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TAX & EXCHANGE CONTROL ALERT

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In the international tax law arena, agreements for the avoidance of double taxation (DTAs) are, very simply, concluded between states with a view to prevent, mitigate or discontinue the levying of tax in respect of the same income, profits or gains or tax imposed in respect of the same donation under the laws of the particular states. In addition, DTAs regulate the rendering of reciprocal assistance in the administration of and collection of taxes under the said laws of the respective states.

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SALE OF LEASE RIGHTS AND LEASE PREMIUM

In 2010, the taxpayer concluded a lease agreement with MN Properties (Pty) Ltd (MN) in terms of which the taxpayer let the same immovable property to MN for a period of 50 years, subject to DF's tenancy under the DF Lease.

The Court found that the payment was not of a capital nature and should have been included in the taxpayer's "gross income" and subject to income tax.

The tax treatment of lease premiums continues to be a vexing issue.

The matter arose again in the recent case of *XYZ (Pty) Ltd v The Commissioner for the South African Revenue Service* (Case No 14189) (as yet unreported) in the Johannesburg Tax Court.

The facts of the case are not entirely clear, but the following summary should suffice. In 2009, the taxpayer concluded a lease (DF Lease) with DF (Pty) Ltd (DF) in respect of certain immovable property. The initial lease period was 12 years, with two renewal periods. Under the DF Lease, the taxpayer undertook to erect a facility on the property. DF ran into financial difficulties.

In 2010, the taxpayer concluded a lease agreement with MN Properties (Pty) Ltd (MN) in terms of which the taxpayer let the same immovable property to MN for a period of 50 years, subject to DF's tenancy under the DF Lease. The taxpayer then assigned the DF Lease to MN, and MN stepped into the shoes of the taxpayer as landlord under the DF Lease. Under the lease agreement with MN, MN agreed to pay the taxpayer a nominal amount per month and a percentage of its turnover. In consideration for the assignment, MN agreed to pay the taxpayer an amount of R125 million. The amount was referred as a "lease premium" by the parties and in the documents.

The taxpayer did not include the amount of R125 million in its "gross income" for purposes of income tax. SARS sought to levy income tax on the amount as revenue in the hands of the taxpayer.

The taxpayer argued that the payment was of a capital nature: it was proceeds on the disposal of an asset, namely, the rights of the taxpayer under the DF Lease.

The Court found that the payment was not of a capital nature and should have been included in the taxpayer's "gross income" and subject to income tax. The Court also imposed penalties.

Unfortunately, it is not readily apparent from the judgment what the grounds were for that finding. Two of the taxpayer's employees gave evidence. Essentially, they testified that the concept "lease premium" was used loosely, and that they viewed the assignment of the DF Lease as a disposal of rights. However, the Court disallowed the evidence on the basis of the

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SARS agreed on beforehand, but it is not apparent from the judgment that this was the case.

parol evidence rule, that is, the rule that, if a document was intended to provide a complete memorial of a legal act, extrinsic evidence as to the import of the document is not allowed. On the other hand, later in the judgment the Court, in fact, does keep referring to the evidence of the employees when interpreting the agreement.

The Court also referred to other facts. It appears as if there were facts which the taxpayer and SARS agreed on beforehand, but it is not apparent from the judgment that this was the case.

On the face of things, it appears as if the entire matter actually hinged on the question of whether the assignment agreement between the taxpayer and MN was a sale agreement, in form, but a lease agreement, in substance. The taxpayer argued that, despite the fact that the agreement referred to the consideration as constituting a "lease premium", the payment was in fact the price for the disposal of the taxpayer's rights under the DF Lease.

The Court, however, was of the view that the agreement constituted a lease, in form and substance, and, as such, the payment was a lease premium. The definition of "gross income" in s1 of the Income Tax Act, No 58 of 1962 specifically includes "an amount received or accrued from another person, as a premium or consideration in the nature of a premium...for the use or occupation or the right of use or occupation of land and buildings".

However, generally, when a landlord disposes of its rights under a lease to another person, any consideration for the acquisition of that right is not a lease premium as it is not paid for the right to use or occupy land.

