respect of the disposal of shares is to determine whether the amount received or accrued is of a capital or revenue nature. Any amount received or accrued of a capital nature is specifically excluded from a person's 'gross income' as defined in section 1. The distinction between capital and revenue is fundamental to the tax system, but neither concept has proved capable of a satisfactory definition in the Act. The question whether shares are held as trading stock or as an investment will to a large extent depend on the intention of the taxpayer.

Despite guidelines laid down by case law, the determination of whether the amount received or accrued on the disposal of a share falls on capital or revenue account is often a contentious matter which can lead to costly and protracted legal disputes.

Section 9C provides taxpayers with certainty that if they hold equity shares for at least three continuous years the gains and losses on disposal will be of a capital nature regardless of the intention with which the shares were originally acquired. Not all types of shares qualify under section 9C; for example, non-participating preference shares, shares in foreign companies (other than JSE-listed shares) and participatory interests in portfolios of collective investment schemes in property fall outside section 9C. Its provisions are now mandatory and no election is required or even possible. The wider ambit of section 9C has necessitated the inclusion of a number of anti-avoidance measures. The capital or revenue nature of shares disposed of within three years of acquisition will continue to be determined according to principles laid down by case law.

Section 9C came into operation on 1 October 2007 and applies to the disposal of qualifying shares on or after that date.

5. BINDING PRIVATE RULINGS

5.1 BPR 116 – Distribution to be received by a resident beneficiary from a trust that is not a resident and the subsequent donation thereof by the beneficiary to another trust that is also not a a resident

This ruling deals with some income tax consequences for a resident beneficiary in respect of an amount to be received as a distribution from a discretionary trust that is not a resident and the subsequent donation of that amount by the beneficiary to another trust that is also not a resident.

In this ruling references to sections are to sections of the Income Tax Act applicable as at 18 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:

- section 10(1)(*k)*(ii)(*dd*);
- section 25B; and
- section 56(1)(*g*)(ii).

Parties to the proposed transaction

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

Trust A: A testamentary and discretionary trust that was formed in a foreign country which is not a resident of South Africa

Trust B: A trust to be formed by the Applicant in the same foreign country as Trust A, which will not be a resident of South Africa

Description of the proposed transactions

The Applicant is a beneficiary of Trust A, by will and testament of its founder. The trust holds all the shares in a company that is not a resident of South Africa. During the 2010 calendar year the trust received a dividend from this company which the trust did not immediately distribute to its beneficiaries.

It is proposed that Trust A will in due course distribute an amount, equal to the amount of that dividend, to the Applicant. The Applicant intends to, immediately on receipt thereof, donate that amount to Trust B.

Conditions and assumptions

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

- the amount of the distribution to be received by the Applicant from Trust A must comply with the requirements under section 10(1)(*k*)(ii)(*dd*); and
- the subsequent donation to be made by the Applicant to Trust B must consist of a right in property situated outside of South Africa.

Ruling

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

- The amount of the distribution to be received by the Applicant from Trust A will not be included in the Applicant's income under section 25B(2A).
- The subsequent donation to be made, by the Applicant to Trust B, will be exempt from donations tax under section 56(1)(*g*)(ii).

5.2 BPR 117 – Obligation to deduct or withhold employees' tax in respect of a share option scheme

This ruling deals with the question as to whether a person, other than the person who pays the employee's remuneration, is obliged to deduct or withhold employee's tax under the provisions of paragraph 11A of the Fourth Schedule to the Act in respect of 'equity instruments' as defined in section 8C of the Income Tax Act.

In this ruling references to sections and paragraphs are to sections of the Income Tax Act and paragraphs of the Fourth Schedule to the Act, applicable as at 24 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:

- section 8C; and
- paragraph 11A of the Fourth Schedule.

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

The Applicant: A company incorporated outside South Africa which has its place of effective management outside South Africa

The Co-Applicant: A company incorporated in and a resident of South Africa which is a subsidiary of the Applicant

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

The Applicant is planning the implementation of two incentive plans in order to reward and retain eligible South African employees and directors of the Co-Applicant. The proposed incentive plans are referred to as Plan A and B.

