DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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HIGH COURT INTERPRETS NWK JUDGMENT

Judgment in the case of *Mariana Bosch and Ian McClelland v Commissioner for the South African Revenue Service (case no A94/2012)* was handed down on 20 November 2012 by a full bench of the Western Cape High Court.

The main judgment was written by Davis J (Baartman J concurring) and a separate judgment was written by Waglay J. The matter was on appeal from the Tax Court.

The appellants were employees of the Foschini group of companies and participants in an employee share incentive scheme run by that group. The appellants were assessed by SARS for income tax in respect of shares received in respect of the scheme.

The type of scheme was what is referred to as a 'deferred delivery scheme'. In essence, employees were granted options to purchase shares, which they had to exercise within 21 days. Once the option was exercised, delivery and payment in respect of the shares were delayed and would take place in three tranches, each two years apart. Before delivery and payment, the employees could not dispose of or encumber the shares, were not entitled to dividends and could not vote the shares. The risks and benefits did not pass to the employees until delivery and payment.

The scheme was subject to a stop loss provision, which provided that employees could sell their shares back to the employer if the share price fell below the consideration that was payable on delivery. Further, employees were also obliged to sell their shares back to the employer for the same consideration payable on delivery if they terminated their service for any reason other than sequestration, death, superannuation, or ill health.

The effect of the scheme was that the provisions of s8A of the Income Tax Act No 58 of 1962 (Act) were bypassed. Only gains arising within the 21 day option period would be caught by s8A and be taxable as income in the hands of the employees, as opposed to the full gains over the longer periods until delivery and payment.

One of the arguments raised by SARS was that the scheme was a simulated transaction and that there was no real unconditional sale at the time of exercise of the option, but that the parties actually intended that the sale be subject to the suspensive condition that the employees remain employed until the date of delivery and payment. This was evidenced by the fact that an obligation to sell the shares back to the employer arose where an employee's employment is terminated. SARS relied on *Commissioner for the South African Revenue Service v NWK Ltd 2011 (2) SA 67 (SCA).*

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The court took the opportunity to analyse the *NWK* judgment. Davis J states that in the *NWK* case the court was faced with what was clearly a simulated transaction, illustrated by the facts. The parties had not created genuine rights and obligations but simulated a loan that was for a larger amount than it actually was, only to allow the taxpayer to get a tax benefit. Davis J further makes the following important remark:

> "Beyond this finding, there is nothing in the careful judgment of Lewis JA which supports the argument that the reasoning as employed in NWK was intended to alter the settled principles developed over more than a century regarding the determination of a simulated transaction for the purposes of tax."

Davis J then goes on to say that the *NWK* judgment needs to be read within the context of previous decisions on simulation such as *Commissioner for Customs and Excise v Randles, Brothers and Hudson Ltd 1941 AD 369, Zanberg v van Zyl 1910 AD 302 and Erf 3138 / Ladysmith (Pty) Ltd v CIR 1996 (3) SA 942*. This is so to ensure that "the body of precedent is read coherently rather than NWK as being an unexplained rupture from more than a century of jurisprudence."

Davis J interprets the test in respect of simulation as laid out in *NWK* as being that the commercial sense of a transaction needs to be examined. Where the form of a transaction attempts to present a commercial rationale, but there is no commercial rationale, and the sole purpose of the transaction is to avoid tax, then the approach taken as in *NWK* is justified. The court seems to suggest that there must firstly be an agreement that purports to have a commercial rationale and secondly, there must in fact be no commercial rationale, such as the one purported, but some other purpose such as tax avoidance (ie something other than what is purported), before it can be said that there is simulation. The fact that a transaction aims to achieve the avoidance of tax does not as such make it a simulated transaction.

Davis J concludes the analysis of *NWK* by stating that, since there is no express declaration in the judgment that it departs from previous jurisprudence, it should be interpreted "to fit within a century of established principle, rather than constituting a dramatic rupture." On the evidence Davis J found that there had been no simulation.

In a separate judgment, Waglay J differed from Davis J in his interpretation of the *NWK* case. Waglay J states that the *NWK* judgment does depart, and dramatically so, from the case law on simulated transactions.

