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TAX AND EXCHANGE CONTROL ALERT

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THE KLUH-ED UP TAXPAYER WINS – A DECISION ON SECTION 26 OF THE INCOME TAX ACT

In its efforts to increase its income from tax revenue, the South African Revenue Service (SARS) sometimes applies legislative provisions in tax legislation in a manner that can best be described as tenuous. An example of this is apparent from the recent decision of the Supreme Court of Appeal (SCA) in *CSARS v Kluh Investments (Pty) Ltd* (115/2015) [2016] ZASCA 5 (1 March 2016).

THE COMPLEX WORLD OF HYBRID DEBT INSTRUMENTS: A RULING APPLICABLE TO NON-RESIDENT ISSUERS

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CLIFFE DEKKER HOFMEYR

THE KLUH-ED UP TAXPAYER WINS – A DECISION ON SECTION 26 OF THE INCOME TAX ACT

The SCA had to decide whether SARS's application of s26(1) of the Income Tax Act, No 58 of 1962 and paragraph 14(1) of the First Schedule to the Act was correct and whether income received within the context of these provisions was capital or revenue in nature.

Section 26(1) of the Act states that if a person carries on "pastoral, agricultural or other farming operations" the taxable income of that person shall be determined in accordance with the provisions of the Act, but subject to the provisions of the First Schedule.

In its efforts to increase its income from tax revenue, the South African Revenue Service (SARS) sometimes applies legislative provisions in tax legislation in a manner that can best be described as tenuous. An example of this is apparent from the recent decision of the Supreme Court of Appeal (SCA) in *CSARS v Kluh Investments (Pty) Ltd* (115/2015) [2016] ZASCA 5 (1 March 2016).

In this case, the SCA had to decide whether SARS's application of s26(1) of the Income Tax Act, No 58 of 1962 (Act) and paragraph 14(1) of the First Schedule to the Act was correct and whether income received within the context of these provisions was capital or revenue in nature. The decision was heard on appeal from the Western Cape High Court in *Kluh Investments (Pty) Ltd v Commissioner, South African Revenue Service* 2015 (1) SA 60 (WCC), which we reported on in our Tax Alert of 12 September 2014 (Keeping the lid on Pandora's box). The taxpayer appealed the Tax Court's decision, which found in favour of SARS. The High Court overturned the Tax Court's decision, prompting SARS to appeal to the SCA.

Section 26(1) of the Act states that if a person carries on "pastoral, agricultural or other farming operations" the taxable income of that person shall be determined in accordance with the provisions of the Act, but subject to the provisions of the First Schedule. Paragraph 14(1) of the First Schedule states that "any amount received by or accrued to a farmer in respect of the disposal of any plantation shall, whether such plantation is disposed of separately or with the land on which it is growing, be deemed not to be a receipt or accrual of a capital nature and shall form part of such farmer's gross income".

Facts

During May 2001, Steinhoff agreed to purchase the forestry, timber-growing and plywood manufacturing business of Thesen as a going concern, including the land and plantation. However, Steinhoff's ultimate holding company blocked the acquisition of the land and plantation as it was, at the time, not their policy to acquire fixed property in South Africa. Steinhoff then agreed to purchase only Thesen's machinery and equipment including the sawmill, and the taxpayer - a special purpose vehicle of a Swiss company - agreed to acquire the remaining assets, which included the land and plantation, and took possession thereof. However, Steinhoff then changed its mind and in 2004 purchased the taxpayer's plantation business. Approximately 90% of the purchase price was in respect of the plantation and the seller realised a significant capital gain of about R45 million. SARS treated this amount as gross income, in terms of s26(1) of the Act, read with paragraph 14(1) of the First Schedule.