In terms of both Plan A and B, the Applicant may grant non-transferrable options to eligible South African employees and directors of the Co-Applicant to acquire fully paid up ordinary shares in the capital of the

Applicant from time to time and free of any consideration. The exercise of these options by the employees and directors of the Co-Applicant is subject to certain conditions as described in the rules of the respective incentive plans.

Ruling

The ruling made in connection with the proposed transaction in terms of Plan A and B is as follows:

- The Applicant and the Co-Applicant will not be obliged to deduct or withhold any employees’ tax on the date of grant of an option under either Plan A or B. The Applicant and the Co-Applicant will only be obliged to deduct or withhold employees’ tax once an option vests as contemplated in section 8C.
- The Applicant and Co-Applicant shall be jointly and severally liable to:
  - deduct or withhold employees’ tax in terms of paragraph 11A of the Fourth Schedule in respect of any section 8C gain which will be included in remuneration;
  - ascertain from SARS the amount to be so deducted or withheld in terms of paragraph 11A; and
  - inform SARS in terms of paragraph 11A(5) if the amount to be deducted or withheld by way of employees’ tax exceeds the amount from which the deduction or withholding will be made.
- Where an option under Plan B is cash settled as contemplated in the Rules of Plan B, the Applicant and Co-Applicant shall be obliged to deduct or withhold employees’ tax in respect of the vesting of an option as contemplated for in section 8C, and no further or additional employees’ tax is to be deducted or withheld in respect of the cash payment.

5.3 BPR 118 – Withholding of Dividend Tax

This ruling deals with the determination of which party will be responsible for withholding dividends tax.

In this ruling references to sections are to section of the Income Tax Act applicable as at 1 April 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, definition of 'dividend';
- section 64D;
- section 64E;
- section 64F;
- section 64G;
- section 64H; and
- section 64K.

Parties to the proposed transaction

The Applicant: A Vesting Trust that is a 'resident' as defined in section 1

The Co-Applicants: Companies that form part of a 'group of companies' as defined in section 1 and each company is a 'resident' as defined

Other Parties:

Holdco: The holding company of the Co-Applicants which is not a 'resident' as defined

Beneficiaries: All Beneficiaries of the Applicant are shareholders of Holdco registered on Holdco's South African branch share register (South African registered shareholders), or their nominees

Description of the proposed transaction

The object and purpose of the Applicant is to receive dividends from the Co-Applicants and to distribute these dividends to its beneficiaries, being

Holdco's South African registered shareholders who hold their shares on the South African branch register, pro rata to their shareholding in Holdco's South African branch register. This object is in accordance with an agreement with the South African Reserve Bank, to prevent large outflows of dividends from South Africa.

In terms of the Articles of Association of Holdco, an amount paid as a dividend to the Applicant by any Co-Applicant is received by the Applicant on behalf of the South African registered shareholders of Holdco. The entitlement of such shareholders to be paid dividends by Holdco pursuant to the said Articles shall be reduced by the corresponding amount which those shareholders are entitled to receive from the Applicant.

An amount is thus paid by any of the Co-Applicants to the Applicant to coincide and correlate with the payment required to be made to the South African registered shareholders in respect of a dividend declared by Holdco.

The above mechanism will effectively reduce the South African group's dividend payment to Holdco and will prevent large outflows of dividends from South Africa which (except for the Applicant's shares in the Co-Applicants) would have to be paid back to the South African registered shareholders.

It is proposed that the following dividend distribution mechanism to distribute the South African dividend be followed:

- dividends flow from the South African group of companies (declaring companies), to the Co-Applicants;
- the trustees of the Applicant authorise the Co-Applicants to pay the dividend declared by them (to be received by the trustees for distribution) into a Central Securities Depository Participant (CSDP) trust account which is nominally held in the Applicant's name for the benefit of the South African registered shareholders;
- the CSDP pays the dividend amount to STRATE which distributes the amount to the various CSDPs; and

- the CSDPs distribute the dividends to the Beneficiaries on the Applicant's behalf.

