



TAX ALERT

THE APPORTIONMENT CONUNDRUM

The judgment

On 15 March 2010, the Gauteng South Division Tax Court delivered its judgment in respect of Case No. 12 401. The Court found that 50% of the taxpayer's audit fees incurred for the 2001 to 2004 years of assessment were tax deductible. The remainder of the audit fees were not allowed as a deduction, having not been incurred in the production of the taxpayer's income. The judgment also dealt with the capital nature of expenses incurred in respect of professional fees, but this article does not aim to focus on that element.

In essence, the taxpayer (a wholly owned subsidiary of a public listed company) acts as intermediate holding company of a number of wholly owned and indirectly held subsidiaries. The collective business operations of the group subsidiaries consist of the operations of mobile communication networks as well as providing and performing certain services in relation thereto. The taxpayer holds its interest in the group subsidiaries as investor on capital account (thereby earning dividends on its investment in the subsidiary companies) and facilitates the lending of funds within the group (earning interest on such monies lent).

The general deduction formula

In terms of the general deduction formula, expenditure, which is actually incurred by a taxpayer in a specific year of assessment, is tax deductible if incurred in the production of the taxpayer's income, is of a revenue nature and is laid out for the purposes of the taxpayer's trade.

Income referred to "*in the production*" of income requirement refers to income that is of a "*taxable*" nature (such as rentals and interest income). Expenditure incurred in the production of exempt income, such as dividends, will thus not be deductible

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being not incurred for the purpose of producing income of a taxable nature. The "*in the production of income*" requirement, is repeated in the guise of section 23(f) of the Income Tax Act which holds that expenses incurred in order to derive an amount which does not constitute income, that is the amount that remains after deducting exempt income from gross income, will not be allowed as a deduction.

In deciding whether expenditure is incurred in the production of the taxpayer's income, relevant considerations are (a) the purpose with which the expenditure is incurred and (b) what the expenditure actually effects (*CIR v Nemojim (Pty) Ltd*, 45 SATC 241). It has also been enunciated in case law, that it is not a requirement that income actually be produced, provided that the expenditure is incurred for the purpose of producing income (*Sub-Nigel Ltd v CIR*, 15 SATC 38).

Where a taxpayer thus incurs expenditure with a dual purpose, for instance, to derive exempt income and interest income, an apportionment of such expenditure may be required. It must further be appreciated that an apportionment of expenditure is only necessary where a need for such apportionment exists. Separately identifiable amounts incurred for different purposes do not require to be apportioned as their deductibility can be judged on their individual merits. It is only when a single indivisible expenditure stream has been laid out for more than a single purpose that the requirement for a possible apportionment may arise.

As to the method of apportionment, no hard and fast rule exists, and the courts have set out various formulae in order to arrive at a fair apportionment. For instance, one appropriate method of apportionment may be in the ratio that the "*income*" bears to the total receipts and accruals (eg. *CIR v Rand Selections Corporation Ltd*, 30 SATC 390 and *CIR v Nemojim*, 45 SATC 241), or in the ratio that the capital invested in the operations earning the non-taxable profits bears to the total capital invested (ITC 832 supra and ITC 1017, 25 SATC 337). However, it is not always possible to devise a fair and reasonable apportionment formula, nor is it necessarily possible to break down the expenditure into deductible and non-deductible components, and another apportionment basis must be found (refer *Tuck v CIR*, 49 SATC 28).

Audit fees, apportionment, and holding companies

Although certain recurrent business expenses such as audit fees are strictly not necessarily concerned with the production of the taxpayer's income (they are more closely linked to the taxpayer's

income-earning structure) SARS' practice, as set out in Practice Note 22, will generally allow a deduction thereof. The Practice Note also sets out that an apportionment is required where that taxpayer receives "*taxable*" and "*exempt*" income streams.

The apportionment problem of the recurrent and other overhead expenditure incurred by investment companies (such as the taxpayer) manifests itself in the case that the recurrent expenditure cannot be applied to a specific and identifiable purpose. Instead, the expenditure is incurred for the "*benefit*" of the company's investment business as a whole, and not in respect of a particular class of income stream.

