

TAX LAW NOTES:

STUDY UNIT 1

INTRODUCTION TO TAXATION

State Expenditure and Financing:

State expenditure is financed through:

1. Increasing the supply of money in the economy – minting own money;
2. Loans;
3. Generating own income.

Generating states “Own Income” can be done by;

1. Sale or lease of property;
2. State enterprises and monopolies;
3. Taxes, duties, levies, and user charges.

What is tax?

Compulsory contribution, payable in money or in kind, to a taxing authority, aimed at funding public expenditure. It can't be levied as a counter performance for identifiable public services and need. It does not necessarily take the taxpayers ability to pay nor the benefits received from the public services into account.

Taxes, Duties and Levies: these terms are synonymous and are state income. They are just used “loosely” by lay people and politicians.

User charges – these are charges linked to a specific type of service used. Income received from this service is used for that specific service. Examples: Toll Road Fees, Water and Electricity.

The ideal tax system:

- There must be a sufficient connection between the State and the taxpayer to justify the taxpayer's tax liability.
- The connecting factors:
 - 1) **SOURCE** – income derived from a source within the Republic.
 - 2) **RESIDENCE** – (income accrues to a resident of the taxpaying state).
 - 3) **CITIZENSHIP** – income accrues to a citizen of the Taxpaying State. South Africa – predominant factor is source.

The Tax Base:

- The bases on how tax can be paid
- 1) Benefit theory: taxed in accordance with the benefits he receives from the various public services. (Impossible to determine how much a person benefits from a particular service/s).
- 2) Ability to pay theory: make a contribution corresponding to the sacrifice the tax requires of him and in the end everyone must make an equal sacrifice (has too many practical problems) – SA.
- 3) Ability to earn theory: ability to earn can also be used as a criterion but it's problematic, i.e. if someone inherits money etc.

THREE broad tax bases are commonly utilized:

- 1) INCOME
- 2) CONSUMPTION (expenditure)
- 3) WEALTH

An equitable tax system:

The “Ideal tax system = Equality criteria” – The Margo Commission mentioned the following criteria:

- Tax neutrality – a person should not be influenced by the tax system to choose one course of action above another – so tax liability will be reduced.
- Equity – horizontal equity requires that similar persons that are in similar circumstances will be taxed. Vertical equity means that taxpayers experiencing different circumstances will be taxed differently – equal sacrifices.
- Certainty and simplicity – certain and simple to assess and collect.
- Cost-effectiveness – cost of collecting tax shouldn't be high.

Direct and Indirect taxes:

DIRECT:

It is intended and expected that the person who is legally bound to pay the tax is the same person who will ultimately be poorer for paying the tax, e.g. tax on the person's income.

INDIRECT:

The person who has the legal obligation to pay the tax is not necessarily the person who bears the tax in the end and thus becomes poorer. The taxpayer will pass on the tax to someone else, e.g. VAT.

Progressive, regressive and proportional taxation:

PROGRESSIVE: the greater the persons tax base, the greater his tax burden (SA – income tax).

REGRESSIVE: the greater the persons tax base, the less of a tax burden he'll have (VAT).

PROPORTIONAL: everyone pays the same % of his or her tax base.

CONCEPTS:

Tax Base:

It's the specific source from which a taxing authority intends to derive tax revenue.

Taxpayer: The person saddled with the liability of paying tax.

Taxable value: The portion of tax base, expressed as an amount, to which the tax rate is applied.

Tax rate: A % applied per unit of taxable value in order to calculate the amount of the tax payable (e.g. 14% VAT).

Tax incidence: **Formal incidence** rests on the person who is legally obliged to pay tax but the **effective incidence** falls on the person who is made poorer by the imposition of the tax.

Tax burden: Indication of the total impact of tax on a person.

Tax law: Body of law dealing with the charging, assessment and collection of taxes.

Working through tax legislation

Checklist:

1. Establish what the tax base is.
2. Identify the possible tax payer.
3. Ascertain the date or period of liability.
4. Establish the taxable value.
5. Determine the taxable rate.
6. Establish the date of payment.
7. Are there any exemptions.

STUDY UNIT 2

THE SOUTH AFRICAN TAX SYSTEM

TAXES LEVIED BY THE NATIONAL SPHERE OF GOVERNMENT

All of the imposts levied by the national sphere of government are administered by the South African Revenue Service (SARS). The most important taxes administered by the SARS are Income tax on individuals. Income tax on companies, Value-added tax (VAT), Estate duty, Donations tax, Capital gains tax Income, Transfer duty, Stamp duties, Secondary tax on companies, etc.

TAXES LEVIED BY THE PROVINCIAL SPHERE OF GOVERNMENT

Section 228 of the Constitution states that a provincial legislature may impose “taxes, levies and duties other than the income tax, value-added tax, general sales tax, rates on property or customs duties”. It also states that these may not be exercised in a way that materially and unreasonably prejudices economic activities.

TAXES LEVIED BY THE LOCAL SPHERE OF GOVERNMENT

Section 229 of the Constitution stipulates that municipalities may impose rates on property (i.e. immovable property tax) and other taxes “appropriate” to local government. However, such taxes may not be levied in a way that materially and unreasonably prejudices economic activities. Municipalities may not levy an income tax, value-added tax, general sales tax or customs duties.

SOURCES OF SOUTH AFRICAN TAX LAW

Legislation and case law

Legislation: The Constitution and various tax statutes.

Tax-related cases: *South African Law Reports*, *South African Tax Cases Reports* and *Juta’s Tax Law Reports*.

Although judgments of the Tax Court do not constitute precedents, they have some persuasive value.

Secondary sources

Textbooks and journals.

TAX LAW AND THE BILL OF RIGHTS

(Equality, non-discrimination and administrative justice).

The Bill of Rights (in the 1996 Constitution)

Section 7 of the Constitution states that the Bill of Rights is a cornerstone of democracy in South Africa. It helps one determine the constitutionality of a taxing statute and/or the constitutionality of the administrative actions taken by SARS. A juristic person, as a taxpayer, can take the tax authorities to task for possible unconstitutional administrative action.

Substantive tax law: the most important rights in the Bill of Rights relate to equality (s9), privacy (s14), freedom of trade, occupation and profession (s22) and property (s25).

Procedural tax law: the most important rights are access to information (s32), just administrative action (s33) and access to courts (s34).

THE INTERPRETATION OF TAX STATUTES

The primary rule regarding interpretation is that the ordinary grammatical meaning of the words must be applied. If there is ambiguity or uncertainty, one must apply the secondary rules of interpretation. ~ **In dubio contra fiscum rule**

This is the secondary rule that imposes a burden upon a subject (the tax payer). The interpretation, which is less cumbersome to the subject, must be endorsed as the true intention of the legislature.

COMMON LAW

According to English law the courts have the discretion to negate certain steps or transactions aimed solely at tax avoidance and with no other commercial value. This rule of English law is not part of South African law.

In *South African Pulp and Paper Industries Ltd v CIR*, the appellant (SAPPI) leased a plantation for a period of 30 years. SAPPI acquired the right to fell the trees and the Commissioner stated that the contract concluded by SAPPI could not have been a lease, but rather another limited real right, as it gave SAPPI a right to consume.

The Commissioner argued that SAPPI was liable for transfer duty. SAPPI argued that it was a contract of lease as the saligna trees felled would regenerate within the 30 year period of the lease. The court found in favour of SAPPI.

In *Bozzone v SIR*, the taxpayer contended unsuccessfully that the contract in terms of which he could mine sand and clay for a 20-year period was a “normal” lease. As the contract implied a right to consume, the court ruled it was not a lease and the appellant was liable for transfer duty.

ADMINISTRATION

The South African Revenue Service (SARS) is responsible for the administration of the various taxes.

OBJECTION AND APPEAL

A taxpayer who feels aggrieved by the Commissioner’s assessment in respect to the various taxes can object to the assessment. It is very important that the grounds are properly and fully set out in the objection, because if the taxpayer is not satisfied with the Commissioner’s decision, and wishes to appeal, the appeal is limited to the grounds set out in the objection (record). If the taxpayer is dissatisfied with the Commissioner’s decision he or she can appeal to a special board or to the tax court. A party who is dissatisfied with

that judgment can appeal to the High Court and then a further appeal to the Supreme Court of Appeal is also possible.

TAX AVOIDANCE VERSUS TAX EVASION

Tax avoidance should be distinguished from tax evasion.

Tax evasion is illegal. It is the non-compliance with the tax laws and includes activities that are deliberately undertaken by a taxpayer to illegally free himself from the tax, which the law charges upon his income. Tax authorities normally resort to criminal prosecution to prevent tax evasion.

Tax avoidance involves the taxpayer's organizing his or her affairs in a fully legal manner and in such a way that he or she has little or no taxable income.

INCOME TAX

Levying of different types of taxes:

The sources of income tax:

1. Normal tax;
2. Donations tax;
3. Turnover tax;
4. Withholding tax.

Administration of the act:

The administration of the act is done by the commissioner of SARS.

Interpretation of the income tax act:

1. Judicial decisions;
2. Approaches to interpretation – primary and secondary rules;
3. Definitions – as laid in section 1;
4. Interpretation act.

Regulations, Practice Notes and Interpretation Notes:

Section 107 allows the Minister of finance to make regulations on the following matters which have the same authority/ power as legislation:

1. Duties of persons with respect to the administration of the act;
2. Limits to which a person is to act;
3. Contents of account to be rendered by the tax payer of returns rendered under the act and the manner in which the accounts are to be authenticated;
4. Method of valuations of annuities and any other limited interests eg: Usufruct.

FORMULA FOR TAXABLE INCOME:

Total receipts + accruals (total income)

MINUS

General exclusions (including general inclusions; specific inclusions and
deemed accruals)

EQUALS

Gross income

MINUS

Exemptions

EQUALS

Income

MINUS

Deductions (includes general deductions; specific deductions & allowances
and special deductions)

EQUALS

“TAXABLE INCOME”

STUDY UNIT 3

INCOME TAX

The general definition of gross income: NB! NB! NB!

- ✓ The year or period of assessment
- ✓ In the case of any resident
- ✓ The total amount, in cash or otherwise
- ✓ Received by, accrued to or in favour of such resident
- ✓ Or any person other than a resident (source)
- ✓ Excluding receipts or accruals of a capital nature
- ✓ But including specific inclusions (par a-n)

1. Year or period of assessment

SECTION 1 READ WITH **SECTION 5**

- Income assessed over a year.
- Year of assessment runs from 1st March to the last day of February the following year.
There are 2 exceptions:
 - 1) A company = the year of assessment is that company's financial year.
 - 2) In the case of certain farmers, fishermen and diamond diggers, it refers to a year running from 1 July to 30 June the following year.
- **Any other period** refers to extraordinary circumstances where a tax is levied for a period of less than twelve months, for example in the case of a natural person who dies in the year of assessment. In such a case an assessment will be made for the period from the beginning of the year of assessment up to and including the date of death of the taxpayer.

2. Resident

It is important to distinguish between a resident and a non-resident.

Resident – taxed on worldwide income. (Residence based tax system)

Non-Resident – Taxed on income that is earned in the republic. (Source based tax system)

Who is a “person” in terms of the act that can be taxed:

1. Natural person
2. Entities (insolvent estate, etc.)
3. Companies
4. Juristic persons (universities)

EXCLUDES: A portfolio of collective investment schemes in property & foreign partnerships.

THE DEFINITION OF RESIDENT – SECTION 1

1. A natural person that:
 - ⇒ Is ordinarily resident in SA
 - ⇒ Is not at any time during the year or assessment period, ordinarily resident in SA, but has been physically present in the Republic for a period exceeding 91 days in the relevant period and 91 days for each of the preceding 5 years of assessment and for the period of 915 days in the preceding 5 years.

Two tests to determine a person's residence

Ordinary Residence Test:

In terms of **Kuttel AND Cohen** cases it is where a person usually resides. It is a place where a person's "real home" is situated.

Physical Presence Test

Not a residence of SA but has been physically present during any period within a year of assessment.

2. A person (other than a natural person), which is incorporated, established or formed in the Republic, or which has its place of effective management in the Republic.

3. **Total amount in cash or otherwise**

The **onus** lies on the Commissioner to determine an amount and the **onus** then lies on the taxpayer in terms of section 82 to prove that the income is **NOT** taxable.

- ⇒ In **CIR v Butcher Brothers (Pty) Ltd**, the taxpayer owned property which he leased out to a lessee on a 50 year lease and a renewal of 49 years. The agreement was that the lessee was entitled to demolish existing buildings and build a theatre. The owner was therefore gaining the theatre. The receiver wanted to tax the owner for the value of the buildings that the lessee was obliged to build ("otherwise"). The owner raised the question of how can one work out how much money the building was worth as the benefit only arises after the lease has expired.

Commissioner in this case needed to prove the value of improvements made by the lessee.

The court held: the receiver said that instead of getting rent, the owner got the buildings thus he tried to avoid tax. The owner contended that it was impossible to put a value on the buildings now (the value would go down in 49 years). Thus – how do we put ascertainable value to buildings? The receiver said: calculate the value of the buildings NOW. The court found in favour of *Butcher Brothers*. Therefore if the CIR is going to tax the taxpayer on an amount other than cash then the amount must have an ASCERTAINABLE MONEY VALUE. (*Benefits received in kind, corporeal or incorporeal, which have monetary value form part of the taxpayer's gross income if it complies with all the requirements.*)

⇒ Section 24M – where a person alienates an asset of which the value cannot be determined in the year of assessment, such value will not be included in the taxpayer's gross income.

Example:

If an employee is promoted and made a director, he can't be taxed by virtue of his promotion – there is no monetary value to his appointment.

If, however, he is paid more due to the promotion, his salary forms part of gross income (increased salary).

Example:

If a person receives shares – would they have an ascertainable value? YES, the value is:

- 1) What value would you give the shares?
- 2) When will you value the shares (market fluctuates)?

The answer to 1) is: MARKET VALUE

The answer to 2) is: AT THE DATE YOU RECEIVE THEM OR WHEN THEY ACCRUE TO YOU.

Problems with this:

⇒ In ***Lace Proprietary Mines***, the parties entered into a contract where certain mineral rights were sold for R1 000 000 and the contract stated that the purchase price was R500 000. The seller was therefore trying to cheat the CIR by paying tax on only R500 000. The court had to thus decide whether the million shares were a representation of the purchase price or if the purchase price in the contract was the actual purchase price.

The court held: if the real value of the shares differed from the purchase price, the court looked at the REAL INTENTION of the parties to establish whether the shares or the stated purchase price was the real p.p. **The shares were found to be the real intention of the parties.**

NB “LOOK AT THE TERMS OF THE CONTRACT”

CSARS v Brummeria Renaissance

Facts:

Investors in a retirement village did not compensate the taxpayer in “cash” for the supply of residential units. They granted the taxpayer interest free loans in exchange for these life rights in the units.

The taxpayer was trying to evade paying income tax on the units that were sold.

Because the “interest free” loans has an ASCRERTAINABLE MONETARY VALUE it was included in the taxpayer gross income.

Example:

If a person acquires a personal right to use something like a flat and that flat can't be sublet, can you give that right a monetary value? “The person receiving the benefit for the use of the flat will be taxed on this benefit as it does have a \$ value though the flat can't be sublet to someone else. The value will be what it would have cost to reside somewhere else, in a similar flat.”

“Monetary value” has a wide meaning to include anything to which we can put a \$ value, as long as an ascertainable value can be found.

4. Received by, accrued to or in favour of:

1) RECEIVED BY;

Geldenhuis V CIR – the taxpayer was a usufructuary of a flock of sheep. With the consent of the bare dominium(actual owner) the sheep were sold and paid to the usufructuary. The commissioner included the proceeds in the gross income of the usufructuary.

The court held that the income was received by or on behalf of the bare dominium and NOT for the benefit of the usufructuary. The usufructuary is only entitled to the fruits of the asset, in this case the interest. Therefore the proceeds should have been included in the gross income of the bare dominium.

CIR v Genn & Co- if an agent received money on behalf of his principle and the proceeds were banked on behalf of such principle it cannot be included in agent's gross income but should rather be included in the gross income of the principle.

The proceeds were collected for the benefit of the principle.

Pyott Limited v CIR – the taxpayer sold biscuits in tin container. For every tin sold the taxpayer received a deposit. If the purchaser returned a tin the deposit will be paid back to the customer.

The deposits received were not paid to any trust account nor was any provision made for the amount should a customer wish to return a tin.

The deposits were paid into the business account and were used for business purposes. The commissioner included the deposits into the gross income of the taxpayer as the money was used for the benefit of the taxpayer.

ILLEGAL RECEIPTS:

COT V G

MP FINANCE GROUP V CSARS – The taxpayer operated an illegal pyramid scheme. The deposits received were not deposited in terms of statutory requirements nor were the deposit paid into any trust account but were used for the benefit of the taxpayer.

The taxpayer contended that the money had to be refunded back to the investors in this pyramid scheme and therefore cannot be included in his gross income.

Court held that illegal proceeds are intended to benefit the taxpayer and therefore included in his gross income.

2) **“ACCRUED TO”**

Delfos: (presumption against double tax). The amount can be taxed either on receiving it or on its accrual.

For a long time, the commissioner choose when to tax an amount, since in this case the amount does not have to be taxed on accrual but can be taxed on the receipt (accrual was disclosed).

Silverglen: there is no judgment on where accrual is not disclosed and where there is an agreement between the taxpayer and the commissioner to be taxed on receipt. The act does not give the taxpayer a choice therefore if the taxpayer doesn't disclose an amount; the commissioner will have access on the receipt or access on the accrual.

There is confusion as to the meaning of “ACCRUED TO”.

Lategan v CIR, the taxpayer was a wine cellar and sold wine in terms of a credit agreement. The p.p. was paid in £ - payable as follows:

- = a deposit of £1 000 in the next tax year (1925 – 1926)
- = another £1 000 in the next tax year (1925 – 1926) etc. until p.p. was paid off.

The court held: the taxpayer is entitled to an accrued amount and the amount, which is payable in future, its present discounted value, and not its full amount, be included in the gross income.

UNCONDITIONAL ENTITLEMENT:

MOOI:

The taxpayer was granted an option to subscribe to shares in the company which employed him. Subject to the following conditions:

“The taxpayer must still be in the employ of the company, at the time the mine at which he worked in came into operation.”

The taxpayer accepted to this condition and three years later when the mine came into operation he exercised his option to subscribe to shares. The option price paid was far below the market price of the shares.

