DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

30 November 2012

IN THIS ISSUE

AVOIDANCE AS ACCEPTED PRACTICE

Judgment was handed down in the important case of *Bosch and McCleland v Commissioner for the South African Revenue Service* on 20 November 2012 by a full bench of the Western Cape High Court (a case we have previously reported on).

Davis J (Baartman J concurring) wrote the main judgment while Waglay J wrote a separate judgment.

The court was confronted with the question of whether a sale coupled with a resale provision, in the context of an employee share incentive scheme, was simulated. SARS relied on the decision in the case of *Commissioner for the South African Revenue Service v NWK Ltd 2011 (2) SA 67 (SCA)* to argue that the sale and resale structure was in reality a conditional sale. SARS argued that there was no commercial purposes or reason for structuring the transaction as a sale coupled with a resale provision, as opposed to a conditional sale, other than to avoid tax (in this case to avoid the application of s8A of the Income Tax Act to the full gain in respect of the scheme shares).

The decision in the *NWK* case was handed down by Lewis JA on 1 December 2010 and has since been the cause of much debate and confusion as to its impact and what the current position is regarding simulation and the structuring of transactions in tax efficient ways.

The root of the debate and confusion is that Lewis JA has seemingly replaced the trite principles and practice regarding simulation and avoidance with a new rule. In addition, there is uncertainty as to what exactly the new rule is. Also, if there is a new rule, does the departure from the established legal principles undermine the rule of law?

The most pertinent issues concerning the *NWK* judgment have been pointed out by Eddie Broomberg in his paper entitled 'On NWK and Founders Hill', a paper to which both Davis J and Waglay J refer in their judgments.

He notes that "the bedrock common law principle that applies in South Africa is more than familiar: A transaction will not be regarded as simulated if the parties genuinely intended that their contract will have effect in accordance with its tenor, and that rule applies <u>even if the transaction is devised solely for the purpose of avoiding tax….</u>" This rule had been established by our courts in a string of cases such as *Zandberg v van Zyl 1910 AD 302*, *Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd 1941 AD 369*, *Erf 3183/1 Ladysmith (Pty) Ltd and another v CIR 58 SATC 229* and *CIR v Conhage (Pty) Ltd 61 SATC 391*.

Broomberg also notes that this conforms to SARS's own established practice and application of the legal principles as is evident from Practice Note 5, dating from 1987, which states that "A taxpayer who has carried out a legitimate tax avoidance scheme, i.e. who has arranged his affairs so as to minimise his tax liability, in a manner which does not involve fraud, dishonesty, misrepresentation or other actions designed to mislead the Commissioner, will have met his duties and obligations under the Act…."

continued

Broomberg suggest that it is difficult to determine what exactly the new rule is because, on reading the *NWK* judgment, a clear distinction is not always drawn between the terms 'evasion' and 'avoidance'. He further suggests that the new rule laid down by Lewis JA is: "If the purpose of the transaction is only to allow the avoidance of tax then the transaction will be regarded as simulated."

Davis J seems to disagree that a new rule was established by the Supreme Court of Appeal (SCA), even though that has been the popular interpretation of the of the *NWK* judgment. He states that: "Broomberg thus views *NWK* as a new and unjustified rule which replaces the previous jurisprudence. In my view, without an express declaration to that effect, *NWK* should be interpreted to fit within a century of established principle, rather than constituting a dramatic rupture."

The reason given by Davis J for the view that *NWK* has not "replaced previous jurisprudence" is that Lewis JA does not expressly state that she is departing from established principles.

It would seem as if Davis J sees the principle established in the *NWK* judgment as being that the lack of commercial rationale coupled with the purpose of tax avoidance can be an indicator of simulation. For there to be simulation, there must be some underlying understanding between the parties that differs from the purported agreement, and that underlying understanding may very well be the avoidance of tax.

Waglay J differs from Davis J on the point of whether *NWK* established a new rule, and agrees with Broomberg's suggestion that there has been a fundamental departure from established law practice. Waglay J interprets *NWK* as laying down the rule that: "any transaction which has as 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 then picks up on the issue of the rule of law also identified by Broomberg. Waglay J's point is essentially that a judgment such as *NWK* that is the cause for so much confusion, uncertainty and debate, cannot stand as binding precedent. This is specifically so where there is an established body of law and the judgment in question appears to depart from that body of law, but does not demonstrate clearly that there is such a departure nor provides reasons as to why the established law is no longer appropriate. The implication is that the *NWK* judgment is simply too vague or unclear to be followed by the courts.