It is trite that, when determining whether the proceeds on disposal of an asset is of a capital nature or a revenue nature, one should have regard to the intention of the taxpayer. One should determine whether the intention of the taxpayer was to dispose of the asset in a scheme of profit-making or whether the intention of the taxpayer was to hold and dispose of the asset as a long-term investment. The receipt would, in the latter case, be of a capital nature, and in the former, of a revenue nature. Although the judgment is not clear on this point, it does appear as if the Court found that, irrespective of the substance and form of the agreement, the payment of R125 million was of a revenue nature.

Unfortunately, it is very difficult to distil any general principles from the judgment in relation to lease premiums and the sale of rights under a lease. One thing is clear, however: when entering into any form of lease, or any agreement in terms of which lease rights are assigned, taxpayers should exercise great caution from a legal perspective, generally, and from a tax law perspective, particularly.

Ben Strauss

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A DIVER'S QUANDARY: THE ROLE OF DOMESTIC LAW IN INTERPRETING DOUBLE TAXATION AGREEMENTS

Whether income falls into a certain category is largely a function of the domestic law of the relevant country.

The court was called to determine whether the consequences of a deeming provision in United Kingdom law extended to the interpretation of a DTA.

In the international tax law arena, agreements for the avoidance of double taxation (DTAs) are, very simply, concluded between states with a view to prevent, mitigate or discontinue the levying of tax in respect of the same income, profits or gains or tax imposed in respect of the same donation under the laws of the particular states. In addition, DTAs regulate the rendering of reciprocal assistance in the administration of and collection of taxes under the said laws of the respective states.

As DTAs are entered into between states to regulate the manner in which each state accounts for tax in their own domestic legislation, a DTA assists to determine whether the state a taxpayer is resident in or the state the income is sourced in has the right to tax a particular type of income. This is done by applying set rules to various types of income, such as dividends or interest income, thereby providing certainty to taxpayers with regard to their tax affairs.

Whether income falls into a certain category is largely a function of the domestic law of the relevant country. In other words, the nature of an instance of income is determined by interpreting the facts of each case, in light of the relevant domestic law. In a South African context, s108 of Income Tax Act, No 58 of 1962 (Income Tax Act), which deals with the prevention of or relief from double taxation, authorises the conclusion of a DTA and provides in subsection 2 that *"as soon as may be after the approval by Parliament of any such agreement, as contemplated in section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the Gazette and the arrangements so notified shall thereupon have effect as if enacted in this Act"*. Section 108(2) makes it clear that a DTA will have effect as if enacted in the Income Tax Act, and as such, a DTA becomes part of our domestic law. However, where there is a conflict between the domestic law and the DTA, s108 in itself does not provide any assistance.

Article 3 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (OECD MTC) determines how its terms are used. More specifically, article 3(2) recognises the interrelation between DTA provisions and domestic law and provides that where any term is not defined therein, unless the context indicates otherwise, it shall have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies.

How domestic tax law is to be applied to determine the meaning of an article in a DTA was dealt with in the recent judgment of the Court of Appeal (England and Wales), Civil Division in the case of *Fowler v Revenue and Customs Commissioners [2018] STC 2401*. More specifically, the court was called to determine whether the consequences of a deeming provision in United Kingdom law extended to the interpretation of a DTA.

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An issue arose as to whether, under the DTA concluded between South Africa and the United Kingdom which came into force on 17 December 2002 and based on the OECD MTC (SA/UK DTA), he was liable to be taxed by South Africa or the United Kingdom on the income arising from those activities.

The relevant facts, key issues, arguments made by the taxpayer, decision of the Court of Appeal including the minority and majority judgments, are summarised below.

Facts

During the 2011/12 and 2012/13 tax years, Martin Fowler, a qualified diver (Taxpayer), undertook diving engagements in the United Kingdom continental shelf waters. The Taxpayer was a tax resident in South Africa but earned income from activities within the jurisdiction of the United Kingdom. An issue arose as to whether, under the DTA concluded between South Africa and the United Kingdom which came into force on 17 December 2002 and based on the OECD MTC (SA/UK DTA), he was liable to be taxed by South Africa or the United Kingdom on the income arising from those activities.