Ruling

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

- The beneficiaries of the Applicant (being the beneficiaries of a vesting trust) are, to the extent that they do not constitute regulated intermediaries, the beneficial owners of the dividends declared by the Co-Applicants.
- The payments by the Co-Applicants into the CSDP's trust account which is nominally held in the Applicant's name for the benefit of the South African registered shareholders as authorised by the trustees of the Applicant are to be treated as payments by the Co-Applicant to a 'regulated intermediary' as defined in section 64D and as such the Co-Applicants do not have to withhold dividends tax from such payments.
- The CSDP used by the Co-Applicants and other CSDPs as regulated intermediaries must withhold dividends tax from the payments of the Co-Applicants' dividends subject to the specific exclusions from this obligation as referred to in section 64G(2).

6. BINDING GENERAL RULINGS

6.1 BGR 6 (issue 2) – VAT – Discounts, rebates and incentives in the fast moving consumable goods industry

This ruling serves to provide:

- a legal framework for the treatment of discounts, rebates and incentives in the Fast Moving Consumable Goods (FMCG) industry, and
- guidelines in determining whether the supplier is required to issue a credit note or receive a tax invoice for discounts, rebates and incentives granted.

Background

It is common in the FMCG industry to grant allowances in the form of discounts, rebates and incentives to retailers. These allowances may either result in the previously agreed consideration for a supply being altered, or may represent payment for a supply of services by the retailer to the supplier.

For purposes of this document, the term 'allowance' will include discounts, rebates and incentives.

The FMCG industry is currently experiencing difficulties in classifying which allowances alter the previously agreed consideration for a supply or represent payment for a supply of services.

Allowances provided in the FMCG industry

In the FMCG industry, the supplier and the retailer enter into a terms of trade agreement in terms of which a combined allowance is determined which consists of various components. General characteristics of such an agreement consist of the following:

- The allowances are determined upfront.

- A list of all the categories of allowances provided is stated in the agreement.

Allowances can be divided into two categories, namely, variable allowances and fixed allowances. 2

Variable allowances

A variable allowance is granted to a retailer subject to the retailer satisfying certain conditions stipulated in the terms of trade agreement. A variable allowance is granted based on conditions that must be met by the retailer. In some instances, the supplier grants the allowance immediately, irrespective of whether the conditions are met or not.

Set out below is a non-exhaustive list and a brief description of the variable allowances in the FMCG industry:

- *Guaranteed allowances* – Allowances received from and paid by suppliers on all purchases/sales, irrespective of the volumes purchased/sold.
- *Early settlement allowances* – Allowances received for prompt payment of due accounts.
- *Growth rebates* – Allowances linked to a volume/value target. A percentage discount is provided when a certain growth percentage has been achieved.
- *Advertising allowances* – An allowance that is determined as a percentage of turnover for each purchase/sale and is not linked to a specific advertising service.
- *Distribution/warehousing allowances* – Payments made by the supplier in return for warehousing/redistribution of stock by the retailer and thereby saving the supplier the costs to store/distribute stock.
- *Swell allowances* – An allowance provided, calculated as a percentage of turnover, regardless of actual damages or breakages occurring in relation to products. No records are kept of these products and the products are not returned. The types of products to which a swell allowance will apply are determined upfront. This is to

simplify the process of providing an allowance for actual damages or breakage.

- *Category management allowances* – An allowance for the exchange of information by suppliers and retailers to determine which products sell faster in order to prioritise shelf space for such products. The allowance is granted for data gathering purposes and to make the supply chain more effective.
- *Incentive discount/trade rebates* – Discounts from suppliers which are all deducted off the supplier's invoice as a reduction to the selling price (supplier) or cost price (retailer).
- *Franchise store allowances* – An allowance given for advertising.
- *Broadbase range scorecard allowance* – An allowance to incentivise retailers to deliver on pre-agreed targets, including areas of support, efficiency and growth.
- *House/brand/quality assurance allowance* – An allowance that qualifies as a cost recovery for quality tests done on products.
- *Bulk allowances* – A volume-based efficiency allowance, also known as a bulk-buy discount, whereby retailers are incentivised to purchase in a manner which reduces the cost of supplying products into their stores. The discount will be an amount per baler or unit or a percentage of the value of those purchases.
- *Tallies* – This allowance is an amount per product purchased/sold. It is product-specific and agreed for goods near its sell-by date.