The commissioner included the difference between the market value of the shares and what was actually paid into the taxpayer’s gross income as amount accrued to him.

The dispute was when did the accrual of shares take place? Was it accrued when the option was granted or when the conditions were fulfilled some three years later?

The court held for a benefit to accrue to the taxpayer they need to become entitled to the benefit unconditionally and therefore only entitle to the benefit once all the conditions have been fulfilled.

In ***Ochberg v CIR***, the taxpayer is UNCONDITIONALLY entitled to an amount.

Then there was CERTAINTY in *CIR v People’s Stores* – the court agreed with *Lategan* and *Ochberg*. They found that the words “accrued to” meant the amount that you were unconditionally entitled to which is not yet due and payable. If it is not on the full contract price, it must be discounted to its present value.

The Legislature responded to this by stating that the current value of the amount must be included in the gross income – taxed on the full contract price.

CIR V PEOPLES STORES – The taxpayer sold goods on cash and credit. Goods that was sold on credit was only payable in the following year of assessment. **NB NB NB NB** – because the taxpayer has a vested right in the income that is payable in the following year it has to be included in the current year of assessment.

3) **“OR IN FAVOUR OF”**

⇒ Must distinguish between:

- a) The amount received by the taxpayer in his capacity as representative of another.
- b) The amount received by him and is legally or morally obliged to transfer it to another once it has accrued.
- c) The right to accrual is transferred before the accrual.
- d) Exceptions to the general rule created by the Act.

Accrual in a representative capacity

E.g. trustee. If a taxpayer receives the money in his representative capacity, the amount cannot be calculated as the taxpayer's personal gross income.

Allocation of income once accrued

Once an amount has accrued to or been received by the taxpayer, the allocation will have no effect on his tax liability.

In *CIR v Witwatersrand Association of Racing Clubs* 1960 (3) SA 296 (A) – the taxpayer held a race for the purposes of donating the profits to charity. Before he held the race, it was decided to hand all the profits to charity.

The court held: the fact that the taxpayer had a moral duty to hand the profits to charity did not alter the fact that the money first accrued to him, before it was given to charity. It was thus TAXABLE IN HIS HANDS (1st accrued to the taxpayer).

Transfer of a right before accrual

The question is whether, in SA, one can legally transfer or cede something before it is entitled or accrued to him is subject to debate. It is accepted that one can transfer a contingent right but this leads to consequences in the income tax field.

Exceptions – “deemed income”

Section 7:

1. Income accrued in favour of, or for the benefit of a minor by donation, settlement, etc. S7(3) and 7(4)
2. Income of a taxpayer's spouse. S7(2)
3. Income received by a person as a result of donation, settlement, etc. by the taxpayer. S7 (5), (6), (7) and (8).

5. Non resident (source)

a) Meaning of “source”

There is no statutory definition, generally the “republic” means within the 9 provinces. In *Epstein* the courts acknowledge the problem with the definitions and laid down certain tests or guidelines:

Overseas Trust Corporation held that the source is not the place from whence income is forthcoming, but indeed its originating cause.

Lever Bros laid down the test to determine source:

1. The determination of the origination cause of the income (what work was done).
2. The localization of that originating cause in order to decide whether it is inside or outside South Africa.

Facts of ***Lever Brothers*** case: Company in SA lent money to a Company in London and interest was paid on this money in \$. The question was where could that interest be taxed? (I.e. where was the source of that income).

1. The court thus used the Overseas Trust Corporation test: the court asked what was the ORIGINATING CAUSE of the income? Lever Bros. The action granting of credit.
2. Where was the ORIGINATING CAUSE? The action was in SA. Therefore the SOURCE is in SA.

In *COT v R* = the originating cause of an annuity (a sum paid out from a trust) is where the trust is situated.
LOOK AT THE FACTS AND THE SURROUNDING CIRCUMSTANCES OF EACH CASE.

b) Mixed and Multiple sources

E.g. purchase and sale or manufacture and sale.

Different causes and factors may contribute to the earning of income:

The main source (or dominant/real or substantive source)

Act – provisions regarding specific enterprises which inherent nature applies extension beyond borders.

1. Relevant income is incidental to the main work.
2. Main source can be distinguished.
3. There is more than one income, but no dominant source.

1. Incidental income

E.g. exchange rate profit = income.

In *ITC*, the taxpayer was a businessman who purchased goods in Japan to sell here. In World War II, Japan was defeated and the value of the Yen dropped. The taxpayer received compensation from the Japanese Government as they had compounded his goods during the war. He made a profit due to the favourable exchange

rate. The CIR wanted to tax him in SA for the profit he made because the originating cause was his business located in SA. He argued that the real reason for his profit was the favourable exchange rate and not due to his business.

The court held: that the profit made from the exchange rate was incidental to his business in SA – its part of his business, thus taxed here.

In *COT v Shein*: the court found that when a taxpayer has to carry on work in another country, i.e. work outside SA, where incidental duties are involved it would be impractical to hold that a portion is derived from outside SA and most within SA.

Therefore where duties are incidental and derived in SA, the taxpayer is taxed in SA especially if the taxpayer is not paid separately for incidental duties.

2. Main source

CIR v Black: the taxpayer was a stock-broker in Johannesburg. He had a similar but separate business in London. The capital he made in London, he used to run the business on London.

The court held: the dominant originating cause of the income was the use of the taxpayer's capital and the income was thus derived from a source outside SA, thus not taxable here.

The test from *Lever Brothers* and *Overseas Trust Corp.* does not always provide an answer to all the situations, e.g. profits from a purchase and sale, the originating cause being the **purchase or the sale??**

In *CIR v Epstein* 1954 (3) SA 689 (A): the taxpayer was a partnership with a person in Argentina. The taxpayer would buy asbestos in SA and send it to Argentina to be sold there. The partner in Argentina would put half the profits in an account for the taxpayer in SA (after all expenses deducted). The taxpayer rendered no services in Argentina. The CIR argued that the taxpayer was liable for tax in SA. The Special Tax Court found in favour of the taxpayer and the CIR took the matter to the Appeal Court. Where there is more than one source, one must determine the dominant source. The asbestos was bought at a discounted price in SA and sold at a profit in Argentina. The profit was made because it was bought at a discounted price. The majority of the AD found that the profits were received from a source WITHIN SA. – LOOK AT ALL THE SURROUNDING FACTORS!!! – Purchase and sale.

In *TVL Associated Hide and Skin Merchants (Pty) Ltd v COT*: the taxpayer was a company registered in SA and it bought cured skins of animals in Botswana and sold them in SA. Thus the originating causes were the fact that the animals were needed plus the skins needed to be cured to sell them. The dominant cause here, according to the majority of the judges, was the PURCHASE AND CURING of hides in Botswana. – Manufacture and sale/procedure and sale.

In *Millin v CIR*: Mrs Millin wrote books in SA but gave the right to print and publish her books in England. She would receive royalties for every book sold. The question was what was the source of those royalties?

There was a number of originating factors:

- i) the writing of the books
- ii) the fact that they were published
- iii) the fact that they were sold

The court held that the dominant cause was SA! – Manufacture and sale

3. Real multiple sources

Where there is not one single main source, the income of each source is dealt with separately.

4. Deemed sources

Section 9 – look at where the originating cause is?

Examples:

1. Dividends;
2. Royalties;
3. Capital gains on movable and immovable property;
4. Interest;
5. Exchange differences.

5. **Not of a capital nature** – RENT IS ALWAYS REVENUE (pay – deduct, Receive – declare)

VISSER – Capital is the “tree” and Income is produced from the capital (“fruits”)

If a receipt is of a capital nature it is NOT taxable.

There is no definition in the Act for “not of a capital nature”.

It is difficult to determine whether something is of a capital nature or not.

Gross income concerns inflows (consider all receipts and accruals to determine if it is included or excluded). Once the taxpayer’s gross income has been established, the deduction process begins: -

1. Exempt income is deducted (determine income) – all allowable deductions (out flows).

Difference between income of a capital nature and expenditure of a capital nature –

Receipts and accruals of a capital nature are excluded from the gross income and therefore not included in the calculation of income and taxable income.

Difference between “capital” and “capital nature” –

business/accounting nature FIXED CAPITAL – purchased by a business to be used continuously. FLOATING CAPITAL – purchased

to sell at a profit. Profit generated from selling a fixed asset = fixed capital. The difference of money generated from the sale of trading stock and expenses incurred = FLOATING capital.

Income taxation: CAPITAL PROFIT – not necessary income of a capital nature (e.g. motor bike) – look at the circumstances regarding the sale, taxpayer's intention – the fact that the company's books could show a sale as capital is irrelevant.

FLOATING PROFIT – this is necessarily of a revenue nature (difference between income and expenditure).

A taxable income is the difference between income (G.I.) and permissible deductions and allowances. IT IS NOT G.I. IF IT IS OF A CAPITAL NATURE (expense may not necessarily be an allowable deduction).

Guidelines and tests developed by the courts (to determine if it's of a capital nature or not)

1. A receipt or accrual is of either a capital or of a revenue nature:

In *Crowe* the court held that something can be either of a capital or revenue nature but there is nothing in between. A specific indivisible amount cannot be of a capital and revenue nature simultaneously.

In *Tuck v CIR*, the court found that the amount the taxpayer received was partly of a capital nature and partly of a revenue nature, thus a divisible amount. The facts were when the taxpayer retired; his company gave him an amount for the services rendered (revenue) and amount for compensation for restraint of trade (capital).

Since the payment was in respect of both and one factor is not more important than the other, the court APPORTIONED the amount (taxed 50% services rendered and tax free for the restraint).

2. Fortuitous receipts or accruals:

A fortuitous gain is such as an inheritance or prize of a capital nature. Winning money by chance (not having to work for it) = of a CAPITAL NATURE. You are not taxed for it unless your profession is e.g. a professional gambler. *Strathmore Exploration & Management Ltd.*

3. Profit made in the operation or a business in carrying out a scheme for profit-making:

Test: *Overseas Trust, Lace Proprietary Mines, Strathmore:*

To establish if the receipt or accrual was acquired in the operation of a business in the carrying out of a scheme of profit-making – if a taxpayer purposefully works towards making a profit then the profit he made will be of the income or revenue nature and he WILL be taxed. The fact that it is acquired through unlawful or unenforceable transaction is irrelevant.

e.g. 2 taxpayer's sell the same asset, books, one as a bookseller (revenue) and the other as a law student selling old books (capital). One needs to look at the person's job, their intention and the underlying circumstances.

Factors to consider

1. The taxpayer's intention – GOLDEN RULE!!!!
The basic test: to determine the nature of the proceeds on the sale, the taxpayer's intention at the time of acquisition and realization of the asset (realize at buying and making a profit)
Natural taxpayer.

Factors regarding the taxpayer's intention:

- Burden of proof
- Taxpayer's evidence
- External/surrounding circumstances

Burden of proof

Onus of proving that the amount is not taxable is on the taxpayer to prove so on a balance of probabilities.

Taxpayer's evidence

This is his intention. In some cases the taxpayer's state of mind and his own evidence is of utmost importance and conclusive. HOWEVER evidence usually advances his own case so the court will rely heavily on surrounding circumstances. That is, own evidence now needs to be weighed up together with all other evidence.

External / surrounding circumstances

- a) **The way the asset was acquired or sold:**
If he inherited the asset and then sold it, the indication will be it is of a capital nature. In CIR v Strathmore Exploration: the taxpayer was a company. A mother owned certain property and in her will she left it to the company instead of to her son. Thus the company inherited the asset. The company then sold the land and the CIR wanted to tax them saying that it was not a capital receipt of the profit but a revenue receipt despite the fact it was inherited as the company's business was involved in properties (this was in the normal; course of business, thus being revenue).
If a taxpayer accepts a chance offer to sell an asset, the proceeds will be of a capital nature.
If, however, the taxpayer actively markets the asset, especially if they sell it quickly, this will be an indication that the profits will be of a revenue nature. E.g. in Strathmore Exploration, the company sold the land as

part of its ordinary stock in trade. It didn't sell the land as a whole; they sold it in parts (subdivided) whenever it was profitable to sell.

- b) **The period for which the asset has been held:**
The asset the asset has been held, the more of an indication, when the asset is sold, that is a receipt of a capital nature. If the asset is sold, as quickly as possible or at the first possible opportunity, the indication is that the proceeds will be of a revenue or income nature.
- c) **Frequency of the transactions:**
The courts distinguish between natural persons and juristic persons.
Juristic persons: a single transaction can result in the proceeds being taxed if that co. is involved in the business of selling that particular asset. E.g. in the *Strathmore case*, the objects clause was to sell land, one sale will involve tax. *Stott* – to carry on business is said that there must be proof of continuity. *Natal Estates* – a surveyor, who does not trade in property, overtime buys and sells land is not said to be trading in property. Not revenue.
Levy – multiplicity of transactions can be a factor showing that a natural person is trading as a business.
Edwards – the true test is the nature of the particular transaction (if it constitutes trade).
Stephan – to salvage cargo from a single wreck is revenue, despite being once off, the intention was to make a profit.
Natural persons: the more frequently a person enters into a type of transaction the more of an indication that it is of a revenue nature. E.g. a lawyer buys a house at a bad time and when the market improves, he sells it for a profit. The first time he won't be taxed but if he continues this frequently, the CIR will tax him due to the frequency. Even if he has different occupation, i.e. a lawyer selling houses, he will be taxed on it as it looks like a profit-making scheme.
- d) **The way in which the transaction is financed:**
If the taxpayer used surplus funds he had himself, his own money, to buy property and then sells it, it will be considered to be of a capital nature (investment).
If however, the money is borrowed from the bank it would indicate the taxpayer intends to speculate (profit-making scheme). Thus the proceeds will be of a revenue nature. (*ITC*)
- e) **Nature of the taxpayer's work or occupation:**
If the taxpayer is an estate agent and he sells a house, the indication is that the proceeds of the sale are of a revenue nature.

E.g. the taxpayer, who is an estate agent, sells his house. He has lived there for 25 years but has to move for certain reasons. He happens to make a profit from the sale and the CIR wants to tax him on the profits made. The court will have to weigh up all the factors, like the fact that he has lived in the house for a long period of time, he had to sell, the house was his home for those 25 years etc. Thus the proceeds could be of a capital nature.

THE INTENTION OF THE TAXPAYER

a) Intention upon requiring the asset:

Often been held that the taxpayer's intention upon acquiring the asset is decisive. But, although his intention is important, it can only be decisive if no other factor intervenes which indicates that the profit made was part of a profit-making scheme. (*CIR v Stott*).

1. Look at the taxpayer's intention at the time of acquiring the asset and
2. The taxpayer's subsequent actions

b) Changes in intention: "crossing the Rubicon"

The reason why you can't only look at the taxpayer's intention is because he may have changed his intention. The mere fact that the asset has been sold at the best possible price does not mean that there was a change in intention (e.g. a lawyer who sells his car that he had for 10 years at a profit. He is allowed to sell it at the best possible price. It doesn't mean that he will be taxed).

The mere fact that a taxpayer has adjusted his asset to meet market demands doesn't mean that he changed his intention (*Stott's case*).

In *Natal Estates Ltd*: the taxpayer grew sugar cane, which he sold. The land was therefore an ONCOME PRODUCING ASSET. When the area was being rezoned as a residential area, the taxpayer started subdividing the land and actively marketed the sale of the property. They entered into sectional title schemes and made good profits. – There is a difference between buying and selling at the best possible price and a change of intention – "crossed the proverbial Rubicon".

c) Mixed intentions:

The following two instances must be distinguished:

- i. Those where the taxpayer has a main or dominant purpose. (*Levy*)
- ii. Those where the taxpayer has a double purpose. (*Durban North Traders*)

The main or dominant purpose: In *COT v Levy*: a taxpayer bought shares mainly as an investment. However he had considered that if the share value went up, he would sell them at a profit. Thus he had mixed intentions. He would sell the shares when he saw he could make a profit otherwise he wouldn't sell. The CIR wanted to tax him on the sale of those shares. The court held that although he had two intentions (revenue and capital) his MAIN OR DOMINANT intention was to buy the shares as an investment. The court said that the

Legislature could not have intended that the taxpayer must not have any intention to make a profit.

Double purpose: In *Durban North Traders v CIR*: the taxpayer owned property and had the intention, in buying it, of letting out the property (if profitable) or selling it (if profitable). Therefore the taxpayer clearly had a double intention – either to use the property as a capital asset (income producing asset) or use it as a revenue asset. Held: the intention was of a revenue nature,

d) The intention in the case of a juristic person:

1. Formulating the juristic person's objectives – not much weight can be attached to the name of the company. The realities of objectives weigh more heavily than formal objectives.
2. Also consider all the factors and surrounding circumstances. The court will consider not only what the juristic person was authorized to do or not but also at what it did.
3. Juristic persons think and act through the medium of living beings (directors).
Richmond – the intention of the company can't be interpreted literally – it is the intention of the directors of the company.
4. Another factor to consider is the intention of the founders, especially if they were the first directors (*SBI*).
5. The intention of a juristic person can also be determined from its formal acts (e.g. records of minute books).

1. **Specific inclusions**

Par (a) – Annuity

An annual payment (life long/period), of a fixed amount, in installments or otherwise. (*Watermeyer* – a gift is not an annuity). Look at the facts of each case. Origin of annuity is irrelevant (donation, will, insurance, etc.) difference between an annuity and a repayment of a debt on installments is that the latter is not an annuity therefore is capital and therefore not included.

The ways in which an annuity is acquired:

1. Bought from an insurance company;
2. Granted by way of gift or legacy;
3. Received as consideration for sale of business or asset for the surrender of such a right.

Par (c) – Remuneration for services rendered

Any amount received or accrued, including voluntary awards for services rendered, received for employment, certain position, the unspent portion of entertainment allowance, services not rendered in terms of a contract, not paid obligatory purely voluntary award. Including remuneration for services rendered being paid to another person (deemed to be accrued to the person who rendered the service).

Par (cA) – Restraint of trade

S1 – amendment! Any amount received or accrued to a natural person, labour broker, personal service trust or company as compensation for R.O.T. The principles in *Tuck* and before 1962 are not included.

A deduction will be allowed in terms of section 11(cA).

Par (d) – Amounts received on termination / variation of an office of employment / in respect of an appointment to an office or position

A lump-sum from a fund (pension, retirement, etc.) is not included. If it is paid out as a result of a death it is deemed to be paid out before the death and therefore taxable.

Severance benefits:

Will be included in gross income if:

1. Received a lump sum payment;
2. Person attained the age of 55 and benefits were due;
3. Benefits were due as a result of being incapable of working;;
4. Termination of services by way of retrenchment;
5. Employer ceased on carrying on trade.