It is common cause that if the Taxpayer were found to be self-employed, such income would constitute business profits within the meaning of article 7 of the SA/UK DTA and would be taxed in South Africa. Alternatively, if he was found to be earning income from employment, article 14 would give the taxing rights to the United Kingdom.

The case was first heard in the First Tier Tribunal, as a preliminary issue, where the Taxpayer was found to be self-employed. This decision was reversed by the Upper Tribunal, which decision the Taxpayer appealed against to the Court of Appeal.

Key issues

The Court of Appeal was called to interpret the provisions of the SA/UK DTA to determine whether the Taxpayer had earned 'Business Profits' under article 7 or 'Income from Employment' under article 14. Essentially, the court was required to determine which country had the right to tax the Taxpayer's diving income.

Article 7 of the SA/UK DTA provides that the profits of an enterprise (ie the carrying on of any business) of a Contracting State shall be taxable only in that State unless the enterprise carried on business (ie includes the performance of professional services and other activities of an independent character) in the other Contracting State through a permanent establishment situated therein. The Taxpayer did not have a permanent establishment in the United Kingdom and accordingly, article 7 would allocate the right to tax him to South Africa, if he was in fact self-employed.

Furthermore, article 7(6) provides that "*where profits include items of income or capital gains which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.*" This provision has the effect that if article 14 were to apply, article 7 would not.

Article 14 applies to income from employment and provides that salaries, wages and other similar remuneration derived by a resident of a Contracting State

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South Africa and not the United Kingdom had the right to tax the income from the diving activities.

in respect of employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. The Taxpayer's diving activities were exercised in the United Kingdom, and as such, to the extent that it was found that those activities generated remuneration *in respect of employment*, the United Kingdom would have a right to tax such employment income.

As article 14 supersedes article 7, if the income constituted income from employment it could not be business profits. The term 'employment' is however not defined in the SA/UK DTA and therefore the case turned on the interpretation of this word. Article 3(2) of the SA/UK DTA followed the OECD MTC and provided that where a term is undefined, it is to be read with the meaning it has under the United Kingdom domestic tax law.

The term 'employment' is partially defined in s4 of the Income Tax (Earnings and Pensions) Act 2003 (2003 Act) to include any employment under a contract of service, contract of apprenticeship and in the service of the Crown. On this point, the Court of Appeal assumed, for purposes of the preliminary issue, that the Taxpayer carried out his diving activities under a contract of service, thereby falling within the definition of 'employment'.

Taxpayer's arguments

The Taxpayer contended that in order to determine which country has taxing rights, regard should be had to s15 of the Income Tax (Trading and Other Income) Act 2005 (2005 Act) which contains provisions that deem earnings from diving activities, to be the carrying on of a trade within the United Kingdom, instead of such income being treated as employment income. The Taxpayer argued that such income would therefore fall squarely within article 7 of the SA/UK DTA on the basis that the income arose from the carrying on of an enterprise. Accordingly, South Africa and not the United Kingdom had the right to tax the income from the diving activities.

Decision of the Court of Appeal

Although the Lord Justices reached two different judgments, they all endorsed the approach to the law taken by the minority per Lewison LJ. Lewison LJ first made a distinction between what is being taxed and who has the right to tax it. As set out above, article 3 of the SA/UK DTA provides guidance with regard to the interpretation of the DTA and the determination of which category a particular income falls into.

Having reference to the provisions of article 3(2) of the SA/UK DTA, the nature of the income from the diving activities would be determined in terms of the United Kingdom domestic law (ie by the provisions of the 2003 Act, read with the provisions of the 2005 Act).

Section 15 of the 2005 Act applies where a person engages in seabed diving activities in the United Kingdom or its continental shelf area and income would have been taxable as employment. Section 15(2) goes on further to provide that "*[t]he performance of the duties of employment is instead treated for income tax purposes as the carrying on of a trade in the United Kingdom.*" The minority and majority judgments differed on the consequences of this deeming provision, as discussed in more detail below.