Fixed allowances

A fixed allowance is granted based on the condition that an actual supply is performed. Fixed allowances in the FMCG industry include the following:

- *New store allowance* – An allowance for the promotion of products with the opening of a new store.
- *Major refurbishment allowance* – A payment to revamp a retailer's store to meet the required standards.

- *Specific promotional/Gondola/Ad hoc allowance* – Payment for promotional support or specific advertising service with the purpose to drive additional sales that does not form part of the annual agreed support grid.
- *Post-recession allowance* – Assistance provided to stores to decrease the effects of a recession.

Issues

The issues under consideration are whether an allowance is regarded as a:

- reduction of the purchase price in which case a credit note must be issued; or
- consideration paid for a supply of a service in which case a tax invoice must be issued.

The law and its application

Reference to sections are to those in the VAT Act.

A vendor making a taxable supply of goods or services must issue a tax invoice to a recipient within 21 days of making that supply. The recipient must retain the tax invoice to substantiate any input tax deduction for the goods or services acquired. Tax invoices form part of the records that vendors (that is, suppliers and recipients) are required to keep under section 55, and are used to create a paper trail for audit purposes.

The details shown on a tax invoice may, in certain circumstances, be incorrect due to various reasons, for example, due to the granting of a discount. Section 21 therefore makes provision for a credit or a debit note to be issued in these instances.

Instances in which credit notes must be issued (section 21)

A supplier (or the recipient[2]) is required to issue a credit note for an allowance granted if the allowance:

- alters the original purchase price of a supply of goods or services in terms of an agreement with the recipient; and

- results in the tax charged on the tax invoice in relation to that supply being incorrect (that is, the amount of tax charged shown on the tax invoice exceeds the actual tax charged).

A credit note must contain the particulars specified in section 21(3), subject to section 21(5).

Instances in which a tax invoice must be issued

A credit note cannot be issued in instances where an allowance does not adjust the price at which goods and services were originally supplied.

An allowance granted to a retailer for having performed a specific function or task (for example, providing specific advertising services), is a supply of a service from the retailer to the supplier. Allowances granted to compensate, subsidise, reward or reimburse a retailer for expenses incurred for or activities undertaken on behalf of the supplier constitutes consideration for a separate supply of services by the retailer to the supplier.

The retailer, as supplier of these services, must issue a tax invoice within 21 days of the date of the supply in accordance with section 20.

Recipient-created tax invoices, debit and credit notes

To the extent that circumstances exist where a supplier is unable to issue a tax invoice, debit or credit note due to circumstances beyond the supplier's control, provision is made for SARS to allow the recipient of a supply to issue a tax invoice for a supply made by a supplier.

The circumstances considered to be beyond the supplier's control are where the recipient of the supply is:

- in control of determining the quantity or quality of the supply; or
- responsible for measuring or testing the goods sold by the supplier.

Interpretation Note No. 56 deals with recipient-created tax invoices, credit notes and debit notes and states which conditions must be met to qualify for the issuing of recipient-created tax invoices, credit notes and debit notes.

Ruling

SARS, with regard to allowances granted in the FMCG industry, issues the following binding general ruling (BGR).

The supplier must issue a tax invoice, except if the provisions of section 20(2) apply, where the allowance is regarded by the supplier and the recipient of the supply as consideration for the supply of a service. The tax invoice must satisfy the requirements of sections 20(4) and (5). A credit note must be issued by the supplier, except if the provisions of section 21(5) apply, where an allowance is regarded by the supplier and the recipient of the supply as a reduction in the original purchase price. The credit note must satisfy the requirements of section 21(3).5

This BGR is conditional upon the supplier maintaining an updated list of all the allowances received or granted for each calendar or financial year, which indicates whether the allowance results in a tax invoice, credit note or debit note being issued. Such list as well as agreements or statements substantiating this classification must be retained as part of record-keeping requirements contemplated in section 55.

To the extent that this BGR does not provide for a specific scenario in respect of allowances granted or received, a VAT Ruling must be applied for from SARS.