A simple example can be illustrated by way of the judgment reach in ITC 832, 21 SATC 320 which dealt with management expenses incurred by taxpayer whose assets consisted partly of equity investments (in the form of shares) and partly of interest-producing loans. The court found that the fact that no dividends were declared in respect of the equity investments did not alter the fact that the taxpayer incurred the expenditure in order to yield dividend and interest income. The judgment thus upheld Revenue's apportionment methodology in the same ratio as the capital invested in the loan to a subsidiary company bore to the sum of the capital so invested and the capital invested in shares of subsidiary companies.

In the matter at hand, SARS refused the taxpayer's apportionment of its audit fees, which was based on 'time spent' by the auditors in respect of a particular class of income stream. The taxpayer based its reasoning on the fact that approximately 6% of the auditors' time was spent in respect of dividend income (even though on average 95% of its total income was derived from dividends). The taxpayer contended that far more time was spent by the auditors related to the verification of interest income.

Conversely, SARS' view was based on its contention that an appropriate apportionment should purely be based on income streams - that is the total dividend income stream calculated as a percentile of the total income generated by the taxpayer.

The court held that neither the taxpayer's nor SARS' method was acceptable to it. The court's view was supported by an erstwhile audit partner (that acted as witness) which stated "*...an audit is not made up of distinct measurable units. The biggest work in the 2006 audit related to the consolidation of accounts. An audit fee is not based only on time. It is not determined solely in accordance with the charge-out rates of the various persons performing the audit. The risk involved and the complexity of the audit are also taken into account.*"

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As none of the apportionment methods was acceptable to it, the court had to decide on a basis, which in its view would be fair and reasonable. The court thus ruled that a 50/50 apportionment of the expenditure concerned was just and equitable. The reason for its decision was that such apportionment will recognise not only the greater importance of the audit for the dividend earning operations, but also the longer time spent by the auditors on the interest earning operations of the taxpayer.

A quick look at the different views held

In commenting on the different apportionment views submitted by the court, SARS, and the taxpayer, it seems as if the 50/50 apportionment reached by the court was arbitrary, and it did not consider a more justifiable method.

The view expressed by SARS was limited in the sense that no "*matching principle*" or direct link existed between expenditure incurred in terms of the audit fees paid and the receipt or accrual of the various income streams of the taxpayer. Audit fees are primarily based on time spent during the audit, also taking into account audit risk and complexity (as submitted by the witness). Unless SARS could substantiate its argument that the majority of the audit activities related to the taxpayer's dividend income earning activities, such argument could not be supported.

The taxpayer submitted that approximately 6% of the auditors' time during the audit was spent on activities relating to the "*dividend income streams*", and that far more time was spent on "*interest earning activities*". A criticism of the taxpayer's argument is that it seems to be purely based on time spent, and that it did not take the other overall audit procedures that did not relate to the interest and dividend activities into account. The taxpayer may have been more successful if such analysis was performed. For instance, audit activities that related to the verification of the two income streams could be apportioned on time spent as the correctness of those income streams must be verified. Any of the audit activities that cannot be directly attributed to the income streams (that is the balance of the time spent on the overall audit) may require a different apportionment method. The case only dealt with the apportionment of audit fees, and not other overhead expenses such as salaries or rentals paid. If these types of expenses had been incurred, the question is whether they would have been apportioned on the same basis? It would depend on the facts, for example, salaries paid to people forming part of the finance department would be dependent on their job description. If their work relates exclusively to the "*interest income portfolio*", a full deduction should be available. Conversely, if their work relates exclusively

to the share portfolio, a deduction may well not be available. Insofar as the payment of rentals is concerned, income streams are not the only consideration, as head count and floor space must be factored into a possible apportionment methodology.

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THE DEFY CASE REVISITED

We have previously discussed the court's findings in favour of SARS in the matter of *Defy v SARS [2010] ZASCA 11* relating to whether a portion of the monies distributed by Defy to its shareholders constituted 'profits of a capital nature', eligible for exemption under section 64B(5)(c)(ii) of the Income Tax Act, 1962 (the Act).

The purpose of this article is not to reconsider the judgement delivered as a whole but to rather consider certain (ancillary, but still important) issues that the court touched on in delivering its judgement.

Nature of STC?