Judgment

As there is no definition of 'farming operations' in the Act, determining whether a person's economic activity constitutes farming operations is essentially a question of fact. The SCA found that the approach adopted by the High Court in this regard

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SARS argued that the purpose of paragraph 14(1) of the First Schedule is to extend tax liability by treating the proceeds of the disposal of a plantation as gross income.

was confusing, in that the facts should be taken as they stand and should be applied to the provisions of the statute. The relevant facts in this regard are as follows:

- Steinhoff owned the equipment necessary for conducting the farming operations and employed the employees who worked on the plantation, whereas the taxpayer owned no equipment and had no employees and therefore did not receive any operational income between the acquisition and disposal of the plantation.
- In terms of the oral agreement concluded between Steinhoff and the taxpayer in 2001, Steinhoff had to conduct the plantation operations so that it could restore the plantation to its June 2001 state, if the arrangement between it and the taxpayer came to an end. In light of this obligation, it obtained insurance for the plantation against fire.
- From the very beginning, the taxpayer did not want anything to do with any farming operations and the whole "*raison d'etre*" of the taxpayer's involvement was to acquire bare ownership of the land and plantation, which Steinhoff was prevented from doing.

The SCA then considered the arguments raised by SARS. Firstly, SARS argued that the purpose of paragraph 14(1) of the First Schedule is to extend tax liability by treating the proceeds of the disposal of a plantation as gross income. The SCA stated that the word 'farmer' in paragraph 14(1) "is clearly a short-hand for a person carrying on farming operations as contemplated in s26(1)". This means that the carrying on of farming operations in terms of s26(1) is necessary for the First Schedule and the deeming provision in paragraph 14(1) to apply. The word 'farmer' in paragraph 14(1), a deeming provision, could not be used, as suggested by SARS, to determine whether the taxpayer was a 'farmer' or conducting farming operations in terms of s26(1). Therefore, the SCA rejected SARS's argument.

Secondly, SARS argued that the mere disposal of the plantation by the taxpayer, as owner of the land, constituted the conduct of operations in terms of s26(1), despite it not being involved in the operations on the land. The SCA found that this argument could be misleading and that paragraph 14(1) recognises that the disposal of a plantation is not a *per se* farming operation. This is evident from paragraph 14(1), which contemplates that the proceeds of the disposal of a plantation are ordinarily capital in nature even where the taxpayer is a farmer and for this reason then deems it to form part of gross income. SARS conceded that its argument would only hold water if the word 'farmer' were substituted with the word 'taxpayer' in paragraph 14(1), which the court could not do. This argument was thus also rejected.

Finally, SARS argued that the farming operations were conducted by Steinhoff on behalf of the taxpayer. The SCA held that even if Steinhoff in some sense acted on behalf of the taxpayer, the taxpayer did not have the right to the yield of the plantation, and the use of the land and the plantation, nor did it derive any income

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The SCA rejected SARS's appeal and dismissed it with costs, including the costs of two counsel.

from the land and the plantation. These rights were granted to Steinhoff, which it exercised and which received income from it. Only Steinhoff could thus be regarded as a 'farmer' in relation to the taxpayer's plantation. The only risk that the taxpayer faced was that the value of its investment in the land might suffer, similar to the risks faced by a landlord or bare *dominium* owner if the tenant or usufructuary breached its obligations. The SCA thus also rejected SARS's argument on this point.

Conclusion and comment

The SCA rejected SARS's appeal and dismissed it with costs, including the costs of two counsel. The decision highlights the fact that in interpreting and applying tax legislation, the courts will look at all the facts before it and will not be misled by SARS's arguments, especially when they are aimed at unjustifiably increasing the revenue collected by SARS. In the past week, SARS announced that for the first time in its history, it had collected in excess of R1 trillion in tax revenue for a fiscal year, being the 2015/2016 fiscal year. If SARS thus wishes to increase the tax net and its tax revenue, it needs to amend the existing legislation, at the risk of increasing taxpayers' already heavy tax burden.

Louis Botha and Heinrich Louw

THE COMPLEX WORLD OF HYBRID DEBT INSTRUMENTS: A RULING APPLICABLE TO NON-RESIDENT ISSUERS

Section 8F of the Income Tax Act, No 58 of 1962 (Act) was introduced to draw a distinction between debt and equity for tax purposes.