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The Justices stated that the earnings from the Taxpayers' employment were to be regarded as profits of the trade which he was deemed to be carrying on.

Minority Judgment

Lewison LJ's approach to interpreting the deeming provision was based on the House of Lords' judgement *Marshall (Inspector of Taxes) v Kerr [1994] STC 638*, quoting from page 649:

"For my part I take the correct approach in construing a deeming provision to be to give the words used their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the purposes of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be within the purposes of the fiction. I further bear in mind that because one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from doing so."

Essentially, the above quote led Lewison LJ to find that:

"what that article [3(2)] does is to import into art 14 the UK tax law definition of 'employment' which is a word otherwise undefined by the treaty. For the purposes of UK tax law, the definition of 'employment' is to be found in s 4 of the 2003 Act. I cannot see anything in s 15 which changes the meaning of that defined term."

Lewison LJ also noted that s15 of the 2005 Act was a product of a 'tax rewrite' which was not intended to alter the law, but rather only sought to modernise the language and make tax laws more accessible. He concluded that s15 of the 2005 Act alters *how* employment income is taxed in the United Kingdom, rather than changing *what* is being taxed. Therefore, the activities undertaken by the Taxpayer still constituted employment activities and all that was changed by deeming provision was the treatment of that income by revenue authority. Henderson LJ concluded that if the Taxpayer was employed as a diver during the relevant tax years, the United Kingdom and not South Africa had the right to tax that income under article 14 of the SA/UK DTA.

Majority Judgment

Henderson LJ and Baker LJ found that s15(2) of the 2005 Act requires that the performance of the duties of employment be treated as the carrying on of a trade in the United Kingdom 'for income tax purposes'. That was found to mean 'for all income tax purposes under UK law', including the treatment of the remuneration received by the Taxpayer.

The Justices stated that the earnings from the Taxpayers' employment were to be regarded as profits of the trade which he was deemed to be carrying on. By virtue of s 6(5) of the 2003 Act, such earnings fell within the charge to tax relating to trading income under the 2005 Act and are not taxed as employment income.

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The activities of and income earned by the Taxpayer were deemed to not constitute employment activities or income and rather must be treated under the tax laws of the United Kingdom as trading activities and income.

Both judgments adopt *Marshall (Inspector of Taxes) v Kerr* as authority for the consequences of deeming provisions. Henderson LJ emphasised the last sentence of the passage quoted by Lewison LJ and reinforced the consequences of a deeming provision by quoting Lord Asquith of Bishopstone in *East End Dwellings Co Ltd v Finsbury BC [1951] 2 All ER 587* where at page 599 he stated:

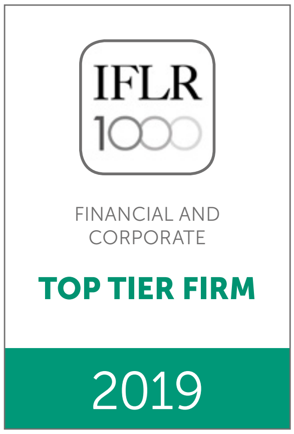
"The statute says that one must imagine a certain state of affairs. It does not say that, having done so, one must cause or permit one's imagination to boggle when it comes to the inevitable corollaries of that state of affairs."

It followed therefore that the activities of and income earned by the Taxpayer were deemed to not constitute employment activities or income and rather must be treated under the tax laws of the United Kingdom as trading activities and income. Meaning that the income fell to be taxed under article 7 of the SA/UK DTA by South Africa.

Conclusion

This case is a good illustration of the practicalities of interpreting the provisions of a DTA and clarifies the extent to which legal functions at the domestic level can alter the effect of a DTA. It is also a reminder to taxpayers that they must be cautious and avoid ambiguity in the ordering of their affairs to avoid disputes of this nature.

Gigi Nyanin and Tsangadzaome Mukumba



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Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 2 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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