Readers will recall that the court had to essentially deal with matters relating to the imposition of Secondary Tax on Companies (STC). In delivering its judgement the court noted that "*[i]t is important to bear in mind that STC is a withholding tax. The tax is levied upon a declared dividend and the burden of the tax will naturally be borne by the recipient of the dividend. The company merely withholds the tax at its source and pays it to the Commissioner.*"

This statement is, with respect, incorrect. STC is not withholding tax on dividends, but a tax levied on a company in declaring dividends. As an example, if this were not the case STC would have been subject to the withholding tax regime governed by double taxation agreements and the STC rate could be reduced in terms of double taxation agreements concluded between South Africa and foreign countries. This principle was confirmed in the matter of *Volkswagen of South Africa (Pty) Ltd v C: SARS 70 SATC 195* where the court found that STC was not tax on dividends or taxation of dividends but rather a tax imposed on the company declaring the dividends and hence STC was outside the ambit of Article 7 of the relevant double taxation agreement (the article dealing with the taxation of dividends in states and applicable reduction in the tax rate on such dividends).

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In contrast to STC the new proposed Dividend Tax will take the form of a tax on shareholders, with a withholding obligation being placed on the declaring company, and certain exemptions being afforded (based mainly on the status of the shareholder). It is with the introduction of Dividend Tax and the attendant change in taxpayer liability in mind that South Africa has undertaken a review of its double taxation agreements and new agreements are being negotiated. Consequently due to double taxation agreements referring to recipients of dividends and not to the company declaring the dividend and the benefits conferred therein are enjoyed by the recipients of the dividends and not the company declaring the dividends, the relief provided in double taxation agreements will be available only once Dividend Tax is implemented.

Blanket penalty imposition?

The Act contains various provisions aimed at firstly preventing and secondly penalising errant taxpayers from failing to adhere to their tax obligations. However, does this mean that SARS is afforded a blanket right to impose such penalties without having regard to the specific facts? The court in the Defy case felt it does not. The court submitted that it is important to ascertain whether a taxpayer has properly interpreted a statute or provision, and if such proper interpretation leads to a certain effect, SARS cannot feel aggrieved even if it does not agree with the result. Put differently, a taxpayer cannot be regarded as having acted improperly merely because it construed a provision in a certain manner - if it honestly believed that its construction and application of the provision is correct, it cannot automatically be penalised even if it is later found that the taxpayer was in fact incorrect in its interpretation or it leads to an (unintended) benefit. Hence, even though the court found that Defy had incorrectly regarded a portion of the dividend as a capital profit, and sought to deduct the incoming exempt dividend as a tax credit as well (the so-called 'double favourable treatment'), the court did not attribute any improper conduct to it as Defy merely applied the provisions in the manner provided for, albeit incorrectly insofar as the capital profit element was concerned. The court thus submitted that the taxpayer could not be prejudiced or penalised purely on the basis of the legislation going against SARS.

Interpreting the law - the purposive approach?

An interesting issue that was touched on by the court pertains to the interpretation of statutes, although the court only made a brief reference thereto. Essentially the court had difficulty in agreeing with the lower court's contention that "...a construction of the parts

of a statute can produce one result but a construction of the sum of its parts can produce another." This statement is a direct consequence of the Tax Court's purposive approach utilised in coming to its decision.

The purposive approach has been applied from time to time by the courts in recent years, most notably in *CSARS v Airworld CC and another 70 SATC 48*. In the Airworld case the court stated that the interpreter had to seek to arrive at an interpretation that gave effect to the purpose with which the legislature had enacted provisions under review and the purpose would be applied together with the fitting meaning of the language of the provision, as a guide in order to ascertain the legislator's intention.

Essentially the lower court in the Defy matter found that the amount distributed to Defy was in fact a capital profit and exempt as purported by Defy, but concluded further that Defy's interpretation of the statute was incorrect. The lower court did not agree with the 'double favourable treatment' Defy's interpretation resulted in - ie. that the amount will benefit from an exemption in Defy Appliances (the subsidiary), a further exemption in Defy and a deduction (as a STC credit) in Defy as well. It was stated that the section read as a whole does not mandate such favourable treatment. Accordingly Defy failed in its appeal to the lower court as the court, despite regarding the distribution as capital profits, employed a purposive approach by regarding the 'double favourable treatment' utilised by Defy in its calculations, as inconsistent with the purpose of the legislature in drafting the section (Defy could not obtain a benefit twice).

