DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

7 September 2012

IN THIS ISSUE

- **Tax evasion: blame it on the bean counters ... or not??**
- **Limitation of taxing rights on pension income under the United States / South Africa tax treaty**

TAX EVASION: BLAME IT ON THE BEAN COUNTERS... OR NOT??

South African tax cases abound with examples where taxpayers shrug their shoulders and point to their (often erstwhile) accountants when accused of tax evasion: "The bean counter is the cause of all the tax trouble...". The intent to evade, negligence or incompetence are pinned solely on the accountant that failed to accurately file the tax return from all relevant, readily available information.

KBI v Mabotsa 55 SATC 98 set the principle that it's the taxpayer's obligation to ensure that his accounting records and tax filings are done by an appropriately qualified person. In *ITC 1576 56 SATC 225*, the Tax Court held that the intent of the taxpayer himself had to be ascertained and not that of the person entrusted with his tax affairs. This case involved an experienced businessman and the Court, understandably, attributed some negligence to the taxpayer because he had failed to question certain dubious accounting entries by his accountant. In *ITC 1577 56 SATC 236* the taxpayer left his tax affairs completely in his accountant's hands. It was held that he, at least, had *dolus eventualis*, that is in light of his abdicating responsibility, he should have foreseen that tax evasion was possible. In *ITC 1489 53 SATC 99* the Court expected of "a shrewd and successful businessman" (professing not to understand the intricacies of accounting) to inquire, nevertheless, why trading stock was only reflected in the accounts at half its value. The court felt that his culpable failure to ask indicated "he wished not to acquire the knowledge". His degree of care was measured against that which a businessman in his position would normally have displayed. *ITC 1430 50 SATC 51* is another example where an 'intelligent' businessman was not allowed to shelter behind his accountant.

Where the accountant, of his own accord, is the author of the taxpayer's tax evasion stratagem (supposedly without any knowledge on the part of the benefitting taxpayer), the question is whether such accountant's intent or negligence could potentially be 'attributed' to the taxpayer. The then Appellate Division (AD) left this issue open in *CIR v Da Costa 1985(3) SA 768 (AD)*. Here the taxpayer had no more than five years' schooling and had engaged a firm of accountants to draw up tax returns from rough cash books provided. The accountants' 'short-cut' bookkeeping drastically reduced the true income. There was no evidence that the taxpayer himself was aware of his accountants' failure to maintain proper books and to submit accurate returns. There was also no collusion between the accountants and the taxpayer. Consequently, no intention to deceive was attributed to the taxpayer, despite SARS submitting the taxpayer should be penalised for his agent's deceit. In the end, the AD left the question open whether an accountant's intent could be attributed to his client. At the time local commentators opined that "... the taxpayer cannot vicariously (by delegation) be held to have had the intent to evade tax simply because his agent had that intent". This differs from the position in England. *Pleasants v Atkinson 1988 STC 847* held that, where an architect had appointed accountants who included private expenditure in the accounts as deductible expenses, it was proper to infer wilful intent (on the part of the architect) from the conduct of the accountants.

Fast-forward to a recent Canadian case where the issue was to what extent a taxpayer could rely on the work of his tax preparer?

In *Hine v. The Queen (2012) TCC 295* the taxpayer was a general contractor who sold renovated homes at handy profits. He was into 'flipping houses'. His accountant (in this case his wife who had a background in financial accounting) prepared his tax returns. Because of the under-declaration of income of some $157 000 during the 2006 tax year, the Canadian Revenue Authority (CRA) imposed a 'gross negligence' penalty – since there had been a false statement or omission in the contractor's tax return.

continued

Evidence before Court was that the contractor's wife was "organized, meticulous and diligent" and that there were "no reservations about her skill set in accounting and financial management and her honesty and integrity". Once her husband started 'flipping houses' she had called the CRA multiple times to ask how to report said income. She testified that the under-declaration of the 2006 income was 'an innocent mistake'. It was for the Court to decide whether the gross negligence penalty was justified?

The CRA referred to numerous cases putting the onus to accurately report income on the taxpayer, especially because Canada had a self-assess system. The CRA alleged that Mr Hine was privy to his wife's gross negligence alternatively there was 'wilful blindness' on his part. In contrast, Mr Hine and his wife argued that 'flipping houses' was a new venture and that they had researched how the income should be reported. They even later cooperated fully with the CRA auditor. It was argued on behalf of Mr Hine (with reference to Canadian precedent) that "... for the gross negligence penalty to apply, there must be greater neglect than simply the failure to use reasonable care. And a reasonable man not noticing a mistake does not make for gross negligence".

The Court allowed Mr Hine's appeal against the gross negligence penalty. It accepted that "... an honest confusion existed in this case and that a mistake was made in that confusion".

The Court also evaluated Mr Hine's complete reliance on his wife to keep proper records and to accurately report his income. Reference was made to case law where taxpayers relied on agents to prepare their tax filings. The Court mentioned the following principles:

- Each case will be fact-specific;
- It is critical to determine whether the taxpayer had knowledge of the negligence of his tax preparer or whether it was reasonable to find that the taxpayer should have made further inquiries;
- The fact that Mr Hine's spouse acted as his tax preparer should be ignored in considering the 'attribution' question – the normal approach should apply.