7. BINDING CLASS RULINGS

7.1 BCR 34 – Taxation of Exchange Traded Notes

This ruling deals with the tax consequences for taxpayer issuing exchange traded notes (ETNs).

In this ruling references to sections are to sections of the Income Tax Act, applicable as at 16 March 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, definition of ‘gross income’ and ‘trading stock’
- section 8(4)(*a*);
- section 11(*a*);
- section 22;
- section 23(*g*);
- section 23B;
- section 23H;
- section 24C
- section 24J;
- section 24L; and
- section 24M.

Class and parties to the proposed transaction

The Issuers: Any person issuing ETNs listed on the Johannesburg Stock Exchange (JSE) from time to time

The Holders: Any person acquiring ETNs from time to time on the JSE

Description of the proposed transaction

An ETN is an agreement entered into between a Holder and an Issuer, in terms of which the Holder pays an amount (the acquisition amount) to the Issuer and the Issuer undertakes to pay to the Holder an amount (the redemption amount) calculated with reference to the value of certain specified assets or a benchmark (the reference portfolio) on the maturity date of the ETN. An ETN (for purposes of this ruling application) is a long-term instrument that is traded through the Johannesburg Stock Exchange (JSE) and the maturity date of the ETN will be a minimum of five years after the date of issue.

The reference portfolio may constitute shares, an index, an exchange rate, or a combination of the aforementioned. Examples of ETNs available in the market, include:

- Equity linked notes which provide the Holders with an opportunity to gain exposure to various equity indices. The equity exposures investors can gain access to are:
  - two Africa equity indices;
  - a total return emerging market MSCI index; and
  - the total return China MSCI index.
- Commodity linked ETNs which offer investors exposure to the performance of a single commodity or index or an index that consists of a basket of commodities.

ETNs may be disposed of by the relevant Holder in the market or to a market maker. In terms of the requirements of the JSE in respect of ETNs, a market maker is required. The Issuer may redeem the ETN prior to the maturity date in the event that:

- there is an event that affects the validity of the ETN;
- the reference portfolio that the ETN tracks ceases to exist or does not have a viewable/determinable price available; or
- the Holder wishes to redeem the ETN against the Issuer.

(In all of the above events the ETN redeems at the current value of the reference portfolio it tracks.)

The Issuer may or may not hedge its obligations in terms of the ETN by acquiring the relevant reference portfolio. In terms of the JSE rules it is not required that the Issuer hedges its obligations in terms of the ETN.

Conditions and assumptions

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

- will only be applicable for issuance of ETN's after the issue date of this ruling;
- is based on the facts as set out in the ETN Programme examples submitted with this ruling application; and

- will not be applicable to ETNs with a Reference Portfolio which comprises any debt instrument.

<u>Ruling</u>

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

- The acquisition amount will be included in the gross income of the Issuer in the year of assessment in which the ETN is issued.
- The redemption amount, payable by the Issuer on the maturity date, will be deductible under section 11(*a*) read with section 23(*g*) by the Issuer in the year of assessment in which the ETN is issued. The amount of such deduction will be a reasonable estimate of the redemption amount (estimated redemption amount), determined on the date of issue of the ETN.
- If the estimated redemption amount, that is deducted in the year of assessment in which the ETN is issued, exceeds the actual redemption amount payable on the maturity date, the difference will be recouped by the Issuer under section 8(4)(*a*) during the year of assessment in which the maturity date falls. If the actual redemption amount payable on the maturity date exceeds the estimated redemption amount that is deducted in the year of assessment in which the ETN is issued, the Issuer will be entitled to a further deduction, under section 11(*a*) read with section 23(*g*), during the year of assessment in which the maturity date falls.
- The ETNs which are the subject of this ruling will not constitute 'instruments', as defined in section 24J(1).
- The provisions of sections 23H, 24C, 24L and 24M will not apply to ETNs issued.

8. GUIDES

8.1 Average Exchange Rates

The term 'average exchange rate' is defined in section 1 of the Income Tax Act, to mean in relation of a year of assessment the average exchange rate determined by using the closing spot rates at the end of daily or monthly intervals during a year of assessment, which must be consistently applied within that year of assessment.