The Supreme Court did not agree and used the classical approach to the interpretation of tax legislation by looking at the precise wording of the legislation and only in the face of absurdity considering the intention of the legislature. It stated that a statute is policy translated into law and that it was not up to the court to either fill in the detail or rewrite the statute. Therefore, it confirmed Defy's view that the 'double favourable treatment' was in fact provided for in the Act but still found against Defy based on its conclusion that the amounts did not represent 'profits of a capital nature'.

The result of the Supreme Court reverting to the classical approach is that (tax) courts are now once again bound to this method of interpretation and taxpayers and practitioners should take heed thereof in attempting to interpret the tax law.

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Profits of a capital nature - other than by disposing of an asset?

Counsel for Defy attempted (albeit unsuccessfully) to argue that the exemption found in section 64B(5)(c)(ii) of the Act allowed for a profit of a capital nature being earned other than by the disposal of an asset. The court regarded that there can be no capital profit if there is no disposal of a capital asset. Is the court's view strictly correct?

The general definition of the Act defines a 'dividend' as an amount distributed by a company to its shareholders. The word 'amount' is not defined but the courts have previously found that it includes not only cash but also anything with an ascertainable money value. Essentially then a dividend is a distribution (normally in cash but sometimes in specie) to shareholders of part or all of a company's profits. A profit available for distribution is, it is submitted, an accounting or business concept. The Act provides further that for purposes of the dividend definition the term 'profits' refers to both realized and unrealized profits of a company, whether of a capital or revenue nature, and irrespective of whether or not those unrealized profits have been recognised in the financial records of the company (readers should note that this provision was not included in the legislation applicable at the time material to the Defy case). As an example - if a company re-values an asset and then distributes the ensuing profit to its shareholders, the dividend calculation should account for the unrealised profit attributable to the asset, even though the profit is an unrealised profit.

It would thus not be inconceivable to have a situation that where a company has reserves available for distribution, and it makes an unrealised profit, the company could distribute an amount to its shareholder, which amount would be regarded as a dividend, and if such amount was distributed *'in the course or in anticipation of the liquidation or winding up or deregistration'* of the company, the company could claim the exemption under section 64B(5)(c)(ii) of the Act, subject to the unrealised profit emanating from a capital asset. It is thus submitted that based on the current dividend definition and the reference to 'realised and unrealised profits', the court could have come to a more favourable conclusion in the Defy case.

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A WARNING TO EMPLOYEES' TAX EVADERS

The recent decision in *Crabbe v United States (Case No. 08-1393)* where a business owner, Mr William Crabbe, was convicted of multiple counts of failure to pay over payroll taxes and filing false returns, highlights the need for employers to be on top of their game when it comes to PAYE compliance. The Minister of Finance in his 2010 budget speech also made it abundantly clear that tough action will be taken on firms who are not PAYE compliant.

Many employers in South Africa are unaware that SARS has the power to hold directors and shareholders, who control or are regularly involved in the management of a company's overall financial affairs, personally liable for PAYE, additional tax, penalties and interest. This means that shareholders and directors could also face criminal sanctions.

This article looks at the basis for Mr Crabbe's convictions and compares it to similar powers available to SARS in the Income Tax Act 58 of 1962.

Facts of the case

Mr Crabbe was the part owner of Columbine Healthcare Inc (CHI) whose business was to provide nurses to healthcare facilities on a short term basis. He held the position of Vice President and apart from a limited day to day role had no managerial duties. The nurses entered into contracts with CHI and were placed with healthcare facilities based on specific needs. CHI entered into agreements with the healthcare facilities and in turn compensated the nurses on a negotiated hourly rate. As an employer, CHI was responsible for all employment, federal and state withholding taxes of the nurses.

During 1999 Mr Crabbe became aware that CHI had not paid or submitted the required payroll tax returns to the IRS. Instead, it became apparent that these funds were being siphoned by Mr Crabbe's business partner in CHI for personal use. Mr Crabbe then sought to retain a tax attorney who advised him that CHI must stay up to date with all payroll tax filings and pay all outstanding amounts as they could afford them. At this time, and with the possibility of diminishing CHI's payroll tax liability, Mr Crabbe explored the possibility of treating the nurses as independent contractors. Mr Crabbe was advised by corporate officers of CHI that treating the nurses as independent contractors was not a viable option.