Section 8F intends to counter tax avoidance by ensuring that equity is not disguised as debt.

On 1 March 2016, the South African Revenue Service (SARS) issued Binding Private Ruling 225 (Ruling), dealing with the dividends tax consequences for a non-resident issuer of hybrid debt instruments.

By way of background, according to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 (Explanatory Memorandum) s8F of the Income Tax Act, No 58 of 1962 (Act) was introduced to draw a distinction between debt and equity for tax purposes. The section was further introduced to limit the deductibility of interest by persons other than natural persons in respect of hybrid debt instruments which are debt in legal form, but have sufficient equity features to place them clearly at the equity end of the debt/equity spectrum.

As set out in the Explanatory Memorandum, s8F intends to counter tax avoidance by ensuring that equity is not disguised as debt. An example of such an instrument would be an interest-bearing debenture which allows the holder thereof to convert the debenture into an ordinary share of the company that issued the debenture. To further the aim of preventing equity from being disguised as debt, s8F(2) deems any interest incurred by a company in respect of a hybrid debt instrument, after it becomes a hybrid debt instrument, to be a dividend *in specie* declared and paid by the company on the last day of its year of assessment, which is not deductible in terms of the Act. The person to whom the interest accrues in respect of the instrument, is deemed to receive a dividend *in specie* on the last day of the company's year of assessment.

Description of the transaction

In the Ruling, a non-resident company that does not have a permanent establishment in South Africa (Applicant) sought clarity on the application of s8F, s64D and s64EA of the Act, in the event that it issues secured and unsecured interest bearing notes (SA Notes) that will be listed on the interest rate market of the JSE. The terms of the SA Notes will, amongst others things, specify an interest rate payable in respect of the SA Notes, and that the obligation of the Applicant to make payments in respect of the SA Notes is conditional upon the market value of the Applicant's assets being equal to or greater than its liabilities.

The salient terms of issue of the SA Notes are as follows:

- They will constitute unsubordinated and unsecured obligations of the Applicant and will rank *pari passu* amongst themselves and equally with all other like obligations of the Applicant.

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SARS ruled that the SA Notes will constitute instruments and hybrid debt instruments for the purposes of s8F.

- They will be denominated in Rand.
- Interest will be payable quarterly in arrears.
- The interest rate in respect of each issue of SA Notes will either be a floating rate or a rate calculated with reference to an index or a rate calculated with reference to a basket of financial instruments. Interest payable on a floating rate will be limited to the income derived on the corresponding income investment made by the Applicant in respect of that SA Note.
- The maturity date of the SA Note will be either five or six years after the date of issue.
- The redemption amount will be equal to the subscription price of the SA Note.
- The SA Notes are issued subject to early redemption provisions following the occurrence of events specified in the pricing supplement.
- The holders of the SA Notes will have no voting rights.

The Applicant indicated that it would use the proceeds of the SA Notes to invest in non-South African debt instruments, index-tracking instruments or other financial instruments in respect of which the Applicant will receive income. There will be no direct or indirect re-investment into South African assets.

Ruling

SARS ruled that the SA Notes will constitute instruments and hybrid debt instruments for the purposes of s8F. The interest payments made by the Applicant in respect of the SA Notes will be deemed to be dividends *in specie* declared and paid by the Applicant on the last day of its year of assessment as contemplated in s8F(2). Furthermore, dividends tax will not be payable by the Applicant in respect of the interest paid on the SA Notes which have been deemed payments of dividends *in specie*. This is because s64EA(b) states that dividends tax is only payable by the issuer company on the distribution of an asset *in specie* if it is made by a resident company. There is also no duty on the beneficial owner to pay withholding tax as s64EA(a) exempts the beneficial owner from this liability where the dividend consists of a distribution of an asset *in specie*.

The ruling is valid for a period of three years from 2 February 2016.

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