TAX

PROFESSIONAL TAX ADVICE VITAL IN MITIGATION OF PENALTIES AND INTEREST

Judgment was handed down in the Tax Court on 18 November 2014 in the case of *Z v The Commissioner* for *for the South African Revenue Service* (case number 13472), as yet unreported.

The dispute concerned the calculation by the taxpayer of his capital gains tax liability arising pursuant to the disposal of shares. In 2007 the taxpayer disposed of his shares in a company for R841 million. In and around the time of the disposal of the shares, a company (A) instituted a damages claim against the taxpayer for an amount of R925 million which related to a transaction that took place in 2003. Shortly after the damages action was instituted, the taxpayer agreed to pay A an amount of almost R700 million in full and final settlement of its claim.

In determining his capital gains tax liability for the 2008 year of assessment, the taxpayer deducted a portion of the settlement amount paid to A from the purchase price received for the disposal of his shares, which the taxpayer regarded as his proceeds for purposes of paragraph 35 of the Eighth Schedule to the Income Tax Act No 58 of 1962 (Income Tax Act). The Commissioner of the South African Revenue Service (Commissioner) disagreed with the taxpayer's adjustment to the proceeds from the disposal of the shares and increased the proceeds by the portion of the settlement amount to arrive at the original proceeds of R841 million.

Various technical arguments were raised by the taxpayer as to why the proceeds from the disposal of the shares should be reduced by a portion of the settlement amount paid to A. However, the Court agreed with the Commissioner's findings that the inclusion of the full amount received by the taxpayer for the sale of the shares for the 2008 year of assessment is unassailable and the appeal must be dismissed.

The purpose of this article is not to discuss the technical arguments surrounding the application of paragraph 35 of the Eighth Schedule to the Income Tax Act. The interesting aspect of the case relates to the imposition of understatement penalties in terms of s221 of the Tax Administration Act No 28 of 2011 (TAA) and interest in terms of s89*quat* of the Income Tax Act (as it read at the time).

In the context of the understatement penalties imposed under the TAA, the Commissioner had imposed a penalty of R47 million on the basis of *"reasonable care not taken"* by the taxpayer or *"no reasonable grounds existing for the tax position taken".* The reasons cited by the Commissioner for reaching this decision was that *"the legislation and the facts are clear".*

The Court indicated that it was common cause that the TAA operates retrospectively and its provisions, including s270(6D) of the TAA, should apply. It appears that the question of whether these provisions of the TAA and the decision to impose such penalty may be unconstitutional and / or subject to an administrative review application were not dealt with by the Court. In any event, if these issues were to be raised it would most likely have to be dealt with in a separate application to the High Court.

The concluded that the taxpayer's conduct constituted a *"substantial understatement"* (as defined in the TAA) and the penalty falls to be reduced from 70% to 10%. In reaching this conclusion, we note that:

- the Court held at para 40 that it is of the view that *"having received advice, there were reasonable grounds for the appellant to take the tax position which is it did. Nor can it be said that he did not take reasonable care – he did so by consulting the experts"*;
- the Court referred to the Tax Court, in the United States of America case of *Estate of Spruill v Commissioner (88 TC 1197 (1987))*, which had to determine whether the fraud penalty was appropriately applied to an understatement of estate tax resulting from a large under evaluation of property. The valuation in turn was determined with the advice of an attorney and an accountant and was based on an independent appraisal. The court, in rejecting the penalty, had the following to say (88 TC 1197: 1245):

  "When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require a taxpayer to challenge the attorney, to seek a "second opinion", would nullify the very purpose of seeking the advice of a presumed expert in the first place. . . .'

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- the Court held that while s270(6D) of the TAA provides that in certain limited circumstances, a Senior South African Revenue Service official must, in considering an objection against the imposition of an understatement penalty, reduce the penalty in whole or in part if satisfied that there were extenuating circumstances, there was no evidence that there were extenuation circumstances which would warrant the reduction to below the understatement penalty.