Waglay J interprets the *NWK* as laying down the rule: "any transaction which has at its aim tax avoidance will be regarded as a simulated transaction irrespective of the fact that the transaction is for all purposes a genuine transaction."

Waglay J, however, is of the view that the *NWK* judgment does not constitute binding precedent that lower courts have to follow. For a judgment to form a binding precendent it must be "clear and unequivocal, it must be plain, unmistakable and explicit in its rejection of previous judgments which it seeks to reverse." The rejection of the previous judgments do not have to be express, but it must be clear from the reasoning.

In the judge's view the *NWK* judgment does not provide any reasons as to why it departs from previous judgments. He also states that the problem is "compounded by the troubled equivalence in the judgment of the phrases 'tax avoidance' and 'tax evasion' two very distinct concepts."

The judge notes that the *NWK* judgment cannot be authority for setting aside a transaction as simulated if the aim of that transaction is tax evasion because tax evasion is a criminal offence and stands to be set aside automatically by virtue of the fact that it is unlawful.

If the *NWK* judgment is authority for setting aside a transaction as simulated where the aim of the transaction is tax avoidance, then it goes against established law, which in principle allows transactions that avoid tax.

Waglay J therefore seems to suggests that the uncertainty and confusion in addition to the lack of reasons indicates that the judgment cannot be used as a precedent that is binding on the lower courts.

SARS's argument as to simulation was rejected. For this and other reasons the appeal was upheld.

Heinrich Louw

'ORDINARILY RESIDENT' - A TAXING QUESTION

Paul Simon wrote the song 'Homeward Bound' while sitting at Widnes Station in Liverpool. It was recorded in December 1965 and peaked at number five on the Billboard Hot 100.

The song described Simon's longing for his girlfriend Kathy Chitty, who lived in London – but also for home in the USA. The chorus goes:

> "Homeward Bound
>
> I wish I was
>
> Homeward Bound
>
> Home, where my thought's escaping
>
> Home, where my music's playing
>
> Home, where my love lies waiting
>
> Silently for me"

Although Paul Simon's lyrics are far removed from the world of tax they are remarkably instructive when it comes to the meaning of 'ordinarily resident' for tax purposes.

The concept of 'ordinarily resident' is not defined in SA tax law. One therefore has to look to cases like *Cohen v CIR 1946 AD 174, 13 SATC 362 and CIR v Kuttel 1992 (3) SA 242 (A), 54 SATC 298* for guidance. In the Cohen case Schreiner JA held that "... ordinary residence would be the country to which [a man] would naturally and as a matter of course return from his wanderings". In the Kuttel case Goldstone JA found that "a person is 'ordinarily resident' where he has his usual or principal residence, that is, what may be described as his real home." [The SARS approach to 'ordinarily resident' is found in Interpretation Note No 3 of 4 February 2002.]

The purpose of this article is not to revisit the residence principles found in SA precedent. It is rather to alert SA taxpayers to recent developments in the UK with regard to the meaning of 'ordinarily resident' and what it really takes to sever the ties that bind.

The recent UK Supreme Court case of *R (Davies and another) v HMRC; R (Gaines-Cooper) v HMRC [2011] UKSC 47* undertook an authoritative analysis of the issue of residence in the UK for tax purposes. The question in relation to both Davies and Gaines-Cooper was whether said taxpayers had become non-resident for UK tax purposes. Davies and James (the first appellants) had moved into furnished Brussels apartments during 2001 but retained their respective homes in Swansea where they frequently visited their families, albeit for relatively short periods. There also were UK visits to oversee their joint business interests and they retained their links to Swansea Rugby Football Club. The second appellant Gaines-Cooper testified that he in 1976 (at age 39) had acquired a domicile of choice in the Seychelles from where he led 'an international existence'. Despite such international existence he spent about three or four months each year in the UK where he had successively maintained substantial homes in Berkshire and in Oxfordshire.

In respect of Davies and James the HMRC asserted that they had "... failed to establish the necessary distinct break with family and social ties in the UK." In *Gaines-Cooper's* case the Special Commissioners found, by looking at the overall position, that England remained the 'centre of gravity of [*Gaines-Cooper's*] life and interests'.