At the end of 1999 CHI again fell behind in settling its ongoing payroll tax liabilities. In 2000 Mr Crabbe, without the knowledge of his business partner, opened a separate bank account (of which he was the sole signatory) intended to be used for settling the outstanding tax liabilities. In 2001 Mr Crabbe set about preparing

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all of CHI's delinquent payroll tax returns (IRS 941) which now spanned two years. Mr Crabbe prepared the outstanding returns and took it upon himself to file them with the IRS. Upon submission of the delinquent returns, Mr Crabbe omitted to complete the "number of employees" field and testified that the payments made were only in respect of CHI's corporate employees and did not include any of the nurses.

In the latter part of 2001 Mr Crabbe continued to file returns, only now it included the number of CHI corporate employees (21 to 31), but again failed to declare the nurses which he admitted at the time of filing was over 100. In October 2002 a financial officer of CHI informed Mr Crabbe of the omissions on the payroll tax return relating to employee numbers. During 2003 the IRS became aware of CHI's non-compliance and instituted criminal proceedings against the company and its officers. In August 2004, after being made aware of the criminal investigation, Mr Crabbe re-submitted returns spanning 1999 to 2002 which now reflected the correct number of employees (including nurses) and tax liabilities.

Despite the compliance efforts of Mr Crabbe he was convicted of ten counts of failure to pay over payroll taxes and six counts of filing false tax returns. The court found that there was a substantial amount of evidence to conclude that the nurses were employees and not independent contractors and that Mr Crabbe was the "responsible person" for purposes of filing payroll taxes and wilfully violated his tax duties as required by the IRS.

Comparison with position in South Africa

Paragraph 2(1) of the Fourth Schedule places an obligation on an employer who pays, or becomes liable to pay amounts by way of "remuneration", to deduct or withhold PAYE, unless the Commissioner has granted authority to the contrary. PAYE deducted must then be remitted to SARS within seven days after the end of the relevant month in which it was deducted or withheld.

The correct amount of PAYE is always due by operation of law at the time remuneration is paid. This is clear from paragraph 4 of the Fourth Schedule which makes any amount "...required to be deducted..." a debt due to the State and, read with paragraph 5 of the Fourth Schedule makes an employer personally liable for amounts which should have been deducted or withheld.

If, for example, a South African employer fails to withhold and pay over PAYE on independent contractors, as was the case in Crabbe, SARS would hold it liable for payment under paragraph 5(1) of the Fourth Schedule. However, to criminally charge an employer for not withholding PAYE, as required under paragraph 2(1) of the Fourth Schedule, it has to be regarded as an offence.

Any person liable to pay remuneration who fails to withhold or pay over PAYE as and when required is guilty of an offence under paragraph 30(1)(a) of the Fourth Schedule. It is further an offence where a person uses amounts deducted as PAYE for any purpose other than payment to SARS as required (paragraph 30(1)(b) of the Fourth Schedule. This would be the case where an employer deducts PAYE from salaries, submits an EMP201 return, but never pays the amount over to SARS.

But what about submitting an incomplete EMP201 return to SARS, such as the omissions by Mr Crabbe relating to employee numbers? Paragraph 30(1)(i) of the Fourth Schedule makes it an offence where any person fails or neglects to maintain records as required under paragraph 14 of the same Schedule. More specifically, paragraph 14(2) of the Fourth Schedule dealing with EMP201's state that every employer must submit "...to the Commissioner such declaration containing such information as the Commissioner may prescribe...". EMP201's (prior to March 2010) contained specified fields for employee numbers relating to PAYE, Skills Development Levies and Unemployment Insurance Fund contributions. By omitting to complete the field or misrepresenting the actual number of employees could result in an employer not providing all the information prescribed by the Commissioner and therefore committing an offence under paragraph 30(1)(i) of the Fourth Schedule. Post 1 March 2010 this is less of a concern as the new EMP201 declarations do not require employee numbers to be disclosed to SARS.