The South African Reserve Bank publishes weighted average exchange rates, based on the foreign exchange transactions of commercial banks, on a quarterly basis. These rates may be used in the determination of the average exchange rate as required in the Act and are supplied on SARS' web page to enable stakeholders (taxpayers) to use it for this purpose.

The use of SARS' average exchange rates is not compulsory. Stakeholders using average exchange rates which differ from those published by SARS must, however, keep record of all calculations for audit purposes.

The tables of the average exchange rates are updated on a quarterly basis. The next update can be expected in September 2012.

The Act provides specifically that certain amounts expressed in a foreign currency be translated into Rand by the application of the applicable average exchange rate.

The sections of the Act are:

- Section 6*quat*(4) - Foreign tax credits
- Section 9D(6) - That portion of the net income of a controlled foreign company, which is included in the income of a resident participant in relation to the controlled foreign company
- Section 9G - The amount to be included in gross income as a result of the disposal of a foreign equity instrument which constitutes trading stock

- Section 25D(2) - The taxable income attributable to a foreign permanent establishment of a resident
- Section 25D(3) - All amounts received by or accrued to, or expenditure or losses incurred by a natural person or a trust, which are denominated in a foreign currency in instances where the natural person or trust has elected to apply the average exchange rate as a method of translation
- Eighth Schedule to the Act - Certain paragraphs have specific provisions regarding the use of the average exchange rate method, for example paragraph 90(2), while other paragraphs has their own translating rule, for example paragraphs 43(1), (2) and (4)

Example to calculate the Average Exchange Rates

Company A changes its year of assessment from December to February and will submit a return covering the period of 14 months (1/1/2003 to 29/2/2004).

The average exchange rate for this year of assessment will thus be calculated over the 14 month period.

The calculation for Australian Dollar, for instance, will thus be:

the sum of the average interest rates of the 14 months of that period / divided by 14 = the average exchange rate to be used.

1 January 2003 to 29 February 2004

2003

Month	**Monthly Average Exchange Rate for Australian Dollar**
January	5.0596
February	4.9399
March	4.8524

April	4.6913
May	4.9641
June	5.2495
July	4.9974
August	4.8134
September	4.8384
October	4.8288
November	4.8212
December	4.8096
2004	
January	5.3257
February	5.2633
Total of 14 months	**69.4546**
divided by 14	**÷ 14**
Average Exchange Rate to be used for this period	**= 4.9610**

8.2 Guide to the disposal of a residence from a company or trust

This guide deals with CGT, dividends tax, STC and transfer duty relief measures that apply to the acquisition by a natural person of a residence from a company or trust between 1 October 2010 and 31 December 2012. The donations tax and value-added tax consequences are also examined.

Paragraph 45 provides that only a natural person (individual) or special trust is entitled to disregard the whole or a portion of the capital gain or

capital loss on disposal of that person's primary residence. Subject to certain exceptions:

- the first R2 million[1] of the capital gain or capital loss must be disregarded, or
- if the proceeds are R2 million or less, the full amount of any capital gain must be disregarded.

Historically many individuals purchased their residences in companies or trusts for a variety of reasons, including protection from creditors, avoidance of transfer duty and estate duty and circumvention of the Group Areas Act 36 of 1966 (repealed). A window of opportunity was granted in 2002 which enabled these individuals to transfer their residences out of their companies or trusts into their own names without suffering any adverse CGT, STC or transfer duty consequences

Following the amendment of the Transfer Duty Act in 2002, it is no longer possible to avoid transfer duty by disposing of the shares or member's interest in a company holding residential property, or by substituting beneficiaries holding contingent interests in the residential property of a discretionary trust.