Par (e) and (eA) – Lump-sum payments from pension, provident, retirement annuity funds

A certain portion, calculated in terms of the Act, is taxed against more favourable average rate not a marginal rate.

A 2/3 portion is included in Gross Income.

Par (f) – Commutation of amount due under a contract or service

Where you have a contract of 5 years which is cancelled after 3, you can receive compensation.

Lump sum payments received:

1. Received by an employee on breach of contract, based on the unexpired portion of the service agreement;
2. From an employer on termination of services in lieu of notice required to be given in terms of service agreement.
3. By an employee on retirement with respect to accumulated leave,

Par (g) – Premiums or like consideration for the use of ownership
LEASE PREMIUMS

Having an ascertainable money value in addition to or instead of rent/royalty payable (right of use).

Rent of buildings, land, plant or machinery etc.

Remember! Rent is always income in nature = “fruits”

Par (h) – Improvements effected to a property in terms of the provisions of a leasing agreement
LEASEHOLD IMPROVEMENTS

Included in the lessor’s gross income. The full amount is included in the year the improvements are made.



Remember! Income and Improvements are included in Gross Income of the Lessor in the full year of assessment.

And the lessee is allowed a deduction over the period of the lease.

Par (i) – Fringe benefits

Cash equivalent or advantage from an employer.

Medical aids, car allowances, cheap accommodation, meals etc

Par (k) – Dividends

Included foreign dividends.

Par (m) – Proceeds from policies, which the employer owns

Key man policies- these are policies which an employer will receive from the death of an employee or director to enable him to buy out his share in the business.

Par (n) – Recoupment

Recovery of a debt

CASES:

Whether accrual is of an income or capital nature:

CIR v Strathmore Exploration and Management Ltd 1956 (J) SA 591 (A):

- Property was left in a will to a company.
- The objects clause of that company empowered it to buy and sell land.
- The land inherited by the company was sold at a profit and the CIR wanted to tax the company on this amount on the basis that the amount received was of a revenue nature.
- The taxpayer relied on the fact that it had acquired the property by way of an inheritance, which indicated that it was a fortuitous gain and not part of a scheme for profit-making.

The court held:

Having regard to the fact that:

1. It was probably left to the company in the first place because it was in a position to deal with the land in the most profitable way.
2. Its objects clause allowed it to participate in land jobbing.
 - The way in which the land was sold and the time span in which it was sold indicated that the receipt was of a revenue nature and was taxable.
 - The fact that the property had been inherited was not by itself sufficient to justify a decision that the proceeds were of a capital nature.

Note: Where the taxpayer is a company, one transaction can attract tax.

John Bell & CO. (Pty) Ltd v SIR 1976 (4) SA 415 (A):

- The taxpayer was a company selling fruit.
- They had a building from where they sold the fruit.
- They then needed to sell the property as they ended the business.
 - ⇒ They didn't sell the property immediately; they waited a few years until they were able to sell it at a profit.
 - ⇒ The company had bought shares in other companies involved in the sale of the property.
 - ⇒ The CIR contended that although the premises on which they had sold the fruit had initially been a capital income producing asset, the taxpayer had CHANGED HIS INTENTIONS and had treated the premises like a stock in trade.
 - ⇒ The CIR argued that they had sold the property at its best possible price and were not truly realizing an asset.
 - ⇒ Looking at the totality of facts, the taxpayer had crossed the Rubicon (*Natal Estates case*)
 - ⇒ The court held: in favour of the taxpayer.
 - ⇒ The CIR said, on the facts that the objects clause of the company allowed the taxpayer to trade in property. The court held that it was of a capital nature as there were not sufficient facts to show there had been a change in intention and that the taxpayer is entitled to sell his asset at the best possible price.

STUDY UNIT 4

EXEMPT INCOME

Exempt income is gross income which is not subject to normal tax and therefore not included in the taxpayers gross income.

The reason that the legislator exempts this income from tax is to encourage courtesy between states and for encouraging investment in state securities.

Two Categories of Exempt Income in terms of section 10 of the act.

Partial Exemptions

Exemptions that apply to particular receipts or accruals because of the nature of the income.

Examples : salaries payable to diplomats and former presidents.

Absolute exemptions

Exemptions that are granted to a specific entity because of the nature of the entity.

Examples : government; political parties and recreational clubs.

SPECIAL KINDS OF INCOME

Certain kinds of trade are taxed in a special way because of the nature of the trade.

Examples;

1. Farming;
2. Mining;
3. Long term insurance;
4. Operator of toll roads.

STUDY UNIT 5

ALLOWABLE DEDUCTIONS

GROSS INCOME
Minus EXEMPT INCOME
Is equal to
INCOME
Minus ALLOWABLE DEDUCTIONS
Is equal to
TAXABLE INCOME

GENERAL DEDUCTION FORMULA

S11 (a) and (b) provide what may be deducted and S23 (f) and (g) provide what may not be deducted. Thus the provisions are sometimes respectively referred to as the positive (s11) and the negative (s23) sides of the general deduction formula.

The positive side of the formula provide that from income derived from the carrying on of a trade, may be deducted.

- any expenditure of loss
- which has actually been incurred or suffered inside or outside the Republic (during the year of assessment)
- in the production of such income (i.e. income derived from carrying on a trade)
- Which is not of a capital nature.

The negative side of the formula that provides that a deduction is not allowed if:

- the expenditure incurred relates to an amount received or accrued which is not income as defined (e.g. expenditure incurred in relation to exempted income)
- The deduction is claimed from income derived from carrying on a trade to the extent to which monies were not laid out or expended for the purposes of trade.

General deduction formula:

- ✓ any expenditure or loss
- ✓ which has actually been incurred or suffered
- ✓ inside or outside the Republic
- ✓ in the production of income from the carrying on of any trade
- ✓ to the extent that the monies claimed as a deduction were laid out for the purposes of the taxpayer's trade
- ✓ Which is not of a capital nature?

1. Any expenditure or loss:

Expenditure is voluntary and loss is involuntary. Both of these have the same consequences; therefore there is no real need to differentiate. An expense need not be in cash, it can be one in kind. The expense in kind must have a monetary value e.g. free board or lodging. It could be the cost price of the asset or its market. If the taxpayer manufactured the asset, he cannot charge for labour only its cost price.

2. Actually incurred or suffered (during the year of assessment):

Expenditure need not actually have been paid out to qualify as a deduction. As long as an absolute and unconditional deduction has been incurred in respect of the expenditure, it qualifies and an allowable deduction. It must be an unconditional obligation to pay this expense. Can deduct the amount even if haven't paid the expense yet as long as you have an unconditional obligation to pay it. If the obligation is conditional, contingent upon something happening, it's not incurred yet.

In *Edgars Stores v CIR*: the taxpayer leased property on which the store existed. In terms of the lease agreement, Edgars had to pay the landlord either a basic rental for the year or one twelfth of its turnover, whichever amount was greater. Edgars would only know what one twelfth of its profits would be at the end of its financial year, which is after the end of the tax year. The taxpayer wanted to deduct from its income one twelfth of its net profits (turnover) and the CIR argued that this rental had not actually been incurred yet because it was contingent upon the basic rental being less than one twelfth of its turnover.

According to s11, one can only deduct an amount, which has actually been incurred, which has been interpreted to mean that you must have an unconditional obligation to pay during the year you want to deduct it. If the condition becomes fulfilled within the year of assessment, you can deduct it in that year. If it only becomes fulfilled in the subsequent year of assessment can only be deducted then. The court held: the taxpayer could deduct the basic rental but could not deduct one twelfth of the turnover rental.

In *Sub-Nigel v CIR*: can only deduct those expenses incurred in that particular year of assessment.

The expense might relate to income earned in a previous or later year of assessment but it can only be deducted in the particular year in which it was incurred.

Full expenditure must be deducted in the year in which it is incurred. E.g. a business enters into a 10 year lease agreement with Y. The full 10 years has to be paid in advance (rent), then to deduct that expense in that year (can't spread it over 10 years) in which you paid it.

However, s23 (h) states that such expenditure is no longer deductible in full in the tax year in which it was actually incurred, but must be spread so as to coincide with the time of supply of the goods or the enjoyment of the benefits. This should be done in a manner, which appears fair and reasonable.

Section 23 H does not apply:

1. In acquisition of trading stock;
2. Unconditional liability to pay in terms of legislation;
3. Expenditure in terms of sections 24 I – L;
4. Any expenditure limited by this section does not exceed R 50 000'

Golden Dumps:

Respondent had been to deliver certain shares to Nash against payment of a certain sum. In its return for the tax year 1985, it claimed as a deduction of cost incurred in purchasing the sum of share for Nash, less the amount paid. The appellant contended that the rights and obligations of the parties had existed at the time of the institution of the action and that the obligation of the respondent to deliver the shares had been “actually incurred” i.t.o. s11 (a) during the 1981 year of assessment. In the case of a liability, which was contingent, the expenditure was incurred only if the condition on which it depended was fulfilled during that year.

Held: that the expenditure had only been “actually incurred” during the 1985 tax year and the appeal was dismissed.

3. Inside or outside the Republic

Can incur an expense whether the expense incurred in or outside the Republic, it can be deducted in SA.

But the expense must be in respect of a trade carried on in the Republic.

Section 11(a).

4. In the production of income derived from the carrying on any trade:

An expenditure or loss must have been incurred in the production of income and in the process of carrying on a trade deals with 2 interrelated issues: “trade” and “income”, s23(f) – provides that expenditure may not be deducted if it’s not incurred in the production of income as defined in the Act. Expenditure must relate to income.

In *PE Electric Tramway Company Ltd v CIR*: the test has to be applied involves determining whether the expenditure is so **closely connected** to the trade that it can be said that it is part of the cost of running the business.

In *Joffe & Co*: the court decided that the expense must be a **necessary concomitant** of the business activities.

In *Sub-Nigel v CIR*: the fact that no income was earned, does not mean that the expenditure was not incurred in the production of income, if

the expenditure was incurred with the purpose of producing income, it can be deducted even if no actual income was earned.

5. To the extent that the monies claimed as a deduction were laid out for the purposes of the taxpayer's trade:

In *Solaqlass*: the court applied the all or nothing rule. This was amended in 1992 – if you could prove what was spent for trade, it could be deducted.

S23 (g) states that the deduction must be for the purposes of the taxpayer's trade. Prior to an amendment, s23 (g) use to say that one can't deduct an expense "unless the expense was wholly and exclusively for the purposes of trade."

This meant, for example, that if the farmer went overseas to buy a prize bull and he took his wife along and had a little holiday too, he would not be able to deduct any expenses incurred on this trip as it wasn't "wholly and exclusively" for the purposes of trade. TODAY, since the amendment in 1992, s23 (g) no longer has the words "wholly and exclusively" for the purposes of trade.

Therefore in the example above, if an expense is partly for trade and partly not, the expense can be apportioned and part can be deducted and part not.

In *L v COT*: L was an attorney who read a lot and got a cataract on her eyes. She thus wanted to have an operation to rectify the problem. She claimed the operation was an expense in the production of her trade (read a lot). She wanted to deduct the operation as an expense for the purposes of her trade (in the production of income). The court did not allow her to deduct the operation amount, as it was not sufficiently related to her trade or production of income.

In *Commissioner of Inland Revenue v Sunnyside Centre*:

The CIR said:

5. The expense had not been incurred in the production of income from the taxpayer's trade (s11 (a)).
6. The expenses had not been incurred wholly and exclusively for the purposes of trade.

6. Not of a capital nature:

An expense can't be deducted if it is an expense of a capital nature. If an expense is of an income nature then it can be deducted (because you are taxed on income). I.e. if you spend money you may deduct the original amount spent.

In *New State Areas Ltd v CIR*: a mining company needed sewerage pipes in order to allow the miners to live on site. They claimed the pipes on the property were of a capital nature (the pipes on the property for as long as possible). **The court held:** to decide whether an amount is deductible or not will depend on each case. If the expense was incurred to acquire a capital asset then the expense is of a capital nature (not deductible).

In *CIR v George Forest Timber Co Ltd*: if an expense was incurred to acquire an income producing asset (e.g. machines) then it will be of a capital nature (not deductible). This expense is incurred as a once-off expense and is not a recurring expense. The expenses used for the operating of the machinery will be of revenue in nature.

In *Herron Investments (Pty) Ltd v SIR*: (the enduring benefit test). The taxpayer rented out property to Pine Forbes (insurance brokers) and the lessee (Pine Forbes) wanted to move out of the premises because they were not modern enough. The taxpayer made alterations to the building and tried to claim the cost, i.e. deduct the costs of the deductions. The court accepted that the expenses were incurred for the purposes of trade and that the expense of the upgrade was in the production of income. The court held: the expenses were of a capital nature and could therefore not be deducted, because it was an advantage of an enduring benefit

PROHIBITED DEDUCTIONS ~ Section 23

S23 (a) – Household and private expenditures

These are items, which relate to his household and private life as opposed to his life as a trader. This includes remuneration of a domestic servant, transport between the taxpayer's home and work, school or university fees, foodstuff, etc.

HICKSON

S23 (c) – Losses or expenses recoverable in terms of an insurance contract, guarantee, security or indemnity

A loss or expense, which would otherwise be an allowable deduction, is not deductible if it is recoverable in terms of an insurance contract, guarantee, security or indemnity. Each case must be established in accordance with the facts and surrounding circumstances.

OOSTHUIZEN

S23 (d) – Tax payable

Any tax, duty, levy, penalty or interest imposed in terms of a provision of an Act.

S23 (e) – Income transferred to reserve funds

This section expressly prohibits the deduction of income carried to a reserve fund or capitalized in anyway, unless the Act makes express provision for this. This provision thus prohibits the transfer of funds to a reserve fund in order to make provision for expected future expenditure.

S23 (f) – Expenditure used to produce exempt income

If income is not included to be taxed why should the expenses used in producing such income be deducted?

S23 (h) – Interest on capital, which the taxpayer has himself employed in his trade

Should the taxpayer invest his own funds in his business, he cannot deduct the interest that he might have earned.

S23 (l) – Payment in restraint of trade

An expense incurred in respect of the payment of any restraint in trade is prohibited, unless **the provisions of S11 (cA) apply**.

Excessive expenditure

The court looks at the following circumstances to determine whether expenditure is excessive or not:

- 1. Value and nature of services rendered;**
- 2. Nature of the business;**
- 3. Relationship between employer and employee;**
- 4. Amount of remuneration in relation to the net profit earned by the employer;**
- 5. Presence of motive.**

SPECIFIC DEDUCTIONS AND ALLOWANCES ~ Section 11 NB!!!!

S11 (c) – Legal costs

Legal costs may be deducted which are incurred in connection with an action for payment of an amount, which would constitute income.

Legal costs incurred in acquiring a capital asset is not deductible.

Smith V SIR

The tax payer was an accountant. He held a position of secretary and director at his firm and was earning income which was taxable.

The firm went insolvent and the reason for the insolvency was due to the fraud that the taxpayer was involved in. He faced criminal charges and wanted to claim the legal costs of the suit.

The court held that the charges were brought against the business that he owned which was capital in nature and therefore NOT a deductible expense.

Advertising

If advertising is linked to the business then SARS will allow a deduction.

However if a donation was made for moral reasons without any business purpose NO deduction will be allowed – PICK n PAY

Damages & Compensation

There must be a connection between the trade carried on and the damages incurred.

Negligence must have constituted an “inevitable concomitant” trade.

Joffe – Death of an employee was caused by the negligence of the business. There cannot be a link that death is inevitable when carrying on trade. Therefore the compensation paid cannot be deducted.

Cantonment of Trade

S11 (cA) – Compensation for restraint of trade

Any amount actually incurred as compensation for any restraint of trade imposed on any natural person, labour broker, personal service company or personal service trust will be allowed as a deduction to the extent that such an amount constitutes income of the person to whom it was paid. The amount that will be allowed as a deduction in a particular year is the lesser of one third of the amount incurred or the value of the amount divided by the number of years during which the restraint of trade applies.

S11 (d) – Repairs

Repairs to property used for the purposes of the taxpayer's trade may be deducted in the tax year in which it actually incurred.

Any costs pertaining to the improvements of a capital asset will not be deductible.

Repair of property occupied for purposes of trade or where income is receivable.

Purpose of repairing machinery, implements, utensils and other articles used by the taxpayer for the purpose of his trade or for beetle treatment were rent is receivable.

Expenses incurred by a mine for the rehabilitation of mining soil, water, sea or air are regarded as repairs.

African Products Manufacturing:

A repair is the restoration by renewal or replacement of a subsidiary part of the whole.

Materials used do not need to be the same as the original.

NOT IMPROVEMENT! Repair is a renewal.

For an asset to be repaired there must be damage or deterioration.

INTENTION: TO RESTORE TO ITS ORIGINAL CONDITION

S11 (e) – Depreciation and wear and tear

An allowance with regard to the depreciation and wear and tear of commodities, machines, accessories, implements and articles used in the course of the taxpayer's trade, is deductible. The diminution of the value of the asset, it is the practice of the commissioner to allow a cost which is fair and reasonable.

The value of any machinery, plants or utensils and articles that diminished by reason of wear and tear.

No allowance for depreciation of buildings or structures of permanent nature.

S11 (o) – Scrapping allowance (alienation, loss or destruction allowance)

I.r.o. certain machinery, implements, utensils, articles and buildings used for trade purposes when any of these items are withdrawn because they have served their purpose and are useless or worn out.

The original cost above is calculated as:

The actual value plus increases in value (if applicable) minus depreciations (if applicable).

Done at the election of the taxpayer.

S11 (h) – Improvements to leased property

The actual expenses of improvements made in terms of a leasing agreement by the lessee can be deducted from the lessee's gross income. The amount can only be deducted in the year in which it was actually incurred.

S11 (bA) – Pre-production interest

If interest, including related finance charges, is actually incurred on any loan, used by the taxpayer for the acquisition, installation etc of any:

- ❖ Machinery, plant, building, improvements to a building
- ❖ Pipeline, transmission line or railway line
- ❖ Aircraft hanger, apron, runway or taxiway

To be used by him for the purposes of his trade **AND** the interest is incurred prior to the financed asset being bought into use for purposes of trade.

Section 11(bA) allows the deduction of interest and related finance charges (*including* raising fees and guarantee or surety fees *but excluding* finance charges under a suspensive sale).

S11 (i) – Bad debts

The taxpayer may deduct bad debts if they are owing to him and have been calculated into his income during the year of assessment.