In the end all three appellants were unsuccessful before the Supreme Court in challenging HMRC's view of them being tax-resident in the UK during the relevant years of assessment. The majority judgment of the Supreme Court (leading judgment by Lord Wilson) held that "... in order to become non-resident in the UK ... the ordinary law requires the UK resident to effect a distinct break in the pattern of his life in the UK. The requirement of distinct break mandates a multifactorial inquiry." The concept 'distinct break' was explained as: "The distinct break relates to the pattern of the taxpayer's life in the UK and no doubt it encompasses a substantial loosening of social and family ties ... 'severence' of such ties is too strong a word in this context." Following the judgment of the Supreme Court it was clear that someone claiming non-resident status in the UK for tax purposes needed to prove a 'substantial loosening of social and family ties' – however, it was not required that such ties be severed completely.

The extent to which 'loosening' of social and family ties must happen to achieve non-resident status is evident from the UK case *Lynette Dawn Yates v HMRC [2012] UKFTT 568 (TTC)*. Ms Yates was born in England in 1955. She married and lived in the UK with her husband. Because she suffered severely from Gaucher disease she moved to the southern coast of Spain in 2000. This was to benefit from the warm dry climate in that part of Spain. Her move to Spain was supported by a Professor Cox who had treated her since 1993. Having first rented a three-bedroom apartment

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Ms Yates soon purchased her own apartment during 2003. It is said that "Ms Yates was able to feel at home there." Due to UK business commitments her husband was not able to join her in Spain. Ms Yates therefore made quite lengthy trips to the UK and visited regularly when her father was diagnosed with cancer. She was in the UK over Christmas for the years 2003 – 2006. Under cross-examination she said she felt it was important to be with her family at Christmas. In 2008 she returned to live permanently in the UK since she felt her relationship with her husband was suffering from their separation.

A CGT dispute arose and the question was whether Ms Yates had been 'ordinarily resident' in the UK during the relevant years? Ms Yates claimed that there was a distinct break in her pattern of life when she went to Spain in 2000.

Judge Walters QC delivered the decision of the First-Tier Tribunal. He specifically applied the 'multifactorial inquiry' laid down by Lord Wilson (see above). Judge Walters held: "The inquiry required is 'essentially one of evaluation'. It looks to what the taxpayer actually does or does not do to alter his or her life's pattern. The taxpayer's intention is relevant to the inquiry but is not determinative. What is being examined is the quality of the taxpayer's absence from the UK."

It was submitted before the First-Tier Tribunal that, since 2000, Ms Yates "home and settled life was in Spain and not in the UK." It was argued that her "... social life in the UK ceased and she continued her life in Spain as it was in the UK."

Judge Walters found the opposite: "I was not persuaded that Ms Yates had created for herself a Spanish-based social life that in any way excluded or replaced her UK-based connections. I attach importance to her repeated return trips to the UK at Christmas (in the winter months) and the evidence of her close family ties ... the evidence from the phone bills of the telephone calls she made reinforced my impression that her most substantial social ties were with English people, whether in England or in Spain". The bottom-line: "For these reasons I find that the quality of Ms Yates's absence from the UK was not such as to support the conclusion that she had made a distinct break in the pattern of her life for the purpose of relinquishing her status as UK resident and ordinarily resident."

In addition to scrutinising Ms Yates's social and family ties, the First-Tier Tribunal also considered the following factors under the 'multifactorial inquiry':

- She remained on the local Kingston Hall electoral role in the UK.
- Her mail came to the UK family home and was then on-sent to her in Spain.
- She kept her UK bank accounts and credit cards - furthermore, they showed substantial activity.
- She continued receiving an UK disability living allowance – she never informed the Department of Pensions of her move to Spain.
- She used her UK dentist and came to the UK for medical treatment.
- Certain personal belongings were left at the UK family home.

The capital gains were accordingly held to be taxable in the UK.