If one has regard to how Wepener J has sought to apply the understatement penalty provisions in s221 and s270(6D) of the TAA, it is noted that:

- the Court firstly considered the taxpayer's behaviour against the understatement penalty percentage table in s223 of the TAA. Having regard to the penalty percentage table:
    - It was never contended that there was *"gross negligence"* or *"intentional tax evasion"* by the taxpayer.
    - On the basis that the taxpayer obtained professional advice, it was held that there were *"reasonable grounds for the tax position taken"* and it cannot be said that *"reasonable care was not taken in completing the return".*
    - The tax return contained a *"substantial understatement"* as defined and, as result of the other behaviours being excluded - the penalty of 10% was imposed.
- Only after the Court had tested the taxpayer's behaviour against the understatement penalty percentage table did it consider the application of s270(6D) of the TAA;
- It may be debatable whether the correct approach is to consider s270(6D) of the TAA on its own (i.e. without first having regard to the penalty percentage table). However, the approach adopted by Wepener J appears to be the most practical approach and avoids a judicial officer from having an unfettered discretion when making a determination as to the extent of the reduction of the penalty in terms of s270(6D) of the TAA (ie having regard to any extenuation circumstances).

In the context of the request for remission of penalties in terms of s89*quat* of the Income Tax Act (as it read at the time) it was also held that there is no reason not to find that the taxpayer's reliance on advice was reasonable and any interest must be waived in full. It must be appreciated that the wording of s89quat no longer refers to *"reasonable grounds"* being contended by the taxpayer. S89*quat* interest may not only be remitted in *"circumstances beyond the control of the taxpayer",* which is far narrower than the previous wording of s89*quat*.

These finding by Wepener J that having received professional advice it cannot be said that there are *"no reasonable grounds for the tax position tax"* nor can it be said that *"reasonable care [was] not taken in completing [a] return"* should assist taxpayers when objecting to any understatement penalties imposed in terms of the TAA.

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DRAFT RULING ON UNBUNDLING TRANSACTIONS

The South African Revenue Service (SARS) recently issued a draft Binding General Ruling (BGR) that addresses the interpretation of the words *"at the end of the day after that distribution"* as used in s46(3)(a)(v) of the Income Tax Act 58 of 1962 (Act).

Section 46 of the Act deals with unbundling transactions and provides parties to such a transaction with relief from various taxes that would otherwise become payable.
Section 46(1) in particular defines an unbundling transaction as any transaction in terms of which an 'unbundling' company transfers its full equity shareholding in an 'unbundled' company to its shareholders, in accordance with the effective interest held by the shareholders in the unbundling company.

In terms of s46(3)(a)(i)(aa) of the Act, where a shareholder acquires unbundled shares through an unbundling transaction, the shareholder must allocate a portion of the expenditure and any market value on valuation date attributable to the unbundling shares to the unbundled shares. In making this allocation, a formula is used.
Section 46(3)(a)(v) of the Act requires that the shareholder applies the ratio that the market value of the unbundled shares *"as at the end of the day after that distribution"*, bears to the sum of the market values of the unbundled and unbundling company shares.

In this regard it should be noted that there has been some confusion as to the interpretation of the requirement *"as at the end of the day after that distribution"*. Clarity was therefore needed on whether this requirement means at the end of the day on which the unbundling transaction occurs or whether this requirement refers to the following day after which the unbundling transaction occurs.

In applying s46(3)(a)(v) of the Act, it must first be indicated when the distribution of the unbundled shares occurs.
In applying the law, SARS has indicated that generally a distribution will occur when the shareholder becomes

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unconditionally entitled to the distribution, that is, when the distribution accrues to the shareholder. Having regard to the aforementioned, it should be noted that SARS has confirmed that the holder of the shares will become unconditionally entitled to a distribution under an unbundling transaction on the first day that the unbundling and the unbundled shares begin trading separately.

In light of the above, SARS ruled that for purposes of s46(3)(a)(v) of the Act and in relation to listed shares, *"as at the end of the day after that distribution"* means as at the end of the first business day after the last day to trade. This is essentially the first day on which the unbundling and unbundled shares begin trading independently of each other.

SARS further ruled that for purposes of s46(3)(a)(v) and in relation to unlisted shares, *"as at the end of the day after that distribution"* means as at the end of the day on which the shareholders become entitled to the distribution. In this regard it be noted that the day on which the shareholders of unlisted shares become entitled to the distribution will depend on the facts and circumstances of the particular case. Generally regard must be had to s59 of the Companies Act No 71 of 2008, which provides that the holders of unlisted shares would become entitled to a distribution on the date on which the distribution is approved by the board of directors unless the board has determined that the distribution will be payable to the shareholders registered in the company's register on a specified date, in which case it will be on that date. Regard must be had to the company's memorandum of incorporation and the relevant director's resolution.

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