TAX

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CAPITAL GAINS TAX DEFERRED

Put simply, capital gains tax (CGT) is levied on the capital gain arising on the disposal of an asset, that is, on the difference between the base cost of the asset and the proceeds accruing on disposal.

In terms of paragraph 35(4) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) when a person disposes of an asset during a current tax year and that person becomes entitled to any amount which is payable in future tax years, that amount is deemed to have accrued to that person during the current tax year. So, if the price of an asset is paid, say, in three equal instalments over three tax years, the person disposing of the asset must account for CGT on full price in the first tax year, that is, the year of the disposal.

That provision is perhaps inequitable as the cash flow does not follow the incidence of tax. Fortunately, there are some principles that mitigate the harsh effects of the rule.

First, it is trite that the rule will only apply to the extent that the person becomes unconditionally entitled to some or all of the proceeds; to the extent that the entitlement to future proceeds is conditional upon the happening of an event, the taxpayer would only need to account for CGT on the future proceeds if and when the event occurs.

Second, in terms of s24M(1) of the Act, to the extent that the proceeds on disposal of an asset will only be quantifiable at a future date, the taxpayer need only account for CGT when the amount becomes quantifiable. For example, if a person sells shares in a company on the basis that a part of the price will be determined with reference to the net profits of the company in a future tax year, then the person would only need to account for CGT in the future tax year when the amount becomes quantifiable.

Third, s24N of the Act provides that, if a person disposes of equity shares in a company for a quantified or quantifiable amount that only becomes due and payable in a future tax year, then the person need only account for CGT in a future year as and when it becomes due and payable, provided certain requirements are met. Notably, the provision only applies if the amount payable is determined with reference to the future profits of the company.

In the case of *Gani v Hassim; In re: East Coast Access (Pty) Limited v Gani* [2015] JOL 32843 (KZD), Mr Gani sold his shares in a company to Mr Hassim. The price of the shares was R5 million in aggregate. The evidence indicated that the parties agreed that Mr Hassim would not pay the price in a lump sum in year one, but in equal monthly instalments over three years with a 'bullet payment' of R2 million at the end of year three.

However, Mr Gani's accountant referred him to the provisions of paragraph 35(4) of the Eighth Schedule to the Act. The accountant advised Mr Gani that he would have to pay CGT in year one, despite the fact that he would only receive the price over a period of three years. The accountant, however, also informed Mr Gani that the principle would not apply if the receipt of the price was made subject to a condition, in which event he would only have to pay the CGT when the condition was fulfilled. For that reason the parties inserted a condition into the agreement between them to the effect that the price would only be paid if the company generated certain levels of profit.

A subsequent dispute arose between the parties. Mr Hassim alleged that, because the agreed profit levels were not attained, he was not obliged to pay Mr Gani the 'bullet payment' of R2 million.

The court found that "[t]he evidence and the probabilities… indicate overwhelmingly that the purpose of the condition regarding the profit target was to delay the payment by Mr Gani of capital gains tax. This was the evidence of Mr Gani and [the accountant], and also Mr Hassim. I do not accept the contention that the purpose of the condition was to ensure that Mr Hassim would be able to pay the entire purchase price out of the profit of the company. Its only purpose was to delay the payment of capital gains tax by bringing the agreement within the ambit of paragraph 13 of Schedule 8 [which relates to the timing of a disposal] or s24N of the Act."

The South African Revenue Service (SARS) may be interested in the finding of the court for the reasons that follow.

First, it is trite that if parties come to an agreement and do not really intend the agreement to have, as between them, the legal effect which its terms convey to the outside world, then the agreement is simulated, and a court will not give effect to the agreement *(Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd* 1941 AD 369). As Lewis JA said in the case of *Commissioner for the South African Revenue Service v NWK Limited* 2011 (2) SA 67 (SCA), "[i]f the purpose of the transaction is only to achieve an object that allows the evasion of tax…then it will be regarded as simulated".

In the *Gani* case the court found on the evidence that the sole purpose of the provision in the agreement was to make the payment of the 'bullet payment' contingent on the company achieving the relevant profit levels.