The Court found that Mr Hine's not questioning the return prepared by his wife did not constitute gross negligence. His belief that she reported the relevant income properly was not unreasonable. There had been no 'wilful blindness'. The Court accepted "this was a simple mistake".

All revenue authorities seem to view taxpayers' blaming of their accountants with a huge pinch of salt.

Hine's outcome favouring the taxpayer is therefore refreshing: the Court clinically evaluated all relevant facts and did not allow the spousal connection to cloud the issue.

Johan van der Walt

LIMITATION OF TAXING RIGHTS ON PENSION INCOME UNDER THE UNITED STATES / SOUTH AFRICA TAX TREATY

Non-resident beneficiaries of a deceased's South African sourced pension income may still be required to submit an income tax return, even where South Africa's taxing rights are limited under a relevant Double Tax Agreement (DTA).

The general principle under South African tax law is that non-residents are taxed on income from, or deemed to be from, a local source unless South Africa's taxing rights have been limited under any relevant DTA. With regard to pension income derived by any person (including non-residents who may have rendered services in South Africa), the deemed source rules under s9(2)(i) of the Income Tax Act, No 58 of 1962 (Act) would likely result in at least a portion of that income falling within the South African tax net.

The scenario becomes more complex where the South African sourced pension is received by a beneficiary of the deceased from a local fund administrator, but that beneficiary has never set foot in South Africa or rendered any services here. The question arises whether the local fund administrator is required to withhold monthly PAYE on that amount and whether the recipient of the pension income is obliged to obtain a tax deduction directive from the South African Revenue Service (SARS). Further, what role would a DTA play in the aforementioned scenario, more specifically the United States/South Africa DTA (US Treaty)?

Article 18 of the US Treaty deals with the taxation of private pensions and annuities as well as the tax treatment of contributions to pension plans. The benefit of the US Treaty is that where it is read in conjunction with the US Treaty Technical Explanation (USTE), it sets out clearly the mode of application of Article 18. The USTE states that, under Article 18(1) of the US Treaty, pension distributions (and other similar remuneration) in consideration of past employment from sources within one Contracting State (in this case South Africa) and beneficially owned by a resident of the other Contracting State (in this case the US), may be taxed by the Source State (in this case South Africa) to a limited extent. The residence state (in this case the US) may also tax the distribution.

Under Article 18(1)(b) of the US Treaty, where South Africa is the source Contracting State, the USTE states that a *pro rata* amount of a pension distribution corresponding to the amount of the gross pension distributions from South African sources will be subject to tax in relation to a beneficiary that is a US resident. However, the aforementioned *pro rata* rule only applies if the beneficial owner

- has been employed in South Africa for a period or periods aggregating two years or more during the 10 year period immediately preceding the date on which the pension first became due; and
- was employed in South Africa for a period or period aggregating 10 years or more.

continued

In relation to a beneficiary of the deceased's pension, it would in most cases not be difficult to argue that neither of the abovementioned requirements will be met, either in relation to period of service in South Africa and/or the fact that the beneficiary never rendered services in South Africa at all. This means that in most cases dealing with the receipt by a non-resident beneficiary of a deceased's South African sourced pension income, the sole taxing rights will be given to the US.

Given the fact that the US would likely be allocated full taxing rights on the South African sourced pension income, it follows that no normal tax liability arises for the non-resident beneficiary. Stated differently, the Fourth Schedule to the Act requires PAYE to be deducted in respect of the employees' normal tax liability – if no normal tax liability exists or is sterilised by the application of a DTA, then no deduction is required by the local fund administrator. Further, as there is no obligation to deduct PAYE by operation of law, there would similarly be no obligation to obtain a tax deduction directive from SARS confirming this.

However, even where there is no need to obtain a tax deduction directive or deduct PAYE for that matter, there may still be an obligation on the non-resident beneficiary to submit a tax return on an annual basis. This is on the basis that the non-resident's pension income would still constitute 'gross income' and more importantly, 'remuneration' for purposes of the Fourth Schedule even though no tax liability exists in South Africa (it is only the taxing provision that is sterilised by the DTA).

To the extent that a non-resident beneficiary receives 'gross income', which is below the required threshold of R120,000 per annum, no obligation arises to submit an annual tax return. However, where the non-resident beneficiary receives 'gross income' in excess of R120,000 per annum, the he would be obliged to submit an annual tax return and would need to claim an exemption from South African tax in respect of the pension income.

Ruaan van Eeden and Carmen Moss-Holdstock

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

This information is published for general information purposes and is not intended to constitute legal advice. Specialist legal advice should always be sought in relation to any particular situation. Cliffe Dekker Hofmeyr will accept no responsibility for any actions taken or not taken on the basis of this publication.

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

www.cliffedekkerhofmeyr.com

©2012

Cliffe Dekker Hofmeyr is a member of DLA Piper Group,
an alliance of legal practices