DLA CLIFFE DEKKER HOFMEYR

2 MARCH 2012

TAX ALERT

RECIPIENT OF ROYALTIES IS ALSO THE BENEFICIAL OWNER – THE VELCRO JUDGMENT

The Tax Court of Canada handed down its long awaited judgment on whether the recipient of royalties was also the beneficial owner in the *Velcro* case on 24 February 2012. By way of background, Velcro Canada Inc. (VCI) paid royalties to a sub-licensee in the Netherlands (the Sub-Licensee), which in turn was obliged to pay 90% thereof to the licensor. In terms of the Treaty concluded between Canada and the Netherlands, the royalty was reduced to 10% compared to the general rate of 25% that would have applied. Ultimately the question was whether the Sub-Licensee in the Netherlands was the beneficial owner of the royalties that were paid by VCI.

In approving the approach that was adopted in the *Prévost* case, it was indicated that one would not be the beneficial owner of an amount if the recipient had no discretion as to the use or application of funds put through it as a conduit without any right to do other than what the ultimate recipient instructs it to do. In the *Prévost* case it was indicated that the beneficial owner of dividends is the person who receives the dividends for his own use and enjoyment and assumes the risk and control of the dividend he received. It was indicated in the *Velcro* case that there are four elements that one should consider to determine whether the recipient is the beneficial owner of the payments, being:

- possession;
- use;
- risk; and
- control.

Ultimately one should thus have determined whether the Sub-Licensee received the payments for his own use and enjoyment and assumed the risk and control of the payments that it received.

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In analysing the cashflows, it was indicated that the Netherlands Sub-Licensee had a discretion to utilise the royalties received. The royalties were co-mingled with other monies and were used to do a variety of things. The Sub-Licensee had exclusive possession and control over the accounts and various charges were deducted before the ultimate licensor was paid.

It was also indicated that the sub-licensor assumed the risk in relation to the royalties. Apart from currency conversion, the royalties were available to the creditors of the sub-licensor. There was also no predetermined flow of funds even though the Sub-Licensee paid approximately 90% of the royalties to the licensor.

Ultimately it was indicated that the Sub-Licensee was not a nominee, ie that the Sub-Licensee acted on behalf of the licensor. It was indicated that the Sub-Licensee was not a conduit or a channel through which the funds were paid.

The approach adopted by the Tax Court in the *Velcro* case is quite important in a South African context given the introduction of the new dividends tax. In particular, the dividends tax is reduced to 5% in terms of some of the Treaties concluded by South Africa compared to the 15% that will generally apply. The dividends tax is imposed with reference to the receipt of the dividend by the beneficial owner. The beneficial owner is defined in section 64D of the Income Tax Act as the person entitled to the benefit of the dividend attaching to a share. Should the approach of the Tax Court in the *Velcro* case be adopted, the fact that the recipient may in turn pay dividends to its own shareholder, would not in itself result in the recipient not being the beneficial owner. Ultimately the question is whether the recipient is a mere conduit or whether it would assume the risk and control of the dividends that are to be received.

Emil Brincker

DIVIDENDS CEDED TO COMPANIES NOT EXEMPT FROM INCOME TAX

Dividends are generally exempt from income tax, subject to the exceptions contained in s10(1)(k)(i) of the Income Tax Act, No 58 of 1962 (the Act).

The Taxation Laws Amendment Act, No 24 of 2011 (the TLAA) introduced a new exception to the dividend exemption, namely ceded dividends.

In terms of a new paragraph (ee) to the proviso to s10(1)(k)(i) of the Act (effective 1 April 2012) the dividend exemption will not apply "*to any dividend received by or accrued to or in favour of a company in consequence of*:

- *any cession; or*
- *any right of that company acquired in consequence of any cession"*.

In its simplest form, a cession is a transfer of a right. Often persons cede (transfer) their right to receive dividends in respect of shares to other persons without actually transferring the shares. If a person ceded the right to dividends to a company, then the dividend will, with effect from 1 April 2012, not be exempt from income tax in the hands of the company. Importantly, the provision contained in s10(1)(k)(i)(ee) of the Act is only applicable to ceded dividends received by or accrued to a company and not individual taxpayers.

In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (Explanatory Memorandum) dated 27 January 2012 (at pages 60 and further) the National Treasury says it had to introduce the provision above because taxpayers often cede dividends to avoid tax. Further, as the person receiving the right (cessionary) has no "meaningful interest" in the underlying shares, the person should be fully taxed.