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DLA CLIFFE DEKKER HOFMEYR

If that provision was not meant to be binding between the parties (an issue which neither the parties nor the court canvassed) then the provision was simulated and should be disregarded for the purpose of determining the incidence of tax. If it is disregarded, then Mr Gani should have paid CGT on the full price at the time of the sale.

Second, in terms of s80B(1) of the Act, in the case where a taxpayer has entered into an impermissible avoidance arrangement, SARS has the power, among other things, to determine the tax consequences by disregarding any steps in, or parts of the arrangement. In terms of s80A of the Act, an arrangement that results in a tax benefit is an impermissible avoidance arrangement if the sole or main purpose of the arrangement was to obtain a tax benefit and, among other things, it lacks 'commercial substance'. Section 80C(1) of the Act states that an avoidance arrangement lacks commercial substance if, among other things, it results in a tax benefit for a party but does not have a significant effect on either the business risks or net cash flows of the party. In terms of the definition of tax benefit in s1, the postponement of any liability for tax is a tax benefit.

If the finding of the judge in the *Gani* case as to the evidence is correct then, arguably, the condition in the agreement, pertaining to the profit levels, having been inserted (according to the judge) only for the purpose of postponing the liability for CGT (a tax benefit), may be seen to be an impermissible avoidance arrangement because it had no effect on the net cash flows of Mr Gani.

In the *Gani* case the court held that the profit levels had been attained and that Mr Gani was, accordingly, entitled to the R2 million 'bullet payment'.

What the case illustrates is that parties to agreements that have the effect of deferring CGT should exercise great caution.

Ben Strauss

VAT TREATMENT OF SUPPLIES TO NON-RESIDENTS

On 30 March 2015 the tax court delivered judgment in the matter of *ABD CC v Commissioner for the South African Revenue Service.* The matter concerned the Value-Added Tax (VAT) treatment of the supply of goods and services to non-residents in circumstances where such goods and services are physically supplied to and consumed by a person within South Africa.

The vendor had certain agreements in place with foreign tour operators in terms of which the vendor would arrange tours in South Africa. The foreign tour operators, in turn, sold tour packages to their customers, who were foreign tourists wishing to visit South Africa.

The tour packages would ordinarily include accommodation, meals at restaurants, guided tours and excursions. The vendor entered into agreements with local service providers (hotels, restaurants, etc.) in order to procure these services for the foreign tour operators and ultimately the foreign tour operators' customers, being the tourists.

The local service providers invoiced the vendor for their services, and the vendor paid them. The vendor, in turn, invoiced the foreign tour operators for its services, and the foreign tour operators paid the vendor. The vendor accounted for VAT at the zero rate in respect of the services that it provided to the foreign tour operators on the basis that they were non-residents, and that s11(2)(l) of the Value-added Tax Act, No 89 of 1991 (VAT Act) applied.

Section 11(2)(l) of the VAT Act provides that:

"(2) Where, but for this section, a supply of services…would be charged with tax at the rate referred to in s7(1), such supply of services shall … be charged with tax at the rate of zero per cent where –

> (l) the services are supplied to a person who is not a resident of the Republic, not being services which are supplied directly –
>
> …
>
> (iii) to the said person or any other person, other than in circumstances contemplated in subparagraph (ii) (bb), if the said person or such other person is in the Republic at the time the services are rendered…"

The South African Revenue Service (SARS) did not agree that the supply of the services could be zero-rated in terms of s11(2)(l) of the VAT Act because, in its view, the vendor rendered services to the tourists while they were in South Africa, and the exclusion contained in s11(2)(l)(iii) of the VAT Act applied. SARS assessed the vendor accordingly.

The vendor objected to the assessment, but SARS disallowed the objection against the imposition of VAT and interest. The vendor then appealed to the Tax Court.

After analysing the relevant documentary and oral evidence, the court seems to suggest that the correct construction to be placed on the contractual relationships between the parties was that the local service providers supplied a service to the vendor, which enabled the vendor to supply a service to the foreign tour operators, and which in turn enabled the foreign tour operators to supply a service to its customers, being the tourists.

In other words, the foreign tour operators contracted the vendor to supply certain services, and the vendor sub-contracted the local service providers to actually render such

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services on behalf of the vendor. Similarly, the vendor could be seen as a sub-contractor of the foreign tour operators in respect of the foreign tour operators' obligations to its customers, being the tourists.