S11 (j) – Doubtful debts

The commissioner in respect of doubtful debts may grant an allowance. The amount allowed in a specific year of assessment, is however added to the taxpayer's income in the following year and a new allowance may be granted.

Other specific deductions

Section 18 provides that a taxpayer who is a natural person may, in certain circumstances provided in this section, deduct all or part of his medical and dental expenses incurred during the year of assessment.

ASSESSED LOSSES

An assessed loss means any amount by which the deductions in terms of section 11 of the Act exceed the income from which they may be deducted.

Assessed losses can only be deducted from that source of income and in that year of assessment in which the loss was suffered.

Assessed losses in previous years of assessment, which were not deducted from the taxpayer's income in that year of assessment, may only be deducted from that source of income which suffers the loss provided, that the source of income was operational in the current year of assessment.

E.g. if Mr X earns a salary as a teacher but also operates a separate business trading as an art dealer, that business's losses cannot be deducted against the income from his trade as a teacher but only from the income he receives from his business as an art dealer.

- In the case of a taxpayer other than a company, assessed losses can also be brought into account against income obtained by means other than the carrying on of a trade. Thus, the assessed loss suffered in the taxpayer's trade, is taken into account against all his income regardless of how it has been earned, and only the balance, if any, is carried forward to the following tax year. Furthermore a taxpayer may also carry forward an assessed loss to a year in which he or she has earned no income or in which he has not carried a trade.
- In the case of a company, an assessed loss can only be taken into account against income obtained from the carrying on of a trade. If a company has not carried on a trade in a specific year, an assessed loss carried forward from the previous year may not be carried forward to the year following the year in which no trade has been conducted. The assessed loss falls away and can never again be allowed as a deduction.

Q: what is an assessed loss?

Natural person: 01/02 - 500 000 + 200 000 (interest) = -300 000

Tax = R0

02/03 ~ no trade ~ +200 000 (interest) = -100 000

Declare = R0

03/04 + 500 000 = R400 000

Company: can deduct unless he stops trading

The function of Section 20(1) – NEW!!!

A person who carries on more than one trade during a year is entitled under s20(1)(b) to set off an assessed loss during that year in one or more trades against the income derived from another trade or other trades during the same year. This is, however, subject to s20A. Incurring assessed losses in more than one trade during a tax year may therefore accumulate these losses for purposes of set-off.

Look at the facts and circumstances of each situation. The test introduced in s20A as a means to uncover these artificially labeled trades. Subsection (1) sets forth the general rule, which seeks to ring-fence, assessed losses from suspect trades to prevent these losses from being deducted against any other income that a taxpayer generates. The rules under this section do not prevent natural persons from using losses from a suspect trade against other income from that trade.

STUDY UNIT 7

THE TAXPAYER

Persons other than companies

Natural persons (individuals)
Deceased estates
Insolvent estates
Special trusts
Trusts
(other than special trusts)
Companies
Public companies
Private companies
Close corporations

Note that a partnership is not a juristic person, and also not a taxable entity for purposes of the Act.

Representative taxpayers

This is needed for minors, disabled persons, etc.

Tax rates

Natural persons = progressive sliding scale
Trusts (other than special trusts) = 40%
Companies = uniform rate of 28 %

Rebates:

Section 6 prescribes the annual rebate for natural persons:

- ⇒ Currently **R 11 440**
- ⇒ Over 65 get additional **R 6 390**
- ⇒ Over 75 get additional **R 2 310**

PAYE, SITE and Provisional Tax – TAX MECHANISMS

1. Pay-as-you-earn: the employer from the employee's weekly or monthly salary deducts tax.
2. Standard income tax on employees: this is the case of an employee whose taxable income does not exceed **R60 000** per year.
3. Provisional tax: provisional taxpayers fall into two categories, namely certain individuals and corporate taxpayers. Certain individuals (e.g. individuals with taxable incomes of less than R1 000 per annum) and companies (e.g. gold-mining companies) are exempted from the obligation to submit provisional tax returns. The following individuals are provisional taxpayers:
 - A person who derives income that does not constitute "remuneration"
 - A company

- A person who notifies the commissioner that he is a provisional tax payer

Provisional tax requires **TWO** obligatory estimates:

1. Last day of the 6th month of the year of assessment;
2. Last day of the year of assessment.

Returns and assessments

In a tax return, the taxpayer must indicate which amounts are in his opinion gross income, which amounts are exempt income, the deductions which he is entitled to, as well as other information which may impact on tax liability or payment, or which is required for tax administrative purposes. It's the taxpayer's duty to ensure the return is submitted timeously and that information contained in it is accurate.

SPECIAL RULES RELATING TO THE TAXATION OF CERTAIN CATEGORIES OF NATURAL PERSONS

MARRIED PERSONS

Each spouse in a marriage is taxed separately, unless a deemed inclusion is applicable in terms of section 7. The word spouse also includes:

1. Marriages recognized in terms of custom or religion;
2. Live-together unions of a permanent nature deemed to be out of community;

DEEMED INCLUSION – SECTION 7(2) – TAX AVOIDANCE !

This is an anti-avoidance provision aimed at preventing married couples from reducing their tax liability by arranging their income to be split between spouses to avoid tax liability.

If a spouse receives income (recipient) in consequence of a donation made by the donor spouse, the donor spouse will be taxed.

The reasonable income test is to be used to determine whether or not spouses are trying to avoid tax liability by splitting their income.

MARRIAGE IN COMMUNITY OF PROPERTY – SECTION 7(2A) & (2C)

TRADE INCOME

- Deemed to have accrued to spouse who carries on trade,
- If trade carried on jointly look at the partnership agreement;
- In absence of partnership agreement you look at the spouses participation and involvement in the trade.

RENTAL AND NON TRADE INCOME AS WELL AS CAPITAL GAINS TAX.

- Deemed to have been received in equal shares.

MINORS - TAX AVOIDANCE!

Q: how is a minor taxed? ~ A minor is taxed as a natural person in his own right. A minor's guardian merely acts as the representative taxpayer for administrative purposes

EXCEPTIONS :

Section 7(3) : if a parent donates money which result in income. Such income will be taxed in the hand of the donor parent.

Section 7(4): relates to cross donation to a third party. The income thereof will be taxed in the hand of the third party's parent.

Eg : A donates income to the minor child of B. B then donates the income to the major child of A. Income is taxed on the hands of B.

PARTNERSHIPS

A partnership is a legal relationship between two or more persons who carry on lawful business or undertaking and which each partner contributes money, labour expertise etc with the object of making a profit.

A partnership is not a separate juristic person and can't be taxed as such. Section 66 provides that the partners of a partnership have to submit joint and individual returns. S77 (7) clearly states that partners, however, are assessed separately.

S24H is very NB re partnership taxation ~ this section provides that as soon as income accrues to the partnership or it is received, it immediately accrues to the partners in the ratio within which they share in profit or loss. The deduction is determined in accordance to which profit and loss is shared

TRUSTS

A trust is specifically included in the definition of person. It is therefore acknowledged to be a taxable entry in its own right. The income tax implications pertaining to trusts are quite complex. In the case of an inter vivos trust, there must be three possible categories of taxpayers: the creator, the beneficiaries and the trustee.

A special trust:

- a. Solely for the benefit of a person who suffers from a mental illness, which incapacitates that person from earning a sufficient income.
- b. In terms of the will of a deceased person, solely for the benefit of beneficiaries who are relatives of the deceased.

S258 provides how trust income should be taxed. If a beneficiary obtains a vested right to trust income, that income is taxed in the hands of that beneficiary. Otherwise the income is taxed in the hands of the trust.

Nature of the income received and distributed by the trusts

Any income distributed to the beneficiaries in terms of the trust deed or the discretion of the trustees is taxed in the hand of the beneficiary.

Persons liable for tax on the income earned by the trust

The provisions of the trust deed, the income tax act and legal principles of the vesting of rights need to be viewed with caution when determining the liability of tax in respect of the income of a trust.

There needs to be a distinction between a vested right and a contingent right.

A vested right means that the beneficiary will definitely receive or accrue the income.

Section 25(B) states that any income received by or accrued to in a year of assessment would have deemed to have accrued to a beneficiary who has a vested right.

The exception being donation in terms of section 7(5) which will be taxed in the hands of the donor!

LIABILITY OF THE DONOR FOR TAX ON INCOME - TAX AVOIDANCE!

Donation, settlement or other dispositions- 7(9) & 7(10)

7(9) – Donations made below market value, the market value is taken into account.

7(10) – Disclosure of donations in tax return.

Deemed inclusion in spouses income – 7(2)

Where a spouse donates income to a trust and where the other spouse is a beneficiary. The donor is taxed.

This is an anti-avoidance provision aimed at spouses wishing to reduce their tax liability.

Deemed inclusion in parents income – 7(3) & 7(4)

Donations to a minor child is taxed in the hands of the parents – representative capacity.

Retained income not vested due to stipulation or condition – 7(5)

There firstly has to be a donation and there should be a condition attached to this donation. The beneficiaries of the trust will therefore not have any right to the income of the donation until a certain event has occurred or the condition has been fulfilled.

To determine whether the donor is liable for tax the reason why the income is retained needs to be determined.

If there is uncertainty or a condition is attached to such a donation it means that the beneficiary does not have a vested right and in terms of section 7(5) the donor will be liable for tax.

Amount vested that could have been revoked – 7(6)

The donor will be taxable whereby he revokes a beneficiary right to inherit. There has to be a clause in the donation whereby the donor has a right to revoke such a right.

Donation of a right to income – 7(7)

If an owner of an income producing asset ceded his right to an income to a third person before accrual, the donor (owner) of that asset will be liable for tax.

The donor will be liable even though the income would have been exempted (eg: charity organisation)

Resident benefiting a non resident – 7(8)

Income received by or accrued to a non-resident by a resident is taxable by the donor resident.

DECEASED ESTATES

A person ceased to be a taxpayer at date of death and a new tax payer, the “deceased estate” is created.

A deceased estate is a separate taxable entity and taxed as a person other than a company. The income that was received by the deceased or has accrued prior to death is taxed in the hands of the deceased. Section 25 provides that income received by the executor, which would have been income of the deceased, had he, or she still been alive, will be taxed in the hands of the heirs. To the extent that the income cannot be said to have been derived for the benefit of ascertainable heirs, the income will be taxed as the income of the deceased estate.

The executor of the estate is taxed in a representative capacity.

The year of assessment of a deceased estate will be from the 1st of March till date of death and the assessment of the tax will be done pro rata.

INSOLVENT ESTATES

It used to be that to tax an insolvent in his personal capacity until the date of sequestration. After sequestration the insolvent was only taxed on the income that accrued to him personally.

Three taxpayers are dealt with:

1. The estate of an insolvent person,

On date of sequestration a new taxpayer is created with a new income tax number.

The trustee of the insolvent estate act as the representative taxpayer.

There are no rebates applicable.

Deductions can be claimed.

If a sequestration order is set aside the commissioner can withdraw any assessment prior to date of sequestration.

2. The insolvent person prior to sequestration,

Tax status is terminated prior to date of sequestration and any assessment raised will be withdrawn if the sequestration order is successfully set aside.

3. The insolvent natural person after sequestration

The insolvent person is regarded as a new taxpayer.

Date of sequestration is determined by court or if it is a voluntary sequestration the day the person declares.

With the consent of the trustee the insolvent person can continue employment/trade and income derived will be taxed in his own hands as a new taxpayer.

SECTION 25C : Where a sequestration order was granted and again been set aside by the court, the estate of the insolvent prior to the order and after the setting aside is regarded as the estate of one of and the same person namely that of the insolvent.

ASSESSED LOSSES : SECTION 20(1)(a)(i)

A person whose estate was sequestrated can't carry forward assessed losses incurred prior to the date of sequestration, unless the order of sequestration is set aside.

Once set aside the balance of assessed losses must be reduced by the amount that was allowed to be set off against the income of the insolvent of estate of such a person from carrying on of any trade.

COMPANIES

The definition of a company includes:

- ⇒ All companies registered in the Republic
- ⇒ A foreign company, if the income is derived from a source within the Republic
- ⇒ Any entity holding shares in a company
- ⇒ An association formed to benefit the public
- ⇒ A unit portfolio

⇒ A close corporation

Normal tax on companies ~ 28%

Period of assessment of a company depends on the company's financial year.

Taxation on foreign companies is based at 33% of income sourced with the republic – similar to non-residents is that taxable income is sourced based.

STC – secondary tax on companies – NOW REPLACED BY DIVIDEND TAX

On or after 17 March 1993 – 31 March 2012 before declaring any dividends tax was deducted from the amount of dividends declared. Therefore a provision had to be made before any dividends were to be declared.

DIVIDENDS

Dividend withholding tax - NEW!!!!!!

This replaced STC at a rate of 15%

Dividend

Dividends are profits distributed to shareholders. Therefore dividends are to be declared as income and taxed in the hands of the shareholders! SECTION 64EA (a)

The following types of dividends are not exempt from income tax:

1. Amounts distributed by a portfolio of a collective investment scheme in property;
2. Amounts received in respect of a restricted equity statement;
3. Amount received by a company in consequence of cession;
4. Amount received in respect of shares borrowed by a company;
5. Foreign dividends and dividends paid by a headquarter company.
6. Amounts received in respect of a discretionary power exercised by a trustee of a trust.

Definition of a dividend: NB

Any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company. Such amount transferred or applied may be by way of a distribution made by the company or as consideration of the acquisition of any share in the company.

EXCLUDES:

1. Any amount that is transferred or applied that that reduces the company's **contributed tax capital**;
2. Any amount that is transferred or applied **constitutes shares** in the company making the transfer ;
3. Any amount that is transferred or applied the **acquisition by a listed company of its own shares**.

LIABILITY OF DIVIDENDS TAX

General rule is that dividends are taxed in the hands of the shareholders (beneficial owner). s64EA (a)

Exception : where the dividend is not an amount but an asset in specie the company that declares the dividend is liable for dividends tax. 64EA (b)

When is dividend tax deemed to have been paid?

1. A listed company and not an asset in specie – date on which dividend is paid;
2. A non-listed company and not an asset in specie – earlier of the date on which the dividend is paid / or become due and payable.
3. Where the dividend is an asset in specie earlier of the date on which the dividend is paid / or become due and payable.

How is a “in specie” amount determined?

1. Market value when declared;
2. If it's a financial instrument on the stock exchange the value on close of business day preceding the declared dividends is used.

Deemed dividends

1. Where the right of dividends was acquired by way of cession and dividends was declared before the acquisition;
2. Where an owner borrowed shares in a listed company and dividends was declared before the acquisition;
3. An owner acquires shares in a company after dividends were declared but an arrangement was made to dispose of the share to the person from whom the share was acquired. The dividends would deem to have been paid from who the shares were acquired from.

Exemptions from dividend tax:

The following beneficial owners are exempt from dividends tax:

1. A South African company;
2. Government, a provincial administration or municipality;
3. A public benefit organization;
4. A trust;

5. An institution, board or body that conducts research, provides services to the state or the general public or that promotes commerce, industry or agriculture as contemplated in section 10(1)(cA);
6. A retirement fund, (eg a pension fund or provident fund) or a medical scheme;
7. A parastatal as contemplated in section 10(1)(t);
8. Shareholder in a registered micro business;
9. A natural person upon receipt of an interest in a residence contemplated in paragraph 51 of the 8th schedule.

Withholding of dividend tax

A company withhold paying tax as a mechanism to collect tax. However the tax liability will shift if the dividends are paid to regulated intermediaries. This risk can be reduced if the beneficial owner is exempt from dividends tax.

Withholding cannot apply where:

1. STC applies;
2. Asset in specie is declared as dividends.

Withholding by companies – 65G

Cannot withhold under the following circumstances:

1. The beneficial owner is exempt;
2. Where the beneficial owner and the company is form part of the same group of companies as defined in section 41.

Withholding by regulated intermediaries 64H

A regulated intermediary is defined as:

1. A central securities depository participant;
2. An authorized user in terms of the Securities Services Act;
3. An approved nominee in terms of the Securities Services Act;
4. A nominee that holds investment on behalf of clients in terms of the Codes of Conduct for administrative and discretionary Financial Service Provider.
5. A portfolio of a collective investment scheme in securities;
6. A transfer secretary approved by the commissioner.

Intermediaries are exempted from dividends tax where:

The dividends are transferred to another intermediary and beneficial owner is exempt.

Payments and Recovery of Dividend tax

Dividend tax must be paid on the last day of the month following the month in which the dividends were paid.

Refund of dividend tax

If a declaration is not received within a specific date with respect to that the beneficial owner is exempt from dividend tax or application of a double tax agreement for a reduced rate is not submitted, dividend tax HAS to be withheld.

The amount will be refunded as long as the above documentation is submitted within three years after payments of the dividends.

- Refund in respect of dividends declared and paid by companies

Primary Source – amount of dividends declared by the company within one year after the beneficial owner submitted the documentation;
Secondary Source – Amount paid to be recovered by the commissioner.

- Refund in respect of dividends paid by regulated intermediaries

One source - amount of dividends declared by the company within one year after the beneficial owner submitted the documentation;

REBATE IN RESPECT OF FOREIGN TAXES

A dividend paid by a non-resident company that is listed on a south African stock exchange is dividends for purposes of dividends tax.

Foreign tax paid should not exceed the amount of dividends tax imposed on dividends.

NOTE : Dividends paid by a non-resident company that is listed on a south African stock exchange and is paid to anon resident is EXEMPT from dividend tax.

STC CREDITS

Relief is sought for dividends paid by companies that have unused STC credits after the effective date of the dividend tax. This relief ensures that profits previously subjected to STC is not subject to dividend tax.

SPECIAL ASPECTS THAT RELATE TO THE TAXATION OF DIFFERENT TYPES OF COMPANIES

SMALL BUSINESS CORPORATION

RATES

0 – R 63 556 – **0%**
63 556 – R 350 000 – **7%**
EXCEEDS R 350 00 – R 20 051 + **28%** of exceeded amount.

Requirements for a small business corporation:

- Gross Income must not exceed R 14 000 000;
- Members must not have an interest in in any other company except;
 1. Listed company;
 2. Body corporate;
 3. Share block company;
 4. Non profit company;
 5. Less than 5% interest in social or cooperative society;
 6. Interst in a friendly society;
 7. Less than 5% interest in a primary savings cooperative bank;
 8. Interest in venture capital company;
- Cooperation not to be a personal service provider;
- Not more than 20% of the total receipt and accruals of the corporation may consist collectively of investment income .