The tools to criminally charge a South African employer in a similar vein to that in Crabbe are available to SARS - the question is whether SARS will look to institute criminal proceeding where an employer subsequently settles all delinquent tax liabilities as was the case with Crabbe. Despite settling all of CHI's tax liabilities one gets the distinct feeling that in the Crabbe case the IRS wanted to make an example of him. The same cannot be said for SARS yet, however, given the statements made by the Minister of Finance in his 2010 budget speech it may just be a matter of time before a similar case finds its way to our courts.

Personal liability

The fact that Mr Crabbe was criminally charged was based, *inter alia*, on the fact that he was regarded as the "responsible person" for purposes of US tax law. The Court in Crabbe held that a person is regarded as being responsible under US tax law if he or she "...has significant, though not necessarily exclusive, authority in the general management and fiscal decision making of the corporation..." In this context a non-exhaustive list of factors were considered such as whether the person held corporate office, controlled financial affairs, had authority to disburse corporate funds, owned stock and had the ability to hire and fire employees.

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In a South African context the issue of personal liability is dealt with under paragraph 16 of the Fourth Schedule. From 1 March 2004 shareholders and directors, in the case of an employer that is a company, can be held personally liable under paragraph 16(2C) of the Fourth Schedule -

"where an employer is a company, every shareholder and director who controls or is regularly involved in the management of the company's overall financial affairs shall be personally liable for the employees' tax, additional tax, penalty or interest for which the company is liable." (own emphasis)

Paragraph 16(2C) of the Fourth Schedule should not be of concern, provided the company is in a position to settle all amounts arising from non-compliance. Should a company not be able to settle the liabilities then, as long as it remains unpaid, SARS would be entitled under paragraph 16(2C) to recover the unpaid tax from those persons whose duties bring them within the ambit of this liability. The South African approach appears to be narrower than that used in the Crabbe case as the Fourth Schedule only refers to overall financial affairs, whereas the US courts include general management in addition to fiscal decision making.

The use by the legislature of expressions such as 'controls', 'regularly', 'involved' and 'overall' is singularly unhelpful. There is neither a test of what constitutes control nor any formula for making such a determination. Because of the elusive nature of the concept 'regularly involved in the management of the company's overall financial affairs', it is not clear whether shareholders, by virtue of being shareholders are liable. The shareholders normally appoint the directors at a general meeting, who then undertake the management of the company. In this respect there is a definite demarcation of responsibility between the directorate and shareholders. But as always the question whether a person controls or is regularly involved in a company's overall financial affairs will be based on the facts of each case.

In Crabbe the court found sufficient indicia of fiscal responsibility because Mr Crabbe had some control over CHI's financial affairs as demonstrated by his unilateral establishment of a bank account

and had the authority to distribute corporate funds as demonstrated by his signing of corporate cheques. The implications of paragraph 16(2C) of the Fourth Schedule are far reaching where a specific person is targeted by SARS under this provision. Once the personal liability tag is placed on a specific person, and an act or omission falls within paragraph 30 of the Fourth Schedule, SARS may pursue criminal proceeding similar to that in the Crabbe case.

Clause 172 of the draft Tax Administration Bill (TAB) also makes provision for the personal liability of any person (not only shareholders or directors) who controls or is regularly involved in the management of the overall financial affairs of a taxpayer. The difference between the TAB, in its current form, and paragraph 16(2C) of the Fourth Schedule is that the personal liability is subject to the discretionary powers of a senior SARS official who must be satisfied that there was an element of negligence or fraud. It remains to be seen how these two clauses will interact with one another once the TAB is promulgated.

Conclusion

Where an employer fails to pay the correct amount of PAYE as and when required it is an offence under the provisions of the Fourth Schedule. This applies equally where an employer fails to properly complete and submit an EMP201 return or misrepresents information required by SARS on a return. In the case of a company, shareholders and directors could find themselves personally liable for PAYE debts including possible criminal sanctions.

The Crabbe case highlights the risks faced by employers when it comes to PAYE compliance, especially where a tax authority has the power to pierce the corporate veil and target business owners in their personal capacity. It is therefore important that people responsible for financial affairs at companies are aware of their obligations as it relates to PAYE compliance. Employers, on the other hand, must ensure that PAYE compliance forms part of an overall solid tax risk management strategy.

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