This is so even though the local service providers physically rendered the services to the tourists.

It was not the case that the vendor obtained a right to have services rendered from the local service providers, which it then ceded to the foreign tour operators.

It was also not the case that the vendor procured or arranged the services from the local service providers as agent for the foreign tour operators. The foreign tour operators and tourists had no direct contractual recourse against the local service providers in case of non-performance. Rather, the vendor acted in its own name when providing the services procured from the local service providers to the foreign tour operators.

The relevant service in this case is the service that is contractually rendered by the vendor to the foreign tour operators, which service is procured from the local service operators, who contractually supply services to the vendor, but physically render them to the tourists.

Generally, the supply of a service to a non-resident may be zero-rated in terms of s11(2)(l) of the VAT Act. However, the court summarised s11(2)(l)(iii) of the VAT Act to mean that "the supply of a service to a non-resident excludes the zero rating provisions <u>if a recipient of such service or any other person to who the service is rendered is in the Republic at the time the service is actually rendered</u>".

The court also noted that in its view, "s11(2)(l)(iii) seems specifically to envisage a situation where the service is supplied (ie contractually) to X but is physically supplied (ie rendered) to Y".

The argument was raised that the time of supply of a service in terms of the VAT Act is generally the earlier of when the invoice is issued or payment is received, and that at that time neither the foreign tour operators nor the tourists were in South Africa.

However, the court noted that s11(2)(l)(iii) of the VAT Act does not refer to the 'time of supply', but specifically refers to the 'time the services are rendered'. At the time that the services were physically rendered and consumed, the tourists were in South Africa.

Accordingly the court dismissed the appeal, and ruled that the services supplied by the vendor could not be zero-rated.

This case is important because it:

- reconfirms that VAT is destination based and is levied in respect of the consumption of goods and services in South Africa;
- illustrates how goods and services can legally or contractually be supplied to one party, but physically or directly be rendered to and consumed by another party; and
- makes it clear that services supplied to non-residents cannot be zero-rated where the person to whom it is legally or contractually supplied, or any other person to whom it is physically or directly rendered, is in South Africa at the time the services are actually rendered.

Heinrich Louw

CONTACT US

For more information about our Tax practice and services, please contact:

Emil Brincker
National Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@dlacdh.com

Andrew Lewis
Director
T + 27 (0)11 562 1500
E andrew.lewis@dlacdh.com

Ben Strauss
Director
T +27 (0)21 405 6063
E ben.strauss@dlacdh.com

Ruaan van Eeden
Director
T +27 (0)11 562 1086
E ruaan.vaneeden@dlacdh.com

Lisa Brunton
Senior Associate
T + 27 (0)21 481 6390
E lisa.brunton@dlacdh.com

Heinrich Louw
Senior Associate
T +27 (0)11 562 1187
E heinrich.louw@dlacdh.com

Tessmerica Moodley
Senior Associate
T +27 (0)21 481 6397
E tessmerica.moodley@dlacdh.com

Mareli Treurnicht
Senior Associate
T + 27 (0)11 562 1103
E mareli.treurnicht@dlacdh.com

Gigi Nyanin
Associate
T + 27 (0)11 562 1120
E gigi.nyanin@dlacdh.com

Nicole Paulsen
Associate
T + 27 (0)11 562 1386
E nicole.paulsen@dlacdh.com

BBBEE STATUS: LEVEL THREE CONTRIBUTOR

JOHANNESBURG
1 Protea Place Sandton Johannesburg 2196, Private Bag X40 Benmore 2010 South Africa
Dx 154 Randburg and Dx 42 Johannesburg
T +27 (0)11 562 1000 **F** +27 (0)11 562 1111 **E** jhb@dlacdh.com

CAPE TOWN
11 Buitengracht Street Cape Town 8001, PO Box 695 Cape Town 8000 South Africa
Dx 5 Cape Town
T +27 (0)21 481 6300 **F** +27 (0)21 481 6388 **E** ctn@dlacdh.com

cliffedekkerhofmeyr.com

DLA CLIFFE DEKKER HOFMEYR