CLOSE CORPORATION

RATE – 28%

GROUP COMPANIES AND SPECIAL CORPRATE RULES –NOT FOR THIS COURSE

OTHER ASPETCS RELATING TO TAXATION OF COMPANIES

ASSESSED LOSSES: 103(2)

ASSESSED LOSSES : BALANCE SET OFF BY COMPANIES

SA Bazaars : prevents a business from carrying over an assessed loss if they have not carried on trade.

IMPORTANT: in order for a business to carry an assessed loss there has to be continuity in trade.

Example: Year 1 : Assessed loss of R 200 000
 Year 2: NO TRADE
 Year 3: Taxable income of R 300 000

Year 1 assessed loss cannot be brought forward to year 3.

Where the intention is to avoid tax; SARS will disallow to set of assessed losses against income if:

1. There is change of shareholding in a company;
2. Change in member's interest in a CC.

CONTROLLED FOREIGN COMPANIES – CFCs S9D

A CFC is a company that is not resident in the republic. Section 9D is used to prevent tax evasion by residents who earn an income from a foreign company.

A CFC is therefore a foreign company in which South African residents hold:

1. Hold more than 50% of participation rights;
2. Exercise more than 50% of voting rights in that company.

Participation rights: A right to participate in all, or part of the benefits of the rights attaching to that share or benefit in that company.

SA residents are taxed on imputed income of the CFC's: A proportional portion of the net income accruing to the CFC.

CFC rule do not apply to any resident who holds less than 5% of voting or participation rights.

Country of residence of a CFC will be where the place the company has its effective management.

Foreign business establishment

A foreign business in relation to a CFC means:

- Fixed place of business located in a country other than RSA for a period not less than a year;
- The company is subject to tax in the country of where its effective management is.
- The other company forms part of the same group of companies;
- The structure, employees, equipment and facilities are located in the same country as the fixed place of business of the CFC.

NET INCOME OF A CFC

Once a foreign company has been established to be a CFC, the SA resident income needs to be determined.

At the end of the foreign tax year a CFC taxable income is calculated in terms of South African Income Tax Act. Once taxable income is calculated the foreign company is treated as a SA resident for the following reason:

1. Definition of gross income;
2. Section 7(8) – relating to donation;
3. No exemption of interest;
4. Section 25B – income beneficiaries of trust.

Income needs to be translated to South African currency.

Assessed losses are to set off against the income of the company and not the individual.

Intergroup transactions:

No deductions or allowances are allowed for any intergroup transaction provided they form part of the same group of companies.

CGT – Calculated at an inclusion rate of 66.6%

TRANSFER PRICING AND THIN CAPITALISATION RULES

Transfer Pricing - Where multinational subsidiaries transfer goods and services between themselves at manipulated prices than they would have at arm's length dealings, section 31 provides for commissioner may adjust the price that would have been paid in an open market under similar conditions.

Thin capitalization is a category of transfer pricing and relates to a funding of a business which has more debt than equity. This leads to the foreign investor being exempted from paying tax on interest and the company being allowed to deduct interest on that debt. Thin capitalization is therefore used to protect the South African economy against distortions.

Transfer pricing and high taxed CFCs

Transfer pricing will not be applicable between a resident and a CFC in which they have an interest where:

1. Transaction should be between a SA resident;
2. SA resident should own at least 10% of the voting rights of the CFC;
3. The transaction should comprise of the use of intellectual property or financial assistance;
4. CFC should have a foreign business establishment;
5. CFC should be high taxed.

HEADQUARTER COMPANIES

A company chooses to be a headquarter company by way of election in terms of section 9I.

Requirements to be a headquarter company:

1. Shareholder of the company each have to hold 10% of equity shares and voting rights;
2. 80% or more of the cost of the company is attributed to interest in equity shares; debt owed; intellectual property.
3. Where gross income exceeds R 5 million, 505 or more should include, rentals, dividends, interest, or service fees received from foreign companies.

There are three barriers that restrict companies in establishing headquarter companies in the republic:

1. The application of s9D and CFC;
2. Application of dividend tax on residents;
3. Transfer pricing rules in respect of debt financing and intellectual property.

CFC :

A headquarter company will only qualify as a CFC in a foreign if the shareholders of the headquarter company is more than 50% of South African residents.

The purpose of this arrangement is that the net income of the CFC will be included in the income of the shareholders

Dividend Tax

If a company is a headquarter company they do not have to withhold dividend tax and the shareholder therefore receives foreign dividends which is exempted.

Financial assistance

Any interest free loans from headquarter companies and foreign companies will be free from transfer pricing provisions. Same will apply to intellectual property.

STUDY UNIT 7

THE TAXATION OF CAPITAL GAINS

This tax was introduced with the aim of dealing with taxpayers who convert income that would ordinarily be taxable into tax-free capital gains. Capital gains tax therefore provides that the taxable capital gains will be added to the person's taxable income.

In order to calculate a capital gain or loss, four requirements have to be met:

- ✓ There has to be an asset
- ✓ There must have been a disposal
- ✓ The base cost of the asset must be determined. In general terms, the base cost of an asset includes the following:
 - ⇒ Acquisition cost
 - ⇒ Improvement cost
 - ⇒ Direct cost in respect of the acquisition and disposal of the asset.
- ✓ The proceeds on disposal of the asset have to be determined.

THE SCHEME FOR THE DETERMINATION OF TAXABLE CAPITAL GAINS

Capital gains tax is not a separate taxation. Therefore any taxable capital gain so determined must, in terms of section 26A of the Act, be included in a person's taxable income for the relevant year of assessment.

Capital gains tax (CGT) is treated as tax on income.

The scheme for the determination of a person's taxable capital gain or assessed capital loss can be set out as follows:

STEP 1:

Disposal of an asset by a person

Proceeds from disposal *deduct* base cost of asset

= **capital gain or capital loss**

STEP 2:

--- Is the gain excluded or deferred? --- Is the loss excluded or limited?

--- Is the gain attributed to another person?

Sum of all capital gains and capital losses that are to be taken into account for year of assessment *deduct* annual exclusion in respect of person (where applicable)

= **aggregate capital gain or aggregate capital loss**

STEP 3:

Deduct assessed capital loss

Add assessed capital loss

Brought forward from previous year
previous year

brought forward from

= **net capital gain or assessed capital loss**

STEP 4:

Multiply by applicable inclusion rate. Carry forward to following year

= **taxable capital gain**

Include in person's taxable income

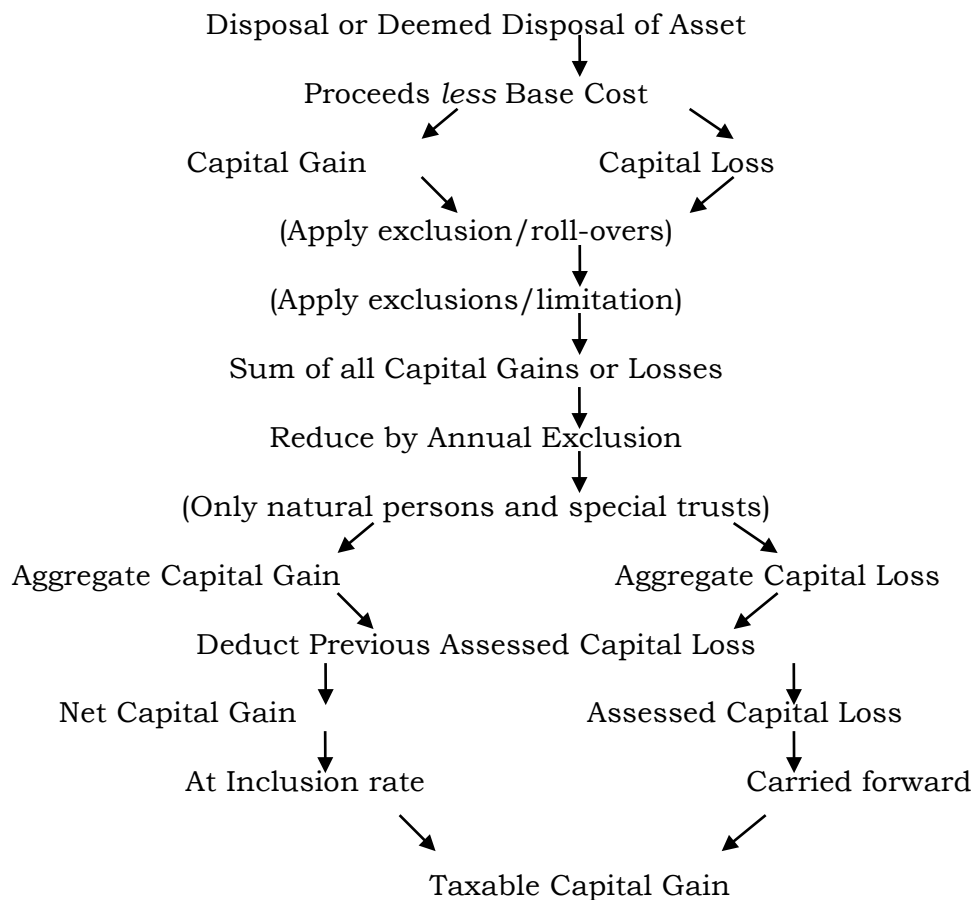
If a disposal or deemed disposal of an asset took place during the year of assessment, the capital gain or loss should be calculated using the following formula:

Proceeds **LESS** Base Cost **EQUALS** Capital gain/loss

Income Tax Act

Gross income		xxx
Less: Exemptions		<u>xx</u>
		xxx
Less: Deductions		(xx)
Plus: Taxable Capital Gain		xxx
Less: s 18 A donations deduction		(xx)
Less: s 18 medical expenses deduction		(xx)
= Taxable income		xxx
Apply rates of tax		xxx
Less: Rebates		<u>(xx)</u>
= Normal tax payable		xxx

Eighth Schedule



Capital gains or losses

- Where the proceeds exceed the base cost of the asset, a capital gain is calculated.
- Where the base cost exceeds the proceeds of the cost of the asset, a capital loss is calculated.

Annual exclusion

Natural persons and special trusts are entitled to an annual exclusion of R17 500 against aggregated capital gains. The annual exclusion is increased to an amount of R120 000 during the year of assessment in which the taxpayer dies.

A special trust is defined as an entity that is created for the benefit of a person suffering from a condition that prevents that person from earning sufficient income to maintain or manage his own financial affairs. The criteria are as follows:

- A mental illness
- A serious physical disability

Aggregate capital gain or loss

An aggregate capital gain or loss is the sum of a person's capital gains or losses for the year, less the annual exclusion for the year.

Net capital gain or assessed capital loss

A person's net capital gain or assessed capital loss for the year of assessment is the

- Aggregate capital gain or loss for the current year, less
- The assessed capital loss brought forward from the previous year

Taxable capital gain

The inclusion rates of net capital gains into the normal income tax calculation are as follows:

- ⇒ Natural persons and special trusts = **33.3%**
- ⇒ An insurer's individual policyholder fund = **33.3%**
- ⇒ An insurer's untaxed policyholder fund, a pension, provident or retirement annuity fund = **0%**
- ⇒ Companies, close corporations, ordinary trusts, co-operatives and other incorporated and unincorporated bodies = **66.6%**

A partnership is not a separate taxable entity; the gains realized will be brought into account proportionately in relation to each partner. The effective maximum rates of tax payable on capital gains in the 2011-year of assessment are as follows:

Natural persons and special trusts (assuming the person is taxed at the maximum marginal rate)	$33.3\% \times 40\% = 13.32\%$
Ordinary trusts	$66.6\% \times 40\% = 26.64\%$

Companies, close corporations and other bodies $66.6\% \times 28\% = 18.65\%$

THE DETERMINATION OF A CAPITAL GAIN OR LOSS

One must 1st determine if a person had a capital gain or loss.

Capital gains and losses must be determined in respect of “assets” that take place on or after the valuation date, namely 1 October 2001.

A capital gain in respect of an asset disposed of during a year of assessment is determined by deducting the “base cost” of that from the “proceeds”.

The four elements in order to establish if a taxpayer has a gain or a loss are:

- 1) ASSETS
- 2) DISPOSALS
- 3) PROCEEDS
- 4) BASE COST

The meaning of “ASSET”

NO ASSET = NO CGT EVENT!!!!!!!

Defined:

- (a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum
- (b) a right or interest of whatever nature to or in such property

Distinguish between a resident and a non-resident as follows:

- ⇒ A resident is subject to CGT on the disposal of any asset as defined, whether situated in the Republic or outside.
- ⇒ A non-resident is subject to CGT on the disposal of:
 - any movable property situated in the Republic
 - any asset of a permanent establishment of the non-resident in the Republic

Assets of a capital as well as a revenue nature are therefore covered by the definition.

DISPOSALS and events treated as disposals

Disposals that take place on or after 1 October 2001.

The rules are set out in paragraphs 11 and 12, and the rules for determining when a disposal is treated as having taken place are set out in paragraph 13.

A disposal is any event, act, forbearance or operation of law, which results in the creation, variation, transfer, or extinction of an asset. A disposal **includes** the alienation or transfer of ownership of an asset (e.g. a sale, donation, or cession), the expiry or abandonment of an asset, the scrapping, loss or destruction of an asset, the granting, renewal, extension or exercise of an option.

A number of listed **events** not involving the creation, variation, transfer or extinction of an asset, such as emigration, are **treated as disposals**:

- ❖ Sale, donation, expropriation, conversion, granting, cession, exchange or any other alienation or transfer of ownership of an asset.
- ❖ Forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset.
- ❖ Scrapping, loss or destruction of an asset.
- ❖ Vesting of an interest in a trust asset in a beneficiary.
- ❖ Distribution of an asset by a company to a shareholder.
- ❖ Granting, renewal, extension or exercising of an option.
- ❖ Decrease in value of a person's interest in a company, trust or partnerships as a result of a 'value shifting agreement'.

A number of listed events involving the transfer of an asset are, on the other hand, specifically excluded from the concept of a disposal. The listed **events not treated as disposals** include:

- ❖ The transfer of an asset by a person as security for a debt and the re-transfer of that asset upon release of the security.
- ❖ The issuing by a company of its shares or debt
- ❖ The issuing by a collective investment scheme of its units
- ❖ The issuing of any bond, debenture, note or other borrowing of money or obtaining of credit
- ❖ A disposal made to correct an error in the registration of immovable property in that person's name in the deed's registry
- ❖ A disposal of any marketable security in terms of a "securities lending arrangement"
- ❖ The distribution of an asset of a trust, by a trustee, to a beneficiary
- ❖ The vesting of a person's asset in consequence of the sequestration of the estate of his spouse
- ❖ When an equity instrument contemplated in SBC has not yet vested

Deemed Disposals

The following are treated as deemed disposals:

- ❖ A disposal is deemed to have taken place if a person ceases to be a resident or a controlled foreign company. This deemed disposal rule does, however, not apply to:
 - immovable property situated in South Africa
 - qualifying equity shares
 - equity instruments under s 8C
 - any right to acquire any marketable security
- ❖ A disposal is deemed to have taken place if a person becomes a resident or a controlled foreign company.
- ❖ A disposal is deemed to have taken place if an asset ceases to be an asset of a non-resident's permanent establishment in South Africa by any means other than a disposal under par 11.
- ❖ A deemed disposal arises when a capital asset becomes trading stock.
- ❖ A deemed disposal arises when a trading stock becomes a capital asset.

- ❖ A deemed disposal also arises when a personal- use asset becomes a non-personal-use asset.
- ❖ A deemed disposal arises when a non-personal-use asset becomes a personal-use asset.
- ❖ A deemed disposal arises on the transfer of an asset between the funds of a long-term insurer.
- ❖ A deemed disposal arises on the reduction or discharge of a debt.

The time of disposal

A capital gain or capital loss must be brought to account for the first time. The time of disposal by means of an event such as a change of ownership effected or to be effected as a result of

- (i) an agreement subject to a suspensive condition, is the date on which that condition is satisfied
- (ii) an agreement which is not subject to any condition is the date on which the agreement is concluded.
- (i) a donation of an asset, is the date of compliance with all the legal requirements for a valid donation
- (ii) the expropriation of an asset in terms of law, is the date on which the person receives the full compensation
- (iii) the forfeiture, termination, redemption, etc., of an asset, is the date of extinction of the asset
- (iv) the granting, renewal or extinction of an option, is the date on which that option is granted, renewed or extended
- (v) the exercise of an option, is the date on which the option is exercised
- (vi) the scrapping, loss or destruction of an asset, is either
 - when the full compensation is received, or
 - when no compensation is payable, the later of the date when it is discovered or when it is established that no compensation is payable

Part disposals

This must be done according to the following formula:

$\frac{\text{Market value of part disposed of}}{\text{Market value of entire asset immediately prior to disposal}}$	X	Amount allowed in terms of paragraph 20 in respect of the entire asset
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What is left of the base cost will be allowed on possible future disposals of the remaining part of the asset.

The formula described above does not apply where a part of the base cost of an asset can be directly attributed

- the part which is disposed of or
- the part which is retained

The following events will not trigger an allocation of part of the allowable expenditure or market value due to the part disposal of an asset:

- the granting of an option in respect of an asset
- the granting, variation or cession of a right of use of an asset without the receipt or accrual of any proceeds

- improvements by a lessee, of immovable property owned by the lessor
- replacement of part of the asset where that replacement comprises a repair.

Example 1:

Pietie has held a four-hectare plot of vacant land at Balito for a considerable length of time. A developer who has offered him R400 000 for half the property has approached him. An estate agent has valued the entire property at R1million. The market value of the property on 1 October 2001 was R700 000, and Pietie has elected to use the market value basis to determine base cost on valuation day.

Base cost of entire asset	R 700 000
Market value of part disposed of	R 400 000
Market value of entire asset	R1 000 000

Base cost of part sold	= $\frac{400\,000 \times 700\,000}{1\,000\,000}$
	= 280 000

Pietie would realize a capital gain of R120 000 (400 000 – 280 000) if he were to dispose of that portion of the vacant land to the developer.

Example 2:

Susan purchased two adjoining plots of land 10 years prior to valuation day within six months of each other. She paid R50 000 for the first plot and R75 000 for the other and thereafter had them consolidated. On 1 October 2006 she decided to re-subdivide the property and sell off the plot that cost her R50 000. She has elected to use the time-apportionment basis to determine the base cost. She sells the plot for R170 000.