So far, so good. However, at page 63 of the Explanatory Memorandum, National Treasury proceeds to make a startling proposal. It says that, if a company is a beneficiary of a discretionary trust, which holds shares, and the trustees decided to allocate dividends in respect of the shares to the company beneficiary, then the dividends will be subject to income tax by virtue of paragraph (ee) to the proviso quoted above because the "company never holds a vested interest in the underlying ordinary shares".

The proposal must be wrong. If a trustee of a discretionary trust decides to vest income (for instance, dividends) in a beneficiary, there is no question of a "cession", a transfer of a right, as

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required by paragraph (ee) to the proviso (see also *Haupt Notes on South African Income Tax Act* 2012 edition at page 93).

More importantly, in terms of the common-law "conduit principle" and the provisions of s25B(2) of the Act, a dividend allocated to a beneficiary of a discretionary trust in the tax year it is received retains its nature as a dividend and is deemed to be derived for the benefit of the beneficiary. While the ruling relates to legislative references of the Act as at 1 January 2011, Binding Class Ruling No. 31 confirmed, based on the particular transaction, that:

- any distribution made by the trustees of the discretionary trust to the beneficiaries will, if distributed within the same year of assessment in which the dividend was received by or accrued to the trust, retain the character of a dividend in the hands of the beneficiaries; and
- such dividends will be exempt in the hands of the beneficiaries under s10(1)(k)(i) of the Act.

Taxpayers contemplating entering into cession of dividend transactions must therefore be mindful of the new proviso to s10(1)(k)(i) of the Act and SARS' interpretation of how the dividend exemption should be applied.

Ben Strauss and Andrew Lewis

"PERSONAL LIABILITY" FOR A LEGAL ENTITY'S TAX DEBTS: A MISGUIDED SHOT ACROSS THE BOW BY SARS?

We have recently seen SARS issuing letters styled "*Notice of Personal Liability of Representative Taxpayer*".

The letter alleges: "*The SARS has reason to believe that you in your capacity as the public officer/representative taxpayer/vendor either alienated, charged or disposed of income in respect of which a tax is chargeable or that you disposed of all or parts of funds or monies which were in your possession or came to you after the tax liability be come (sic) payable and same amount of monies could have been utilised to pay the outstanding tax liability.*"

Lengthy verbatim quotations from the Income Tax Act, No 58 of 1962 and the Value-Added Tax Act, No 89 of 1991 follow. Then the demand: "*Consequently and in terms of s74A and 74B(1) of the IT Act and in terms of s57A and 57B(1) of the Vat Act this office [here it was Gauteng Central Enforcement, High Value Debt, MegaWattPark] requires you to provide* ***a comprehensive written representation*** *(emphasis added) (sic) as to why SARS should not hold you personally liable for the current debt owing to SARS as indicated above.*" Furthermore: "*... this office may at any time submit any of the information presented to it for further scrutiny, for either civil and / or criminal investigation purposes.*" Should the requested information not be furnished within ten working days, the consequence will be that "*...the Commissioner shall have no alternative but to come to the reasonable conclusion that you are personally liable for the outstanding tax liability.*" It closes by stating that the Commissioner can "*... exhaust all legal remedies available to it in order to recover the full outstanding tax liability from you.*"

Mere mention that the representation made might later be used for "*civil and/or criminal investigation purposes*" will probably scare many an addressee.

So, when exactly can SARS actually hold an individual (eg the director or shareholder of a company/member of a CC/trustee of a trust etc) personally liable for the legal entity's tax debt?

A legal entity like a company, CC or trust (for tax purposes) has a separate legal persona. SARS must respect that. *Ochberg v Commissioner for Inland Revenue 1931 AD 215* held:

"*The law endows a company with a fictitious personality. The wisdom of allowing a person to escape the natural consequences of his commercial sins under the ordinary law, and for his own private purposes virtually to turn himself into a corporation with limited liability may well be open to doubt. But as long as the law allows it the court has to recognise the position. But then too the person himself must abide by that. A company being a juristic person, remains a juristic person separate and distinct from the person who may own all the shares, and must not be confused with the latter.*"

SARS could attempt to brush aside the entity's legal persona by applying the "piercing of the corporate veil" doctrine. That's not easy though.