SARS's Interpretation Note No 3 does not mention the concept of 'distinct break' as applied in the UK. It does state: "The purpose, nature and intention of the taxpayer's absence must be established to determine whether a taxpayer is still ordinarily resident." Where someone is ordinarily resident is a question of fact. In answering that question SARS could well take into account the various factors considered in Ms Yates's instance.

Local high net worth individuals are sometimes advised 'to formally emigrate', both for Exchange Control and tax purposes. The aim is to achieve the expatriation of their wealth from SA and to become non-resident for SA tax purposes.

Any SA taxpayer seeking to become non-resident should take note that the paper work (such as Exchange Control form M.P. 336(b)) is quite important. Even more important is that, having become non-resident, such taxpayer should live his or her life accordingly.

To become 'non-resident' (wink wink) and to live as if nothing has changed could have significant tax risks.

Johan van der Walt

PROPOSED CHANGES TO VAT LEGISLATION FOR VENDORS PURCHASING FIXED PROPERTY FROM NON-VENDORS

Where a vendor purchases fixed property from a non-vendor, the vendor is required to pay transfer duty as opposed to value-added tax (VAT).

The transfer duty is calculated on the purchase price of the property, or the fair market value thereof, whichever is the higher. If the vendor purchases the fixed property for the purpose of making taxable supplies, such as the supply of commercial accommodation, the vendor is entitled to a notional input tax credit on the basis that the fixed property is viewed as second-hand goods.

Prior to 10 January 2012, the amount that a vendor could claim as a notional input tax credit was limited to the amount of transfer duty paid by the vendor on acquisition of the fixed property. For example, where a vendor purchased fixed property from a non-vendor for a purchase consideration of R5 million and paid transfer duty of R317,000, the vendor was allowed an input tax credit limited to R317,000.

According to Treasury, the input tax credit ceiling was arguably unfair as generally it meant that the notional input credits allowed did not fully compensate the vendor for most or all of the VAT paid by previous owners. As a result, on 10 January 2012, legislative amendments were introduced to delink VAT and transfer duty. The definition of 'input tax' in s1 of the Value-Added Tax Act, No 89 of 1991 (Act) was amended to eliminate the transfer duty ceiling and to subject the acquisition of fixed property from non-vendors to largely the same rules applicable for the claiming of notional input tax credits in respect of other second-hand goods.

Following the amendment, the notional input tax deduction is calculated with reference to the tax fraction (14/114) applied to the lesser of any consideration in money given by the vendor for the fixed property or its open market value. Applied to the above example, the amendment results in the vendor being entitled to an input tax credit of R614,035 (R5,000,000 x 14/114) as opposed to the amount of transfer duty paid (R317,000).

Where, however, a vendor purchases fixed property otherwise than for the purpose of making taxable supplies, no input tax credit is allowed under the Act. An example is where the vendor purchases the fixed property for private use, another where the fixed property is purchased for the supply of residential accommodation (an exempt supply). If the vendor subsequently changes the use to which the fixed property is put and applies the property in the course of making taxable supplies (eg by letting the property as commercial accommodation), the fixed property will be deemed to have been supplied to the vendor (s18(4) of the Act). As a consequence of the deemed supply, the vendor is entitled to a VAT input tax credit.

But, despite the amendment to the definition of 'input tax' in s1 of the Act, Treasury did not, ostensibly as a result of an oversight, make the corresponding amendments to the change in use adjustment provisions in s18 (read with s16) of the Act by removing the transfer duty ceiling. The unfortunate but clearly unintended result is that a vendor who subsequently applies the property in the course of making taxable supplies will only be entitled to an input tax credit of the amount of transfer duty paid. This inconsistency results in the prejudicial treatment of vendors who purchase fixed property from a non-vendor but are only subsequently entitled to an input tax deduction arising from a change in use of the property.

Fortunately, the Taxation Laws Amendment Bill of 2012 addresses this anomaly by removing the transfer duty ceiling in the context of a vendor who purchases fixed property and does not immediately use the property for the purpose of making taxable supplies but later has a change in intention. It is noted that the proposed amendment will have retrospective effect to 10 January 2012, thus ensuring that the said oversight does not operate to the prejudice of unsuspecting vendors.

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