Proceeds	R170 000
Expenditure (recognizable fraction)	- $\frac{R\,50\,000}{15}$
Gain	= $\frac{R120\,000}{15}$

The property was acquired 10 years prior to valuation day and sold 5 years thereafter. Therefore the portion of profit to be added to expenditure is 10 divided by 15. The time-apportionment base cost of the asset is therefore R50 000 + (R120 000 x 10/15) = R130 000.

Proceeds	R170 000
Time-apportionment base cost	- $\frac{R130\,000}{15}$
Capital gain	= $\frac{R\,40\,000}{15}$

Debt substitution

Sometimes a debtor discharges or reduces a debt by disposing of an asset to the creditor. The debtor would determine the proceeds and base cost to calculate the capital gain or loss as follows:

- proceeds: the amount by which the debt owed to the creditor is reduced as a result of the disposal
- base cost: (as determined in par 20)

The creditor would calculate the proceeds and base cost as follows:

- proceeds: the market value of the asset as obtained from the debtor
- base cost: the amount by which the creditor's claim was reduced

The creditor will only account for capital gain or loss if the gain or loss is not taken into account for determining his taxable income, e.g. bad debt ito s11 (i).

Amounts constituting part of an asset's BASE COST – par 20(1)

All these amounts would, by implication, include value-added tax not allowed as an input credit for VAT purposes:

- cost of acquisition
- cost of creating an asset
- cost of obtaining a valuation for CGT purposes
- remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser
- transfer costs (including ECC's but not repairs as a result of the ECC)
- stamp duty, transfer duty or similar duty
- advertising costs to find a seller or to find a buyer
- sales commission
- moving costs --- but only in acquiring or disposing of an asset (e.g. this would exclude the costs incurred by a company in moving assets to a new branch)
- installation costs including foundations and supporting structures
- a portion of the donations tax payable by a donor of an asset
- a portion of the donations tax payable by a donee of an asset
- cost of exercising an option to acquire an asset

The amounts that may be added to an asset's base cost also include the following:

- (a) expenditure actually incurred in establishing, maintaining or defending a legal title to or right in that asset
- (b) the cost of improving or enhancing an asset (but not of repairing it, unless the exception in (c) below applies), provided that the improvement or enhancement is reflected in the state or nature of the asset at the time of disposal

Example:

Nelly acquires a second property at a cost of R300 000 in November 2001. She intends to use this property partly for business purposes and she derives rental income from the property. Nelly replaces the kitchen at a cost of R30 000 and installs a security system costing R10 000. In 2004 she installs a jacuzzi in one of the bedrooms at a cost of R25 000. In 2008 the jacuzzi cracks and all the water leaks out. It is not worth repairing, so she has it removed. Nelly's base cost will be R300 000 + R10 000 = R310 000. The replacement of the kitchen is not added to the base cost as it is considered to be a repair and the jacuzzi is not added to the base cost, as it no longer exists as part of the property.

- (c) certain holding costs of assets that are used wholly and exclusively for business purposes, shares listed on a recognized stock exchange or an interest in a collective investment scheme, all of which may be added to the base cost of these assets.

The qualifying holding expenditure

- ⇒ repairs and maintenance, insurance, protection
- ⇒ rates and taxes on immovable property
- ⇒ interest on loans used to directly finance the cost of acquiring an asset and any improvements thereto
- ⇒ interest on amounts used to repay existing loans

NB = Only one-third of such holding expenditure is allowable.

Examples:

Non-qualifying interest - private purpose

Jo-Anne obtains a bond, which she uses to purchase a holiday home that she lets from time to time.

Reason: The interest is incurred partly for private purposes and is therefore not wholly and exclusively laid out for business purposes.

Non-qualifying interest - indirectly incurred

John purchases a piece of vacant land on which he intends to build a factory. He finances the acquisition by means of a bank overdraft. The next day he wins the Powerball and repays the overdraft. Shortly thereafter, after squandering his winnings on horse races, he has to resort to the overdraft to purchase a private motor vehicle.

Reason: there is no longer a direct relationship between the overdraft and the land.

Qualifying interest - vacant land acquired for business purposes

Peter incurs interest directly in financing the purchase of vacant land for the purpose of erecting a factory building.

Reason: directly related to the cost of acquisition. Note that such pre-production interest would not qualify in terms of section 11(bA) of the Income Tax Act since that section does not include land --- ITC 1619 (1996), 59 SATC 309.

Interest incurred in financing the cost of shares

Thomas acquires 2000 shares in XYZ Ltd, a company listed on the JSE, at a cost of R100 000, which he finances by means of a bank loan. During the year ended 28 February 2003 he incurs interest on the loan of R15 000.

Interest incurred	R15 000
Non-allowable portion (2 ÷ 3 x 6 R 15 000)	(R10 000)
Interest that may be added to base cost	<u>R 5 000</u>

(d) Amounts already taken into account, upon the acquisition of the cost

The following gains can be included in the base cost:

- ⇒ The net amount included in a lessor's gross income in respect of improvements effected to the leased property by a lessee
- ⇒ Recoupments in respect of assets in terms of section 8(5)
- ⇒ In the case of an interest in a CFC (controlled foreign company) the proportion of the net income taxed in terms of section 9D and of the net capital gain *less*: exempt foreign dividends in terms of section 10(1)(k)(ii)(cc)

The amount included in 'gross income' for income tax purposes, must be included in the base cost of the asset

- ⇒ Marketable securities or equity instruments
- ⇒ Lease assets (recoupments)
- ⇒ Fringe benefit assets
- ⇒ Lease improvements (included in lessor's gross income)
- ⇒ Share in a controlled foreign company (CFC) – a right in a CFC held directly or indirectly by a resident must be increased by the proportional amount of net income of CFC in the resident's hands *less* taxable gain, *plus* the net taxable gain of CFC, *less* foreign dividend distributed.

Amount included in base cost

A right in a CFC held directly or indirectly by a resident must be increased by the proportional amount of net income in resident's hands

- Less taxable gain
- Plus net capital gain of CFC
- Less foreign dividend distributed

Amounts excluded from the base cost

- (a) Expenditure already claimed in determining taxable income for normal tax purposes.
- (b) Expenditure recovered or recouped.

Example:

John buys an asset from Peter for R50 000 in five equal installments of R10 000. After seven years John has still not paid the last installment. Peter agrees to accept R5 000 in full and final settlement.

The base cost of the asset will be R50 000 – R5 000 = R45 000

(c) Expenditure unpaid and not due and payable when asset is disposed of

Example:

Mary buys an asset from Sharon. The purchase price is payable in annual installments of R10 000 over five years. After two years Mary sells the asset to Adam for R25 000, and continues to pay off the loan to Sharon over the next 3 years. The base cost of Mary's asset in the year of disposal will be R10 000 x 2 = R20 000. The outstanding payments will be treated as capital losses in the years in which they are paid.

However, this provision does not apply in respect of any disposal in a year of assessment commencing on or after 24 January 2005.

Qualifying expenditure excluded from base cost

The expenditure incurred in respect of an asset does not include:

- Holding costs
- The valuation date value of any option or right to acquire any marketable security
- VAT
- Any amount that has for any reason been reduced or recovered or paid by another person

Immigrants

The treatment of immigrants disposing of assets after becoming South African residents does not apply to:

- Immovable property and any interest in immovable property situated in South Africa
- Assets attributable to a 'permanent establishment' through which the immigrant carries on business in South Africa

Gains and losses on these two classes of assets always fall within the CGT net and are not influenced by the residential status of the owner.

Loss-limitation rules applicable when the immigrant disposes of these assets at a loss, on or after immigration date:

- Where both the proceeds from the disposal and the base cost expenditure incurred on the asset prior to immigration date are lower than its market value on the date of becoming a resident, the immigrant must be treated as having acquired the asset at a cost equal to the higher of:
 - the base cost expenditure incurred in respect of the asset prior to the immigration date
 - the proceeds less the base cost expenditure incurred on or after immigration date in respect of the asset

- Where both the proceeds from the disposal of the asset and the market value of the asset as at the date of becoming a resident are lower than the base cost expenditure incurred on the asset prior to that date, the immigrant must be treated as having acquired the asset at a cost equal to the higher of:
 - the market value of the asset on that date
 - the proceeds less the base cost expenditure incurred on the asset on or after that date

Amounts constituting PROCEEDS

Definition: the proceeds from the disposal of an asset are equal to the amount received by or accrued to or in favour of a person in respect of that disposal (paragraph 35). The following amounts will, **not** form part of the **proceeds**:

- ⇒ Any amount taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain.
- ⇒ Any amount of the proceeds that has been repaid or has become repayable to the person to whom that asset was disposed of.
- ⇒ Any reduction, as a result of the cancellation or variation of the agreement governing the disposal.

Any portion of a receipt or accrual from the disposal of an asset that constitutes gross income in a person's hands or that is taken into account when determining that person's taxable income before the inclusion of any taxable capital gain is therefore not taken into account as part of the proceeds from that disposal for the purposes of CGT. To determine whether and to what extent a receipt or accrual from the disposal of an asset must be taken into an account as proceeds for the purposes of CGT, one must therefore determine whether and to what extent that receipt or accrual is taken into account as part of a person's gross income.

Example:

Phoenix Limited sells one of its warehouses for an amount of R5 million. R2 million of this amount is apportioned to the stock of finished goods on hand at the time of the sale, and the remaining R3 million represents the amount payable for the machinery in the warehouse. The machinery had originally been acquired at R6 million and had been written down by means of wear and tear allowances to R2 million at the time of sale. R1 million of the amount of R3 million payable for the machinery must therefore be included in Phoenix's income as a recoupment in terms of section 8(4)(a) of the Act of wear and tear allowances previously deducted in respect of the machinery. Only R2 million will therefore form part of the proceeds of the machinery for purposes of CGT. The R2 million payable for the trading stock will form part of Phoenix's gross income and therefore not be taken into account for purposes of CGT.

The Eighth Schedule also contains some deeming provisions in terms of which a person is treated as having dispose of an asset for a specific

amount. A donation is treated as a disposal of an asset by the donor and an acquisition of that asset by the donee at market value (par 38). The rule also substitutes the market value of the asset for the actual consideration to which the parties agreed in the case of a disposal for a consideration not measurable in money.

Example:

Thomas donates a yacht exceeding ten meters in length to Maria as a token of his affection for her. There is no marital-like union between them at the time in spite of Thomas's efforts to establish one. The yacht has a base cost of R1 million and has a market value of R2,5 million at the time of the donation. Thomas and Maria do not qualify as spouses. The base cost of R1 million in the hands of Thomas is therefore not transferred to Maria. The transaction is treated as a disposal by Thomas for a consideration of R2,5 million. Thomas will therefore realize a capital gain of R1 500 000 in respect of the donation, while Maria will be treated as having acquired the yacht at a base cost of R2,5 million.

Example:

Keagan sells an aircraft with a base cost R1 million and a market value of R3,5 million to Matthew for a consideration that cannot be turned into money. Keagan cannot treat the transaction as a disposal for a consideration having a value of nil and claim the base cost of the aircraft as a capital loss. Keagan and Matthew will have to treat the transaction as a disposal and acquisition at R3 500 000. Keagan will therefore realize a capital gain of R2 500 000 in respect of this disposal.

A deceased person is treated as having disposed of his or her assets at market value on the date of death with the exception of:

- ⇒ Assets transferred to the surviving spouse
- ⇒ Assets bequeathed by the deceased to a public benefit organization approved by the Commissioner in terms of section 30
- ⇒ A long-term insurance policy of the deceased or the benefit from a pension, provident or retirement annuity fund which, if the proceeds had been paid to the deceased, the capital gain or capital loss would have been disregarded in terms of paragraph 54 or 55, as the case may be

The deceased estate is treated as having acquired those assets at a cost equal to market value. Where the assets are finally distributed to the heirs, legatees (other than the surviving spouse or an approved public benefit organization) or to a trustee of a trust:

- ⇒ The deceased estate is treated as having disposed of the assets for proceeds equal to the base cost of the deceased estate in respect of the asset,
- ⇒ The heir, legatee or trustee is treated as having acquired such an asset at a cost equal to such base cost (par 40).

If, during the winding up of the estate, assets are disposed of, the deceased estate is treated in the same manner as the deceased would have been treated, had the deceased dispose of the asset.

Disposal of certain debt claims (par 35A)

Par 35A is only applicable when the following three conditions are met:

- (1) A person must have disposed of an asset during the year of assessment, but a portion the proceeds will only accrue in a subsequent year of assessment.
- (2) The person must have subsequently disposed of any right to claim payment in respect of that disposal.
- (3) The claim must include any amount that has not yet accrued to that person at the time of the disposal of the claim.

The effect of par 35A is two-fold:

- (1) So much of the consideration derived by him the disposal of the claim that has not yet accrued to him, must be treated as an amount of consideration that accrues to him on the disposal of the relevant asset, and
- (2) So much of any capital gain or loss determined on the disposal of the claim that has not yet accrued to him, must be disregarded.

Disposal of interest in a company or trust that holds personal-use assets

Par 15 this paragraph provides for the limitation of losses on certain personal-use assets such as personal-use aircraft, boats and certain rights and interests.

Par 37 this paragraph is an anti-avoidance provision that pretends persons from circumventing par 15 by means of holding these assets in a company or trust.

Par 53 this paragraph provides that all capital gains or capital losses, determined in respect of personal-use assets of a natural person or a special trust, should be disregarded. This par defines personal-use assets.

Example:

Peter acquires all the shares in a company of which the sole asset is a valuable painting. He pays R120 000 for the shares, a value based on the current value of the painting. He later acquires liquid funds and decides to sell his shares in the company, but because of the recessionary economic conditions, the painting has declined in value and he realizes only R70 000 for the shares. Explain the CGT consequences.

Answer:

He is deemed to have disposed of the shares for their market value determined as if the painting had not decreased in value, that is, for R120 000, so that he is effectively precluded from deducting the actual capital loss of R50 000 that is attributable to the decrease in the value of the painting.

Disposals and donations not at arm's length or to a connected person

When a person disposes of an asset to:

- ⇒ Anyone by means of a donation or for a consideration not measurable in money or
- ⇒ To a connected person for a consideration that does not reflect an arm's length price.

Then the disposal is treated as a disposal of an amount equal to the market value on the date of the disposal.

Example:

XYZ Co and ABC Co are connected persons in relation to each other. XYZ sells a fully-depreciated asset that was acquired at a cost of R100 to ABC for R100. The market value of the asset at the date of the disposal was R120. Explain the CGT consequences.

Answer:

In terms of par 38(1)(a), XYZ has proceeds of R120 (market value) – R100 (recoupment) = R20 and a base cost of nil (R100 cost reduced by capital allowances of R100 ito par 20(3)(a) = R0), resulting in a capital gain of R20. ABC acquires the asset at a base cost of R120.

Capital losses on disposals to connected persons

In terms of par 39, a person's capital loss determined in respect of the disposal of an asset to a connected person is treated as a 'clogged' loss. A person must disregard capital losses ('clogged' loss) on the disposals to a person who

- ⇒ Was his connected person immediately before the disposal or
- ⇒ Is a member of the same group of companies immediately after the disposal or
- ⇒ Is a trust with a beneficiary that is a member of the same group of companies immediately after the disposal

For the purposes of par 39, a connected person in relation to a natural person does not include a relative of that person other than a parent, child, stepchild, brother, sister, grandchild or grandparent.

Example:

In year 1, Fugee Ltd sells an office building to a fellow subsidiary, Begee Ltd, at a capital loss of R7 million. In year 4, Fugee Ltd sells a block of listed shares to Begee Ltd at a capital gain of R5 million. Explain the CGT consequences.

Answer:

Fugee Ltd must disregard the capital loss of R7 million in year 1, since Begee Ltd is its connected person, but it may carry forward the capital loss and set it off against the capital gain of R5 million made on the subsequent disposal of shares to Begee Ltd. The capital gain of R5 million, will therefore, be tax free, while Fugee Ltd may carry forward the balance of the capital loss of R2 million (R7 million – R5 million) to set off against capital gains on future disposals to Begee Ltd. If Begee Ltd has ceased to be a connected person of

Fugee Ltd before year 4; Fugee Ltd.'s capital loss of R7 million would have fallen away.

THE TREATMENT OF ASSETS ACQUIRED PRIOR TO 1 OCTOBER 2001

As a general rule the base cost of such assets is calculated in a way that excludes any capital gains or losses before 01/10/01.

Par 26 – 32 sets out how the valuations date value (VDV) of these assets should be determined. Any incurred expenditure on or after the said date that qualifies as being part of the base costs is then added to the VDV.

The valuation date value of an asset will, as a general rule, be any one of the following amounts:

- ⇒ Its market value as at 01/10/01
- ⇒ 20% of the proceeds from its disposal, after deducting from those proceeds any expenses qualifying as base cost that were incurred after 01/10/01
- ⇒ The time apportionment base cost of that asset in terms of paragraph 30.

THE CAPITAL GAIN OR LOSS EXCLUDED

Where the proceeds exceed the base cost of the asset, a capital gain is determined. However, the following must be noted:

- ❖ Various capital gains must be disregarded or excluded
- ❖ Certain capital gains may be rolled-over
- ❖ Certain gains resulting from a donation can be attributed to the donor

Where the base cost exceeds the proceeds of the asset, a capital loss is calculated. However, the following must be noted:

- ❖ Various capital losses must be disregarded or limited

Excluded and limited gains and losses

The gains and losses to be excluded when aggregating a person's capital gains and losses include the following:

1. Primary residence exclusion
 - ⇒ The R2 million gross rule:
Any capital gain on the disposal of a primary residence by a natural person or special trust will be excluded if the proceeds from the disposal do not exceed R2 million
 - ⇒ The R 2 million gain rule:
If the R2 million rule is not applicable the natural person or special trust must disregard any capital gains or losses of R1,5 million of a primary residence

These exclusions are per primary residence and NOT per person holding an interest and must thus be apportioned.

Important definitions:

- ❖ 'primary source' – one in which a natural person or a special trust holds an interest. In addition, the natural person or the beneficiary of the special trust or the spouse of the person or beneficiary must:
 - ordinarily reside or have resided in the residence and regard it as his main residence and
 - use or have used it mainly for domestic purposes
 - ❖ 'residence' – any structure, including a boat, caravan or mobile home, which is used as a place of residence by a natural person, together with any appurtenance belonging thereto and enjoyed therewith.
- Three other requirements of the primary residence exclusion:
- (1) it is limited to a land size of two hectares
 - (2) uninterrupted ordinary residence is required
 - (3) any trade use of the primary residence is not allowed

Example:

Peter is married to Paula in COP and the primary residence falls within their joint estate. The residence was originally purchased on the 1 October 2006 for R800 000 solely to be utilized as a primary residence. Five years later they sold the residence for R3 million in order to purchase another primary residence. Calculate the taxable gain for Peter and Paula.