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ITC 1611 59 SATC 126 described piercing of the veil as a "radical step" and held:

"*... a court can lift the veil only if that is legitimate by application of established doctrines, such as the plus valet rule or the fraus legis rule (or in other cases of fraud or dishonesty) or, possibly, the actio pauliana, that is if the requirements for such application are present, or a finding of a true relationship of principal and agent. There is, we consider, no self-standing doctrine of piercing the veil.*"

Ditto for a trust. Recently *Rees & others v Harris & others [2011] JOL 28014 (GSJ)* (not a tax case) held:

"*Thus, in appropriate circumstances, the veneer of a trust can be pierced in the same way as the corporate veil of a company. Consequently, where the trustees of a trust clearly do not treat the trust as a separate entity, and where special circumstances exist to show there has been an abuse of the trust entity by the trustee, the veneer must be pierced. It follows that if a legitimately established trust is used or misused in an improper fashion by its trustees to perpetrate deceit, and/or fraud, the natural person behind the trust veneer must be held personally liable.*"

Consequently, SARS' point of departure must be that liability for the tax debt of a company, CC or trust rests with the legal entity in the first place. Normally directors, shareholders, members and trustees would not be personally liable for the entity's tax debts where it cannot pay SARS.

The 1973 Companies Act provided in s424 that someone could be personally liable for a company's debt where the individual knowingly was party to the carrying on of the business of the company "*recklessly or with intent to defraud creditors of the company.*" [See *Philotex (Pty) Ltd and others v Snyman and others 1998 (2) SA 138 (SCA)* at 146G for what would be needed to prove same.] In the past SARS has not relied on s424 to establish personal liability. Perhaps the evidentiary burden relating to fraudulent and reckless trading was regarded as insurmountable?

The 2008 Companies Act provides in s22 (1) that "*a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose*". The liability of directors and prescribed officers is covered in s77. Sub-section 77(3)(b) provides that a director is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having been a party to an act or omission by the company despite knowing that it was being conducted in a manner prohibited by s22(1). However, under ss77(9), a court may relieve the director from liability on any terms the court considers just if it appears that (a) the director acted honestly and reasonably; or (b) regarding the circumstances, it would be fair to excuse the director.

Case law, both the old and new company law provisions as well as the relevant criteria set out in the Income Tax and VAT Acts themselves make it clear that SARS has a mountain to climb before it can pin personal liability on directors, shareholders, members and trustees. Perhaps it's "easier said (or rather threatened?), than done".

In future, the question of personal liability for a legal entity's tax debt will be regulated by the soon to be promulgated Tax Administration Act (TAA). Chapter 11, Part D specifically deals with the "*Collection of Tax Debt from Third Parties*".

Section 180 provides that a person could be personally liable for any tax debt of the taxpayer (eg a company, CC or trust) to the extent that the person's negligence or fraud resulted in the failure to pay the tax debt if:

- The person controls or is regularly involved in the management of the overall financial affairs of the taxpayer; and
- A senior SARS official (defined term) is satisfied that such person is or was negligent or fraudulent in respect of the payment of the tax debts of the taxpayer.

When exactly a person will be seen to "*control or [to be] regularly involved in the management of the overall financial affairs*" of any entity is a question of fact. Each case will depend on its own facts.

So will the entity's Financial Director, alternatively the back-office clerk responsible to make the EFT payment of the tax due, incur personal liability? Unfortunately the Draft Explanatory Memorandum to the TAA gives no guidance. Seemingly the omnipotent "senior SARS official" will make the calls regarding the degree of involvement in the management of the overall financial affairs of the entity as well as whether there had been any negligence or fraud.

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Under s184 (1), SARS has the same powers of recovery against the assets of a person referred to in Part D as it has against the taxpayer's own assets (ie those of the company, CC or trust). Sub-section 184(2)(a) affords the person potentially facing personal liability an opportunity to make representations before the s180 liability is established (as long as that does not jeopardise the collection of the tax debt), alternatively, under ss(b), "as soon as practical" afterwards.

The recent push for "personal liability" might be part of a revenue collection drive with SARS' year-end approaching.

Still, any individual receiving a SARS letter intimating "personal liability" for a legal entity's tax debts should be very careful in responding – more so, seeing that SARS believes it can simply use the information gathered "*... for criminal investigation purposes*".

SARS' power to establish "personal liability" for a legal entity's tax debt is limited. It requires a proper understanding and application of the relevant legal principles.

To immediately raise the white flag once SARS fires a (misguided) shot of "personal liability" across an individual's bow, might give SARS an undeserved advantage.

Johan van der Walt

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