Before the amendments effected by the Revenue Laws Amendment Act 74 of 2002 the distribution of a capital profit in anticipation of or in the course of liquidation, winding up or deregistration of a company was exempt from STC. However, since the amendments, any capital profit derived by a company on or after 1 October 2001 is subject to STC, even if distributed in anticipation of or in the course of liquidation, winding up or deregistration. Furthermore, with effect from 1 January 2011 all capital profits, regardless of whether derived before or after 1 October 2001, are subject to STC. STC has been repealed with effect from 1 April 2012 but has been replaced by dividends tax under section 64E which also applies regardless of the capital or revenue nature of profits out of which a dividend is distributed. Dividends tax is levied at a rate of 15% compared to the previous STC rate of 10%. Outside the relief measures discussed in this guide, maintaining a

residence in a company or trust has, amongst others, the following tax consequences:

- A natural person who holds an interest in a primary residence owned by a trust is not entitled to the primary residence exclusion except in the case of a lessee who is not a connected person in relation to the trust.
- A company or trust is not entitled to the primary residence exclusion.
- A company would potentially be liable for CGT at a rate of 14% on any capital gain on a residence disposed of during years of assessment commencing before 1 March 2012 and at 18,65% thereafter.
- A trust would potentially be liable for CGT at a rate of 20 on any capital gain on the disposal of a residence before 1 March 2012 and at 26,64% thereafter.
- A trust that vests a residence in a resident beneficiary must disregard any capital gain on such a disposal and the beneficiary must take it into account. An individual's effective CGT rate is 0% to 10% up to 29 February 2012 and 0% to 13,32% thereafter.
- Guide to the Disposal of a Residence from a Company or Trust 3

- A natural person acquiring the residence will be subject to transfer duty on a sliding scale at a rate varying between 0 and 8%.
- A company would potentially be liable for STC at a rate of 10% on the distribution of a residence as a dividend *in specie* before 1 April 2012. Thereafter it would potentially be liable for dividends tax at a rate of 15% on such a distribution *in specie* unless the dividend was exempt or qualified to be taxed at a reduced rate.

Retaining a residence in a company or trust may carry other benefits (for example, a trust may provide estate duty savings and protection of assets from creditors). However, these advantages need to be weighed up against the loss of the primary residence exclusion (worth up to R266 400 in tax

savings) and the higher rate of CGT in a company (18,65% v 13,32%) or trust (26,64% v 13,32%) and the imposition of dividends tax at 15%.

It has emerged that many individuals did not avail themselves of the 2002 opportunity, with the result that they now face the adverse tax consequences described above when disposing of a residential property from a company or trust.

Paragraph 51

A further window of opportunity in the form of paragraph 51 of the Eighth Schedule, which operated on a roll-over basis, was introduced by the Taxation Laws Amendment Act 17 of 2009. Paragraph 51 applies to the disposal of a residence by a company or trust on or after 11 February 2009 but no later than 30 September 2010. Thus paragraph 51 will apply to residences acquired under contracts signed on or before 30 September 2010 which are not subject to any suspensive conditions at that date. There is no time limit on the registration of the property in the deeds registry. In other words a property acquired unconditionally on or before 30 September 2010 which is registered after that date must still be dealt with under paragraph 51.

A disposal of a residence that is subject to suspensive conditions which are only fulfilled after 30 September 2010 must be addressed under paragraph 51A.

For guidance on paragraph 51, see Appendix B of the *Comprehensive Guide to CGT* (Issue 4).

Paragraph 51A

On 17 February 2010 it was announced in the 2010 Budget Tax Proposals that paragraph 51 was inadequate and that a 'new, more flexible window period is proposed so that these residential property entities are to be liquidated or dissolved with limited compliance and enforcement effort.'

The Taxation Laws Amendment Act 7 of 2010, promulgated on 2 November 2010, inserted paragraph 51A which widens the relief in a number of respects but also imposes new conditions. The revised relief measure

came into operation on 1 October 2010 and applies to the disposal of a residence from a company or trust on or after that date and before 1 January 2013.

Further amendments to paragraph 51A have been made by the Taxation Laws Amendment Act 24 of 2011, most of which have been backdated to 1 October 2010. These amendments:

- extend the relief to qualifying holiday homes;
- clarify who may be an acquirer;
- confirm that the connected person relationship between the company or trust and the acquirer must be determined at the time of disposal;
- require a trust to be terminated rather than revoked; and
- effect a number of technical corrections.

This guide deals with the relief measures in paragraph 51A and related provisions.

9. 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.