Answer:

Assume that Peter and Paula had no other taxable gains or losses during the year in question. Peter and Paula's taxable capital gains are determined as follows:

	Total	Peter	Paula
Capital gain apportioned:	2 200 000	1 100 000	1 100 000
Disregard	<u>1 500 000</u>	<u>750 000</u>	<u>750 000</u>
Balance subject to CGT	700 000	350 000	350 000
Annual exclusion		<u>30 000</u>	<u>30 000</u>
Aggregate capital loss		<u>320 000</u>	<u>320 000</u>
Taxable capital gain (R320 000 x 33.3%)		106 560	106 560

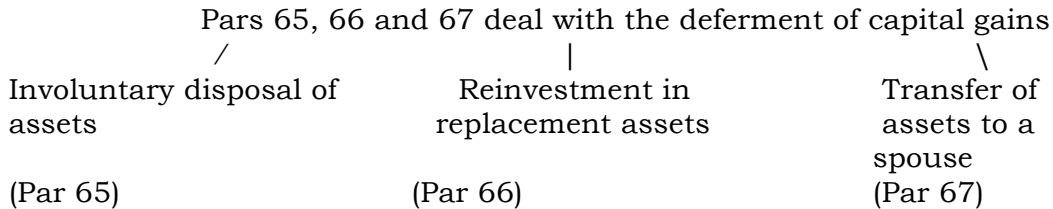
2. A gain or loss from the disposal of a personal-use asset, which is an asset of a natural person or a special trust that is used mainly for purposes other than carrying on a trade.
3. A gain or loss from a disposal resulting in the receipt of certain retirement benefits (lump sum).
4. A gain from the disposal of small business assets prescribed in par 52.
5. A gain or loss from a disposal resulting in the receipt of specified long-term insurance benefits (par 55).
6. A gain or loss from a disposal resulting in the receipt of compensation for personal injury, illness or defamation (par 59)
7. A gain or loss from the exercise of an option (par 58).
8. A gain or loss resulting from a donation to a public benefit organization (par 62).
9. A gain or loss by a natural person from gambling, games and competitions conducted under the Republic's laws (par 60).
10. A gain or loss by a collective investment scheme.
11. Disposal by a creditor of debt owed by connected person (par 56)

- ✓ he must disregard any capital loss on the disposal, even if the disposal is to an unconnected person

12. Disposal of small business assets exclusion (par 57)

Deferred gains and losses

The 3 important roll-over provisions:



In certain circumstances a gain or loss will not be recognized in the year in which it arises but will be *rolled over* and taken into account in a future year. The circumstances in which a gain or loss will be rolled over include the following:

- (a) Involuntary disposals (par 65) – Where a capital gain arises where an asset is destroyed, lost, expropriated or stolen and the person receives compensation (insurance) and the proceeds are used to acquire a replacement asset. In order to qualify for this relief, the proceeds from that disposal must be equal to or exceed the base cost of the asset involved. The taxpayer must, in addition, satisfy the Commission that:
- ❖ An amount at least equal to the receipts and accruals from the disposal of the original asset has been or will be used to acquire a replacement asset or assets,
 - ❖ The contract or contracts to acquire the replacement asset or assets have been or will be concluded within a year of the disposal of the original asset, and
 - ❖ The replacement asset or assets have been or will be brought into use within three years of disposal of the original asset.

Where the replacement asset or assets constitute depreciable assets, the capital gain from that involuntary disposal will, as a general rule be spread over the period during which a capital allowance or deduction is allowed in respect of the replacement assets.

Par 65 also provides for a few specific situations:

- ❖ When the replacement asset is a depreciable asset: the person must treat a certain portion of the disregarded capital gain as a capital gain in each year of assessment during which the asset is being depreciated. The amount to be treated as a capital gain in the year of assessment equals:

TOTAL CAPITAL GAIN

X

allowance for the replacement asset allowance in the current year of assessment

Total allowance allowable on replacement asset for all years of assessment

Example:

Arson Ltd purchased a machine on 29 February 2004 at the cost of R100 000. On 28 February 2005 the machine was destroyed in a fire. The company received R120 00 from its insurer as compensation. Arson Ltd purchased a more advanced replacement machine on 30 June 2005 at a cost of R150 000. Arson Ltd has a 30 June year end. Determine the capital to be brought into account in the 2005 to 2008 years of assessment.

Answer:

The capital gain on the disposal of the old machine was R20 000. Under par 65 this must be disregarded and spread over future years of assessment in proportion to the capital allowances to be claimed on the replacement asset.

The capital allowances on the new machine will be as follow:

2005: R150 000 x 40% = R60 000

2006: R150 000 x 20% = R30 000

2007: R150 000 x 20% = R30 000

2008: R150 000 x 0% = R30 000

The capital gain of R20 000 must be recognized as follows:

2005: R20 000 x R60 000/R150 000 (40%) = R8 000

2006: R20 000 x R30 000/R150 000 (20%) = R4 000

2007: R20 000 x R30 000/R150 000 (20%) = R4 000

2008: R20 000 x R30 000/R150 000 (20%) = R4 000

⇒ When a person who has made the election acquires more than one replacement asset, he must allocate the capital on the disposal of the original asset.

⇒ When the replacement asset is disposed of before the full amount of the previously disregarded capital gain has been taxed.

(b) Reinvestment in replacement assets under paragraph 66.

Where a capital gain arises on the disposal of an asset that qualifies for a capital allowance or deduction. In order to qualify for this relief, the proceeds from that disposal must be equal to or exceed the base cost of the asset involved. The taxpayer must, in addition, satisfy the Commissioner that :

- ❖ An amount at least equal to the receipts or accruals from the disposal of the original asset has been or will be used to acquire one or more replacement assets, all of which qualify for a capital allowance or deduction
- ❖ The contract or contracts to acquire the replacement asset or assets have been or will be concluded within a year of the disposal of the original asset, and
- ❖ The replacement asset or assets have been or will be brought into use within three years of the disposal of the original asset.

A person must include a portion of the disregarded capital gain contemplated above in its aggregate capital or loss in each year of assessment during which the asset is being depreciated. The amount to be treated as a capital gain in the year of assessment equals:

TOTAL CAPITAL GAIN

X

allowance for the replacement asset allowance in the current year of assessment

Total allowance allowable on replacement asset for all years of assessment

Par 66 also provides for a few specific situations:

- When the person who has made the election acquires more than one replacement asset.
- When the replacement asset is disposed of before the full amount of the previously disregarded capital gain has not yet been taxed.

(c) A transfer of assets between spouses.

Par 67 provides for the transfer of the base cost of an asset in a person's hands to that person's spouse where the latter is a resident, and

- ⇒ The asset is transferred to that spouse during that person's lifetime or as a result of that person's death, or
- ⇒ Where that asset is transferred to that spouse in consequence of a divorce order or, in the case of the termination of a permanent marital-like union, in consequence of an agreement of division of assets that has been made an order of court,

The transferor-spouse must disregard any capital gain or loss determined iro the disposal of an asset to his or her spouse. The transferee is treated as having:

- Acquired the asset on the same date on which it was acquired by the transferor
- Acquired the asset for an amount equal to the base cot expenditure incurred by the transferor prior to the disposal
- Incurred that expense on the same date and in the same currency that it was incurred by he transferor
- Used the asset in the same manner that is was used by the transferor in the period prior to the disposal
- Received an amount equal to the amount received by the transferor iro that asset would have constituted proceeds disposal of that asset had that transferor disposed of it to a person other than the transferee.

IS THE GAIN ATTRIBUTED TO ANOTHER PERSON?

A capital gain is in some circumstances attributed to and taxed in the hands of a person other than the one whose hands it arises.

Attribution of capital gains

The attribution rules are similar to tax provisions:

- Gain vested in a spouse ~par 68~taxed in the hands of the donor spouse (S7(2))
- Gain vested in a minor ~par 69~taxed in the hands of the donor parent (S7(3)+(4))
- Gain not vested in the beneficiary because its subject to a condition ~par 70~taxed in the hands of the donor (S7(5))
- Gain vested in the beneficiary but can be revoked by donor ~par 71~taxed in the hands of the donor (S7(6))
- Asset or gain vested in a non-resident beneficiary ~par 72 ~taxed in the hands of the donor (S7(8))
- S7 income and capital gain taxed in the hands of the donor. Selling price left outstanding as an interest-free or low interest loan ~ par 73 ~ the amount that ca be deemed a capital gain in the hands of the donor is limited to: the interest saving enjoyed less any income deemed back to the donor iro S7.

THE DETERMINATION OF A PERSON'S AGGREGATE CAPITAL GAIN OR LOSS

A capital gain or loss is first determined separately in respect of each asset disposed of by a taxpayer during a year of assessment.

There are the following 2NB steps in determining a person's aggregate capital gain or loss:

- ⇒ all a person's capital gains and/or loses are added together.
- ⇒ thereafter, the total amount of such capital gains and/or losses is reduced by the annual exclusion, that is R17 500 in the case of a natural person or a special trust (pars 6 and 7).

CGT FOR DIFFERENT ENTITIES OR PERSONS

Trusts (par 80-82)

The capital gains of a trust may be taxed:

- In the hands of the beneficiaries
- In the trust
- In the hands of the person who donated the assets to the trust

The death of beneficiary of a special trust

The trust must continue to exist for the purposes of the tax on capital gains until the earlier of the following dates:

- The date of disposal of all the assets held by the trust
- Two years after the date of death of the beneficiary

Death of a natural person and the deceased estate

There are 3 categories of taxpayers:

- (1) The deceased person: must be treated as having disposed of his assets to his deceased estate for proceeds equal to their market value on the date of his death.
The deceased person will also be entitled to:
 - An exclusion of **R 300 000** in the year of death
 - A primary residence exclusion
 - A potential small business asset relief
- (2) The deceased estate: is treated as having acquired the assets from the deceased person at the market value. The CGT treatment of assets disposed of by the executor can be divided into two categories:
 - Assets disposed of to specific heirs, legatees or to a trustee of a trust
 - Assets disposed of to parties that are not specific heirs or legatees
- (3) Insolvent estates: when the estate of a natural person has been voluntarily or compulsory sequestrated, the person before sequestration and the insolvent estate will be treated as one and the same person for normal tax purposes. The disposal of assets by a person's insolvent estate is treated in the same manner as if the person himself had disposed them of.
- (4) Partnerships: they are not taxed as a separate entity. Individual partners must bear the consequences of CGT. SARS regards each partner as having a fractional interest in the partnerships assets. When partner withdraws from the partnership:
 - There will be disposal of that partners interest and a capital gain or loss must be determined and
 - The remaining partners, who acquired that partner's interest, will reflect an increase in base cost.

THE DETERMINATION OF A NET CAPITAL GAIN OR AN ASSESSED CAPITAL LOSS

After determining a person's aggregate capital gain or aggregate capital loss, the person's assessed capital loss in respect of the previous year of assessment, if any, must be deducted from the aggregate capital gain or added to the aggregate capital loss to determine the net capital gain or assessed capital loss for the current year of assessment (pars 6 and 7). A person will have an assessed capital loss for a year.

- ❖ Where that person has an assessed capital loss brought forward from a previous year that exceeds any aggregate capital gain for that year; or
- ❖ Where that person has an aggregate capital loss for that year with or without an assessed capital loss brought forward from a previous year; or

- ❖ Where that person has no aggregate capital gain or loss for the year but an assessed capital loss brought forward from a previous year (par 9).

Example 1:

Aggregate capital gain for 2003	100 000
Assessed capital loss for 2002	(50 000)
Net capital gain for 2003	50 000

Example 2:

Aggregate capital loss for 2003	50 000
Assessed capital loss for 2002	50 000
Net capital loss for 2003	100 000

If a person sustains an assessed capital loss for a tax year, that loss cannot be set-off against the person's ordinary income of a revenue nature.

DETERMINATION OF A TAXABLE CAPITAL GAIN

The full amount of a net capital gain for a year of assessment is not subjected to tax at the effective rates applying for purposes of normal tax. The net capital gain is firstly reduced by multiplying it by the applicable inclusion rate to determine the amount of a person's taxable capital gain that must be included in that person's taxable income for that year of assessment.

The inclusion rates to be used in arriving at a taxable capital gain are the following:

Type of taxpayer	Inclusion rate %
Individuals	33.3
Retirement funds	N/A
Trusts:	
---Unit	N/A
---Special	33.3
---Other	66.6
Life assurers:	
---Individual policy holders fund	33.3
---Company policy holders fund	66.6
---Corporate fund	66.6
---Untaxed policy holder fund	0
Companies	66.6
Permanent establishments (branches)	66.6

Once a person's taxable capital gain has been determined, that taxable capital gain is included in the person's taxable income. The inclusion rates of 66.6% and 33.3 % applying for purposes of CGT therefore have the effect of lowering the effective rate of normal tax applying in respect of capital gains.

STUDY UNIT :8

TAX AVOIDANCE

TAX EVASION V TAX AVOIDANCE

Tax evasion: this refers to illegal activities intentionally undertaken by the taxpayer to free himself from any tax burden.

Example : the taxpayer omits income from his annual tax return.

Tax avoidance :

This is where a tax payer arranges his affair in a perfectly legal manner in an effort to either reduce his tax liability or to incur no tax liability.

There is no harm in entering into a bona fide transaction and as a result avoid any tax liability:

Case : Duke of Westminster - every man is entitled to arrange his affairs within the confinement of the act in such a way that his tax liability is less than what otherwise would have been.

Conhage – affairs must be arranged within the bounds of antiavoidance provisions

IMPERMISSABLE TAX AVOIDANCE ARRANGEMENTS NB!!!

SECTION 80A-80L

REQUIREMENTS FOR SECTION 80 A

REQUIREMENT 1 - ARRANGEMENT

There must be an arrangement. What is an arrangement?

1. Transactions;
2. Operations;
3. Schemes;
4. Agreements;
5. Understandings;
6. Any of the above involving alienation of property

REQUIREMENT 2 – TAX BENEFIT

The arrangement must lead to a tax benefit. The term benefit would include an avoidance, postponement or reduction of tax liability.

REQUIREMENT 3 – MAIN PURPOSE WAS TO DERIVE A TAX BENEFIT

Section 80G – presumption that the arrangement was entered into with the purpose of acquiring a tax benefit. The taxpayer then need to prove that the main or sole purpose in entering into the arrangement was NOT to acquire a tax benefit.

Ovenstone: places a heavy burden of proof on the taxpayer.

REQUIREMENT 4: IN CONTEXT OR NOT IN CONTEXT OF THE BUSINESS

***NOT IN CONTEXT:** - only one of the following needs to be complied.

1. **Means or manner not normally employed** – means or manner not employed for a bona fide business purpose other than obtaining a tax benefit.
2. **Rights or obligations not normally created** – these rights or obligations would not have been created between people dealing in arm's length.
3. **Misuse or abuse of the provisions of the act** – this deals with the interpretation of the act.

The rules of interpretation and the constitution, namely the contextual and purposive approach must be followed when interpreting legislation.

This requirement was developed by a Canadian court in the case of **Canada Trustco Mortgage co:**

This case underlined the fact that there are two stages to the interpretation process.

1. Determine the spirit, purpose and object of the provision that tax payer relied on which gave rise to the tax benefit;
2. Determine whether the transaction frustrates or defeats the spirit, purpose and object of the provision.

***IN CONTEXT – LACK OF COMMERCIAL SUBSTANCE**

Avoidance arrangement lacks commercial substance if it results in a significant at benefit for the party but the avoidance arrangement does not have a significant effect upon either the business risks or net cash flow of that party – **section 80C(1)**

Indicators of lack of commercial substance:

1. Legal substance differs significantly from the legal form of its individual steps.
 - Legal substance : is the true legal rights and obligations flowing from the transaction, therefore the true reality.
 - Legal form: is what the taxpayer has actually done, which means the legal form of his transaction.

Substance over form

Recent court cases have based their findings on substance of the scheme and have ignored the form which the schemes were cast by means of different contracts:

Ladysmith (PTY) limited: the court ignored the disguised transaction and considered the true intention of the parties.

NWK Ltd : there is nothing wrong in arranging your affairs to be tax effective, however there is a problem if you disguise or dress up your affairs to avoid tax.

2. Inclusion or presence of round trip financing.

These are funds which are transferred between parties which result in a direct or indirect tax benefit and reduces , offset or eliminates any business risks by any party.
3. Inclusion or presence of an accommodating or tax indifferent party.
 - A party receives income that has no impact on his tax liability;
 - BUT would the participation of this accommodating or tax indifferent party it would have had an effect on the tax liability of another party.
4. The inclusion or presence of elements that have the effect of offsetting or cancelling each other.

NORMALITY – CASE LAW

Meyerowitz :

The taxpayer received share in profits from his publisher with respect to books that he had authored. He ceded this interest to a company that he and his wife owned. His father formed a trust that benefited the taxpayer minor children. The company then ceded the interest to that income to the trust.

It was quiet evident that the taxpayer avoided tax as his main purpose and was therefore taxed in his hands.

Geusteyn, forsyth, & Joubert:

A partnership was transferred into a company. The court found that the sole or main purpose was not to avoid tax but was a business decision.

Hicklin:

Shareholder of a dormant company with substantial reserves wanted to dispose of the company. They had two options.

The first was to deregister the company in which case the dividends were due to the shareholders and the other was to sell the shares to another company which will pay a capital amount to the shareholders, itself receive the distributable reserves as dividends and deregister the company. The latter option was used.

The dividend received by the company was tax free. The proceeds received by the other shareholders was not taxable as it was CAPITAL in nature.

This transaction was found not to abnormal and no anti avoidance provisions could be applied.

Louw

Deals with the incorporation of a partnership of engineers.

The result of this was that the salaries and dividends received as income as shareholder were less than what was received when their were partners. Another result was that the shareholders could borrow interest free loans from the surplus reserves.

The incorporation from a partnership to a company was seen not to be abnormal however the granting of intrest free loans were abnormal.

REPORTABLE ARRANGEMENTS – ss 80 M-T

An arrangement by virtue of which a tax benefit is derived.

Arrangements provide assistance insofar that they serve as an early warning system for detecting potential impermissible avoidance arrangement.

