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TAX & EXCHANGE CONTROL ALERT

IN THIS **ISSUE**

NO TRADE, NO DEDUCTION – A JUDGMENT ABOUT SECTION 11(a) OF THE INCOME TAX ACT

On 20 April 2017, the Tax Court handed down its decision in *X Group (Pty) Ltd v The Commissioner for the South African Revenue Service* (Case No: 13671) (as yet unreported). The case dealt with an amount of R90 million that X Group (Pty) Ltd had claimed as an expense or loss during the 2007 year of assessment, which deduction was disallowed by the South African Revenue Service.

EXCHANGE CONTROL – UPDATE REGARDING POST SVDP REGULARISATION

In our Tax and Exchange Control Alert of 15 September 2017, we discussed the process that persons can follow to regularise their offshore held assets from a tax and exchange control perspective, if they did not do so prior to 31 August 2017: the date on which the Special Voluntary Disclosure Programme window period, for tax and Excon, came to an end.

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On 20 April 2017, the Tax Court handed down its decision in *X Group (Pty) Ltd v The Commissioner for the South African Revenue Service* (Case No: 13671) (as yet unreported). The case dealt with an amount of R90 million that X Group (Pty) Ltd (Taxpayer) had claimed as an expense or loss during the 2007 year of assessment, which deduction was disallowed by the South African Revenue Service (SARS).

The court rejected the Taxpayer's argument that the expense was a contingent liability that related to the production of income in the 2003 year of assessment.

Facts

The Taxpayer had concluded two separate agreements with ABC for the delivery of coal to ABC during the 2002 and 2003 calendar years (Coal Agreements). During 2003, subsequent to concluding these Coal Agreements, the Taxpayer sold its business to a private company, Z Entity. The Taxpayer sold its assets and sale contracts, including the Coal Agreements, to Z Entity (Sale of Business Agreement). During 2004, after Z Entity delivered some coal to ABC in terms of the Coal Agreements, a dispute arose between Z Entity (the judgment refers to Z, but presumably it is meant to refer to Z Entity) and ABC. ABC alleged that Z Entity breached the Coal Agreements and that it suffered a loss as a result of the breach. On 5 September 2007, the Taxpayer concluded a settlement agreement in terms of which it paid R90 million to ABC and its managing director. The Taxpayer was no longer carrying on the trade of selling coal at the time.

The Taxpayer's auditor, D, testified that the R90 million paid to ABC related to coal purchased in 2002, which would only be delivered later. He also testified that ABC did not consent to the assignment of rights and obligations from the Taxpayer to Z Entity as required in terms of the Sale of Business Agreement, which is why the Taxpayer accepted liability for ABC's loss.

Judgment

One of the issues the court considered was whether the Taxpayer was carrying on the trade of selling coal when it paid the amount of R90 million and whether the expense was incurred in the production of income or for the purpose of trade. With reference to the judgment in *Caltex Oil (SA) Ltd v CIR* 1975 (1) SA 665 (A), the court held that the 2007 year of assessment was the year in which the expense had been incurred and was only deductible in that year. The court rejected the Taxpayer's argument that the expense was a contingent liability that related to the

Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

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NO TRADE, NO DEDUCTION – A JUDGMENT ABOUT SECTION 11(a) OF THE INCOME TAX ACT

CONTINUED

The court concluded that the Taxpayer could not claim the R90 million expense paid to ABC as a deduction in terms of s11(a) of the Act during the 2007 year of assessment.

production of income in the 2003 year of assessment. It held that ABC's claim arose due to the deliberate decision of the Taxpayer's managing director, who was also Z Entity's managing director, to cause Z Entity to breach the Coal Agreements.

When the Sale of Business Agreement was concluded, the Taxpayer had not breached the Coal Agreements. At the time, a future intentional breach of contract had not been contemplated as a contingent liability, for which the Taxpayer would remain liable after concluding the Sale of Business Agreement.

With regard to the production of income requirement in s11(a) of the Income Tax Act 58 of 1962 (Act), the court held that the deduction claimed had to be necessary or essential, or had to be incurred to enable the Taxpayer to produce the income that it was aimed at generating. The court held that this requirement had not been met because, among other things, there was no causal link between the income produced by the Taxpayer and the repudiation of the contract by Z Entity.

The court concluded that the Taxpayer could not claim the R90 million expense paid to ABC as a deduction in terms of s11(a) of the Act during the 2007 year of assessment. It also made a costs order in favour of SARS.

(Note: In the name of the judgment, the taxpayer is referred to as X Group (Pty) Ltd. In the main text of the judgment, the judgment makes reference to an entity by the name of "Z Group (Pty) Ltd", which appears to refer to the taxpayer. This article is written with the understanding that references to "Z Group (Pty) Ltd" refer to the taxpayer.)

Louis Botha

EXCHANGE CONTROL – UPDATE REGARDING POST SVDP REGULARISATION

The Finsurv SVDP Unit, which is considering Excon applications submitted in terms of the SVDP, released an updated guideline document on 13 November 2017, regarding regularisation from an Excon perspective.

In our Tax and Exchange Control Alert of 15 September 2017, we discussed the process that persons can follow to regularise their offshore held assets from a tax and exchange control (Excon) perspective, if they did not do so prior to 31 August 2017: the date on which the Special Voluntary Disclosure Programme (SVDP) window period, for tax and Excon, came to an end.

It would be worthwhile for applicants to consider repatriating at least a portion of their unauthorised foreign assets, in order to reduce the levy that will be payable.

While the process to regularise one's offshore assets from a tax and Excon perspective after 31 August 2017 remains the same as discussed in the Alert, the Finsurv SVDP Unit, which is considering Excon applications submitted in terms of the SVDP, released an updated guideline document on 13 November 2017, regarding regularisation from an Excon perspective. While the updated guideline document still states that applicants can submit applications to the Financial Surveillance of the South African Reserve Bank (FinSurv) directly or through an authorised dealer, it provides more detail regarding potential penalties.

The updated guideline document states that as a general guideline, where voluntary disclosure is made by a contravening party and the person decides to repatriate the unauthorised assets, the minimum penalty (levy) is approximately 10% or more, but that a penalty of 20% or more could apply where the unauthorised foreign assets are retained abroad. It should be kept in mind that this is only a guideline and that FinSurv can in some cases still impose a penalty of 40%, where they deem this necessary. FinSurv retains this discretion in terms of Regulation 22 of the Exchange Control Regulations, 1961.

In light of the above, it would be worthwhile for applicants to consider repatriating at least a portion of their unauthorised foreign assets, in order to reduce the levy that will be payable.

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