It is interesting to note that Waglay J also specifically mentions, as does Broomberg, that if the new rule establishes that any transaction that has as its aim the avoidance of tax (as opposed to evasion) is a simulated transaction, then it "goes against the accepted practice in our income tax law which permits transactions aimed at tax avoidance."

It is anticipated that the case will go on appeal to the Supreme Court of Appeal and it will be interesting to see whether that court will agree with Davis J's approach of reading *NWK* as being consistent with established law.

Heinrich Louw

'BREAK FEE': CAPITAL OR REVENUE?

A break fee is a fee paid by a target company to bidders, during an acquisition, if the pending deal is terminated.

The Canadian Federal Court of Appeal (FCA) was recently tasked with deciding whether a 'break fee' received in return for withdrawing from a take-over bid was an income or capital receipt.

The case of *Morguard Corporation v The Queen 2012, TCC 55*, was an appeal from the assessment made under the Canadian Income Tax Act RSC 1985 (CITA) that the break fee received by the Appellant taxpayer constituted a revenue receipt.

The Appellant was a Canadian public corporation. The Appellant and its affiliates were in the automotive parts and industrial products distribution business. After many years, it decided to exit the business, selling its automotive holdings for cash and using the cash proceeds to acquire control and ownership positions in a number of real estate companies that owned and managed residential and commercial rental properties. The Appellant started to implement its business strategy by acquiring controlling positions in a number of real estate companies.

continued

After numerous successful take-over bids, in June 2000, the Appellant launched an unsuccessful take-over bid for a corporation known as Acanthus Real Estate (Acanthus). During negotiations it lost the target in its take-over battle and as a result, sold nearly 20% of its previously acquired position in Acanthus. It received a $7.7 million break fee, as per the amending agreement to a pre-acquisition agreement signed between the Appellant and Acanthus.

The issue before the court was whether the break fee received by the Appellant in respect of its unsuccessful acquisition, should be characterised as an income receipt or capital receipt. The Appellant argued that the break fee should be classified as a non-taxable capital receipt. The counsel for the Crown argued that the break fee was an integral part of, and received in the ordinary course of, the Appellant's commercial business operations, thus constituting a revenue receipt.

The court turned to the FCA case of *The Queen v Cranswick*, [1982] 1 F.C. 813, 82 DTC 6073, in order to determine whether the break fee constituted a windfall capital receipt that was not subject to tax. Applying the seven factors elucidated in this case, the court found that there is no doubt, having considered and balanced the factors in *Creswick*, that the Appellant did not receive a non-taxable windfall.

Secondly, the court considered the question of capital versus revenue. From the outset the court acknowledged that Canadian law, not unlike its South African counterpart, does not recognise a single infallible test in determining the capital or revenue nature of a receipt.

The court emphasised the necessity of considering decisions handed down in previously decided cases dealing with essentially similar payments. Applying this principle, the court based its decision mainly on the *Ikea Limited v Canada [1998] 1 S.C.R. 196, 98 DTC 6092* case, which effectively found that the issue to be decided is whether the amount received is linked to the capital purpose or whether the receipt was a necessary incident of the conduct of the Appellant's business. In the present instance, the court found that the break fee was an amount received in the course of the Appellant's business, commercial activities and its chosen business structure and strategy in a similar way as dividends, rent or management fees may be received.

The court further acknowledged that it is settled under the modern Canadian view of characterising business income, that break fees are ordinarily deductible business expenses to the payor. Therefore what needs to be addressed is whether such fees constitute ordinary business income to the recipient. This then, is clearly addressed through the application of the principles in the Ikea case mentioned above.

In applying the abovementioned principles, the court concluded that the break fee had become an integral, if perhaps secondary purpose, of the pre-acquisition agreement and the subsequent renegotiation agreement, thus rendering it a receipt of a revenue nature.

Nicole Paulsen and Danielle le Roux

DLA CLIFFE DEKKER HOFMEYR

CONTACT US

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

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

Alastair Morphet
Director
T +27 (0)11 562 1391
E alastair.morphet@dlacdh.com

Andrew Seaber
Senior Associate
T +27 (0)11 562 1768
E andrew.seaber@dlacdh.com

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

Heinrich Louw
Associate
T +27 (0)11 562 1085
E heinrich.louw@dlacdh.com

Johan van der Walt
Director
T +27 (0)11 562 1177
E johan.vanderwalt@dlacdh.com

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

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

Carmen Moss-Holdstock
Associate
T + 27 (0)11 562 1614
E carmen.moss-holdstock@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