Consequences of Tax Avoidance – 80B

Commissioner empowered to take certain action:

- General remedy;
- Specific remedy;
- Disregard or combine any steps in/parts of an arrangement;
- Disregard and accommodating or tax indifferent party or deem the party or any other person as one of the same person;
- Deem connected persons to the impermissible avoidance arrangements as one and the same person.

HOW TO ANSWER A TAX AVOIDANCE QUESTION IN THE EXAM! NB!

Step 1 : INTRODUCTION – Distinguish between tax avoidance and tax evasion.

Step 2: You need to mention that this set of facts deal with **tax avoidance**.

Step 3: Four requirements of section 80A-L and apply your theory to the set of facts and identify the requirements!

- NB mention section 80G – Onus

Step 4 : Discuss normality with cases

Step 5 : Conclusion – Important: mention the Conhage and Louw case and include the remedies that SARS has 80B

ASSESSED LOSSES AND TAX AVOIDANCE 103(2)

This provision is used when a company, CC or trust is acquired with an assessed loss. Basically income can be diverted and set off against the assessed loss.

Requirements :

1. There must be an agreement affecting a company or trust or change in;
 - Shareholding of the company;
 - Member interest in a CC;
 - Trustees or beneficiaries of a trust.
2. The above must result in a receipt or accrual of income or capital gain;
3. The purpose is to utilize the assessed loss.

Once the requirements have been met the assessed loss may NOT be used!

CASES:

New Urban Properties

Assessed loss was not carried forward as a requirement for an assessed loss to be carried forward that there has to be continuity of trade.

In this case the taxpayer carried on trade but did not carry in his traditional trading activities.

Glen Anil Development Corporation

The children of a township developer purchased shares of the holding company of a group of companies that had no assets other than assessed losses in Glen Anil.

The purpose was to reduce the taxpayers estate as well as liability for estate duty. A further result of this transaction was that undistributed profit tax could be saved and that there would be savings on normal tax available to the tax payer.

The court found that the taxpayer failed to discharge the presumption that the main purpose was to use the assessed losses as required by section 103(4).

Conshu (Pty) Ltd

There is no time frame which the provisions can be invoked.

STUDY UNIT :9

TAX ADMINISTRATION

INTRODUCTION

Previously tax practitioners relied on the income tax act that provides for the procedure that is to be followed when dealing with disputes and dispute resolution.

The Tax Administration Act of 2011 came into effect on the 01/10/2012 and please note that the provisions relating to interest is not yet in force.

The purpose of the Tax Administration Act was to consolidate all the various tax acts that deal with secrecy, search and seizure, object and appeal and tax collection process in one act to streamline and simplify tax administration matters.

It is important to note that in terms of section 4 of the TAA is that if there is a conflict with the TAA and any other Act the Income Tax act will prevail.

THE IMPORATANCE OF THE CONSTITUTION AND ADMINISTRATIVE LAW

Any decision that SARS make is essentially a decision made by an organ of the state and is subject to the provisions of the constitution as well as the promotion of administrative justice act (PAJA). Taxpayers have the rights conferred in the promotion of access to information act (PAIA).

When dealing with tax administration s195 of the constitution as well as the SARS service charter should be the first point of departure. These documentations prescribe the responsibilities and duties of SARS towards the taxpayer.

Pharmaceutical Manufacturing Association of SA:

The court dealt with the common law grounds of review and the constitution.

The following principles came to light:

- 1) Control of public power is always a constitutional matter;
- 2) There are two systems of law regulation administration that is common law and the constitution, where the latter is grounded.
- 3) Courts power to review administrative action is derived from PAJA and the constitution;
- 4) The common law informs the provisions of PAJA and the constitution, and derives its force from the constitution in section 33.

Just administrative action

in terms of section 33(1) of the constitution everyone is entitled to administrative action that is lawful and if anyone's rights have been adversely affected written reason is to be given in terms of section 33(2).

PAJA was enacted to give effect to these provisions.

The right to privacy

Section 14 of the constitution entitles everyone to the right of privacy which included the right not to have their person or home searched, their property searched or their possession seized, or privacy of their communication infringed.

However the commissioner's power of search and seizure can be limited in terms of section 36.

Case : *Mistry & Ferucci*

The right to equality

The right to equality is entrenched in section 9 of the constitution. Everyone is equal in front of the law and everyone is entitled to equal benefit and protection of the law. Section 9(3) prohibits the state from unfairly discriminating citizens on one or more of the grounds that are listed.

The question is whether the imposing of different taxes is vulnerable to constitutional attack under the equality clause. The answer will depend on the scope of the right to equality and the meaning of the concept of discrimination within this context, as interpreted by the constitutional court.

Limitation of fundamental rights

Any limitation needs to be done in accordance with section 36 of the constitution.

The section states that the rights contained in the bill of rights may be limited only in terms of the law of general application to the extent that the limitation is reasonable and justifiable in an open democratic society based on human dignity, equality and freedom.

POWERS AND DUTIES OF THE COMMISSIONER FOR SARS – SECTION 6 TAA

1. Obtain full information in relation to:
 - A taxable event;
 - Obligation of a person to comply with the tax act;
 - Anything that will effect a person liability of tax.
2. Ascertain whether or not a person has submitted the correct returns, information or document in terms of the tax act.
3. Establish the identity of the person to determine the tax liability;
4. Determine the liability for tax;
5. Collect tax and refund over paid tax;
6. Determine whether an offence has been committed in terms of the act;
 - Lay criminal charges;
 - And provide assistance in these charges
7. Enforce SARS powers and duties under the tax act;
8. Perform any other administrative function to carry out the provisions of the act;
9. Provide assistance under an international tax agreement.

REGISTRATION AS TAXPAYER, SUBMISSION OF TAX RETURNS AND RECORD KEEPING

Registration

A person needs to register themselves at SARS to be allocated as tax reference number within 21 days after becoming obliged to register.

Registration needs to be done at a local SARS branch. A completed application form as well supporting documents need to be handed in to be successfully registered at SARS

Once registered the following changes need to be updated at SARS once affected:

1. Postal and physical address;
2. Representative vendor;
3. Banking details for transacting with SARS;
4. Electronic address used for communication.

Returns:

Returns need to be completed and submitted on the correct form within the prescribed time as determined in the act. The taxpayer has to sign the form/ his representative. If the return is submitted via e-filing it's deemed to have been signed once submitted.

Third party returns:

The commissioner may request the following persons to submit a tax return:

1. A person who employs someone;
2. A person who pays amounts to another person;
3. A person who receives amounts on behalf of another person;
4. A person who otherwise transacts with another person.

Statement concerning accounts:

If a taxpayer submits financial statement or accounts done by his/ her book keeper SARS will request the taxpayer to submit a certificate or statement from the person setting out the following:

1. Extent of examination of the taxpayer's book of account;
2. The extent of the examination of the documents from which the taxpayer books of account were drawn up and;
3. Whether or not entries in the book of accounts and documents disclose the true nature of transactions, receipts or accruals, payments or debits in so far as may be ascertained from the examination.

Retention of records:

In terms of section 29 of the act the taxpayer needs to keep his records for a period of 5 years. The exception being the following:

1. If there is an audit, the audit has to be completed before documents can be destroyed;
2. Where a person has raised an objection or appeal on an assessment, records have to be kept until a decision has been made.

Documents needed to be kept have to original and sorted in an orderly fashion or any other method that the commissioner requests them to be kept in.

INFORMATION GATHERING

Inspection verification and audit

SARS can request for an audit or inspection which may include a random or risk assessment basis – s40. A SARS official may be requested by a senior official to conduct a field audit or criminal investigation. The SARS official that is involved in the audit must provide the taxpayer with feedback with respect to the audit completion stage.

Upon conclusion of the audit or criminal investigation, SARS must:

1. Where the audit was inconclusive, inform the taxpayer within 21 business days;
2. Where the audit identified potential adjustments of a material nature, provide the taxpayer with a document containing the outcome of the audit within 21 business days after the conclusion of the audit or investigation.

Referral for criminal investigation

A distinction needs to be drawn between a criminal investigation and a civil investigation. The main difference is the onus of proof.

Criminal investigation – SARS bears the onus that an offence has been committed

Civil investigation – Onus on the taxpayer that the correct amount has been paid. The taxpayer has to provide SARS with all requested information.

A serious tax offence suspect will be convicted:

1. To imprisonment exceeding two years without an option of a fine;
2. To a fine exceeding the equivalent amount of a fine under the adjustment of fines act.

Inspection

A SARS official may, for the purpose of the administration of the tax act and without prior notice may conduct an inspection on the premises where there is reasonable belief that a trade or enterprise is being carried to determine:

1. the identity of the person occupying the premises;

Whether such a person is registered for tax;

Whether the person retains records, books of accounts or documents in the forms as required by the act.

Request for relevant material – s46

SARS may require a taxpayer to submit “relevant” material to SARS as required. This must be done with reasonable specificity. A senior SARS official may further:

- Require relevant material from an objectively classifiable class of taxpayers;
- Direct that relevant material be provided under oath or solemn declaration;
- Request relevant material that a person has available for purposes of revenue estimation.

Production of relevant material – s47

The purpose of this request is that a person is interviewed by a SARS official concerning the tax affairs of the taxpayer, if the interview:

1. Is intended to clarify the issue concern for SARS to render further verification or audit unnecessary and;
2. Is not for purpose of a criminal investigation.

Field audit or criminal investigation - s48

A SARS official duly authorised to conduct investigation, verification or audit may request a person to make relevant material available at the person’s premises.

Such a request needs to be done at least 10 days prior notice. This request is done by notice, which must:

- State the place where, date and time that the audit or investigation is due to start and;
- Indicate the initial scope of the investigation.

Assistance during field audit or criminal investigation – s49

The person at whom premises and audit or criminal investigation is carried out is required to provide reasonable assistance to SARS. Eg: answer questions, make photo copies.

Inquiries

Where there are reasonable grounds to believe that a person has failed to comply with an obligation imposed under the tax act or the person committed a tax offence and relevant material is going to be revealed at an inquiry a judge may grant an order that a designated person acts as presiding officer at an inquiry.

The following incriminating evidence will be admissible at an inquiry:

1. The administering or taking of an oath or the administering or making of a solemn declaration;
2. Giving false evidence or making a false statement;

3. Failing to answer questions fully and satisfactorily that were lawfully put to a person.

Search and Seizure

SARS may search premises in order to seize relevant material that may provide evidence of a person's non-compliance with the tax act. as a general rule SARS has to get a warrant issued by a judge.

Under a warrant – s59-61

Premises would include buildings, aircraft, vehicle, vessel or place. In the above application SARS must set out facts that indicate that there are reasonable grounds to believe that:

- A person failed to comply with the act or committed a tax offence;
- Relevant material likely to be found that may provide evidence of failure of offence.

The warrant must contain the following:

1. The alleged failure or offence;
2. The person alleged to have failed to comply or to have committed the offence;
3. The premises to be searched;
4. The fact that relevant material is likely to be found on the premises.

When conducting the search SARS official may:

1. Open or remove anything which the official suspects to contain relevant material;
2. Seize any relevant material;
3. Where relevant material is on a computer or storage device it may be retained for as long as necessary;
4. Make extracts from or copies of relevant material.

Search of premises not identified in the warrant:

SARS may not enter premises that are not identified in the warrant, the exception being that there is reasonable belief that:

1. The relevant material included in the warrant that may provide evidence of the persons non-compliance or offence, is at the premises not identified in the warrant; the relevant material may be removed or destroyed;
2. A warrant cannot be obtained in time to prevent the removal or destruction, and
3. The delay in obtaining the warrant would defeat the object of the search and seizure.

Search without a warrant

SARS may only search a premises with the consent of the taxpayer and a senior SARS official is satisfied that:

- There may be an imminent removal or destruction of relevant material likely to be found on the premises;
- If SARS applied for a search warrant under the relevant empowering section of the act, a search warrant will be issued and;
- The delay in obtaining a warrant would defeat the object of the search and seizure.

Legal professional privilege – s64

This privilege refers to a person's privilege to refuse to disclose, and to prevent any other person from disclosing, confidential communications between the person and his attorney. Such privilege protects communications between attorney and client that are made for the purpose of seeking legal advice.

Where a claim of legal privilege is foreseeable, SARS must arrange for the attendance of an attorney before execution to determine whether certain documents are privileged or not.

ASSESSMENTS

Once a taxpayer submits a tax return, SARS will then process the information and issue an assessment. Once assessed SARS will then have to issue the taxpayer a notice of assessment which contains the following information:

1. The name of the taxpayer;
2. The taxpayers reference number;
3. The date of assessment;
4. The amount of the assessment;
5. The tax period in relation to the assessment;
6. The date for paying the amount assessed;
7. A summary of process with respect to lodging an objection.

The different types of assessment:

1. **Additional assessment** s92 – where the taxpayer believes that the assessment was not done with compliance of the act;
2. **Reduced assessment** s 93 – is raised under the following circumstances:
 - The assessment was disputed under the dispute resolution provisions;
 - The reduction is necessary to give effect to a judgment pursuant to an against the decision of the tax court;
 - Where there is an error in the return.

3. **Jeopardy assessment** s 94 – this is done prior to the date that a tax return is due if it is satisfied that such assessment is necessary to secure an amount of tax that otherwise be in jeopardy. Eg where a taxpayer is fleeing the country.

The taxpayer has the following remedies:

1. Amount assessed is too excessive;
 2. Circumstances that justify a jeopardy assessment does not exist.
4. **Estimated assessment** s 95 – this will be raised by SARS on their own and will occur when the taxpayer has failed to submit the return and information submitted is inaccurate or incomplete.

Withdrawal of an assessment

An assessment will be withdrawn under the following circumstances:

1. Assessment was issued to the incorrect taxpayer;
2. Assessment was raised for an incorrect tax period;
3. Assessment was issued with respect to an incorrect payment allocation

Limitation for issuing assessments:

SARS will NOT raise an assessment under the following circumstance:

1. Where 3 years have passed since the date of the original assessment;
2. In case of self-assessment a period of 5 years have passed since the date of the original assessment;
3. In case of a dispute that was resolved through the dispute resolution process.
- 4.

Finality of assessment – s100

The act provides that assessment becomes final after a certain event has taken place. NB to note that SARS may still raise an additional assessment.

An extension for an object/ appeal will not be granted:

1. If the taxpayer did not object;
2. Dispute was settled through the dispute resolution process;
3. After the objection the taxpayer did not file a notice of appeal;
4. Where an appeal has been determined by the tax court and there is no right to further appeal;
5. Where an appeal has been determined by the high court and there is no right to further appeal.

PAYMENT OF TAX

A tax payer is obliged to pay his tax liability on a specific date. SARS may however request that a taxpayer pay his debt at an earlier date.

In terms of **Metcash** a taxpayer has to pay his amount due to SARS even though he has lodged an objection / appeal and a decision has not been made.

WHO IS A TAXPAYER?

1. A person chargeable to tax;
2. A representative tax payer;
3. A withholding agent;
4. A responsible third party;
5. And a person who is subject of a request to provide information under an international agreement.

RECOVERY OF TAX:

1. Civil judgment;
2. Sequestration / liquidation proceedings;
3. Collection of tax by third parties;
4. A person who involved in the management of the taxpayers financial affairs;
5. Liability of shareholders.

PENALTIES:- noncompliance of payment

Where a penalty assessment has been raised SARS must provide the taxpayer with the following:

1. Details of non-compliance;
2. The amount of penalty imposed;
3. The date of payment;
4. The automatic increase of the penalty;
5. Summary of procedures for requesting remittance of the penalty.

Voluntary disclosure program

Where a tax payer has committed an offence or default he may approach to apply for voluntary disclosure relief and if successful SARS will not pursue and criminal prosecution.

Requirements:

1. Must be made voluntarily;
2. Involves a default that was not previously disclosed;
3. Be full and complete in all respects;
4. Involve the potential imposition of an understatement penalty in respect of the default;
5. Not result in refund due by SARS;
6. Be made in the prescribed form and manner

DISPUTE RESOLUTION

The onus of proof is on the taxpayer to prove the following:

- The amount is not taxable;
- An amount is deductible or may be set off;
- The rate in question applicable to a specific person;
- An amount qualifies for a reduction payable;
- The valuation is correct;
- Decision subject to appeal is incorrect.

STEP 1 – REASON FOR ASSESSMENT

A taxpayer can request reason for assessment within 30 days after the assessment has been raised.

STEP 2 – OBJECTION AGAINST THE ASSESSMENT

In this step the taxpayer lodges an objection with respect to the reasons of the assessment.

Requirements for an objection;

1. Must be lodged on the prescribed forms;
2. Done within the specified period;
3. Details on the grounds which it is made on;
4. The address of the taxpayer would like to receive notice;
5. Must be signed by the taxpayer;
6. Must be delivered to the commissioner.

STEP 3 – APPEAL AGAINST THE ASSESSMENT

At this stage the taxpayer can either accept or deny the objection raised. He can either proceed to alternative dispute resolution or litigate the matter to the tax/high court.

STEP 4 – ADR

- In his notice of appeal indicate that he intends to make use of the ADR process;
- Commissioner needs to confirm that this matter can be resolved through the ADR process;
- Commissioner can also propose that the ADR process should be used;
- Proceedings to take place within 20 days after the date of receipt of the notice of appeal;
- Proceedings need to be finalized within 90 days after the date of receipt of the notice of appeal;

STEP 5 – TAX BOARD

Hears matter that does not exceed R 500 000. Consist of a chairperson, SARS official and any member from the commercial community.

STEP 6: TAX/ HIGH COURT

Matter should first pass through the tax court and an appeal is then made to the high court.

REGISTRATION OF TAX PRACTITIONERS

Any person advising clients or the public on any aspect of the tax act has to be registered at SARS as a tax practitioner.

The following are exceptions:

1. A person who provides the advice or completes or assists in completing a document solely for no consideration to that person or his employer or a connected person in relation to that employer or person;
2. A person who provides advice solely in anticipation of or in the course of any litigation to which the commissioner is a party or where the commissioner is a complainant;
3. A person who provides advice solely as an incidental or subordinate part of providing goods or other services to another person.
4. A person who provides advice or completes a document solely to or in respect of the employer by whom that person is employed on a full time basis or to or in respect of that employer and connected persons in relation to that employer;
5. A person who provides the advice or completes or assists in completing a document solely under the direct supervision of a person who is registered as a tax practitioner.

Bibliography:

- ⇒ SILKE: SOUTH AFRICAN INCOME TAX 2013, Stiglingh et al
Published by LexisNexis.
- ⇒ UNISA Tutorial Letter 501/2013 for LML4804

Notes compiled and examples used from the above two sources.