DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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IN THIS ISSUE

- Deductibility of fines: McLaren Racing Limited v Her Majesty's Revenue and Customs
- Improving tax incentives for retirement savings

DEDUCTIBILITY OF FINES: MCLAREN RACING LIMITED V HER MAJESTY'S REVENUE AND CUSTOMS

Those of you who are Formula One fans will remember vividly that in 2007 the McLaren team was fined US$100 million by the ***Federation Internationale de l'Automobile*** (FIA) because they had been engaged in a scheme (and I am not sure whether that is the correct word) whereby Mr Nigel Stepney, a top mechanic with Ferrari, had passed information on to Mr Coughlan, the chief designer at McLaren.

My memory is that at the time this had seemed as shocking as finding out that Lance Armstrong is a doper! But as a result of having to pay this fine, there was a serious reduction in the gross income of McLaren.

The question for Her Majesty's Revenue and Customs (HMRC) was whether the US$100 million penalty was deductible against McLaren's taxable profits. In terms of English tax law there were two questions that arose – whether the loss from having to pay the penalty was connected to McLaren's trade, and whether the loss arose out of that trade.

When this matter came before the First Tier Tax Tribunal in *McLaren Racing Limited v HMRC [2012] UKFTT 601 (TC)*, there was an extensive review of the English authorities concerning the question of whether the loss arose out of trade and was sufficiently closely connected to the trade.

In South Africa, s23(o)(ii) of the Income Tax Act, No 58 of 1962 (Act) prohibits the deduction of any expenditure incurred, which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or in any other country if that activity would be unlawful had it been carried out in the Republic. The issue in the McLaren case is that the fine was imposed by a private body and not by virtue of a statutory provision or other law. For instance, in the case of *McKnight v Sheppard (1999) 71 TC 419*, the Court had looked at fines imposed on a stockbroker by the Stock Exchange. At that time the Stock Exchange was a gentleman's club and was not regulated by statute. Lightman J held that neither the fine nor the legal expenses were allowable as a deduction. However, this matter subsequently went to the Court of Appeal and the House of Lords. They were happy to limit the deductibility to the legal expenses. Lord Hoffmann wrote the speech for the House of Lords and had effectively said that the reason the penalty was not deductible is because its purpose is to punish the taxpayer and the Court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden with the rest of the community by a deduction for the purposes of the tax.

As a result of obtaining confidential information from Ferrari, McLaren was fined a sum of US$100 million less its share of the income from Formula One in terms of the Concorde Agreement. That resulted in a loss of US$64,5 million net. Mr Nawbatt for HMRC argued that the penalty was a loss for the conduct of McLaren's employees and their gathering of and intention to use Ferrari's information. It was conduct prohibited by Mr Coughlan's contract of employment and so was outside of McLaren's regular business. The penalty was not incurred in the capacity of McLaren's trade, but as a punishment for a serious breach of the rules. Mr James, acting for McLaren, had argued that there is a difference between the nature of a penalty levied by a body such as the Stock Exchange which has a public function to protect the public (in South Africa see

continued

The Johannesburg Stock Exchange v Witwatersrand Nigel 1988 (3) SA 132 (A)) and the nature of a contractual payment such as that paid by McLaren. He argued that the fine was incurred because the of actions of McLaren's employees, and even if they were unauthorised, it was incurred in the course of McLaren's trade. The fine was really for the use rather than the possession of the Ferrari information. Accordingly, it was not a punishment for McLaren personally, it was more of a commercial deterrent to others and so the cost was an inherent risk of their trade. McLaren were contractually bound under English law to pay the penalty.

The Tribunal, in analysing what was McLaren's trade preferred the formulation that it was 'trying to make money from the design and racing of Formula One cars'. They preferred this formulation to 'trying to make money by participating in Formula One racing subject to any rules imposed in the Concorde Agreement' because on that basis the employee's action would not be for the purpose of trade. The Tribunal did not believe that the word 'trade' could be limited to exclude the contravention of another person's civil rights. Otherwise when a taxpayer was assessed to tax, he could say I am not taxable on that profit because it involves the contravention of another's right. Even though these activities of McLaren were not normal or ordinary they were activities so closely associated with the main stream of McLaren's trade that the Tribunal felt they were part of it. The penalty levied by the World Motor Sport Council took account of the resources of the team and to be a deterrent sufficiently large to deter similar behaviour in the future. It was not a policy of personal punishment for McLaren. The penalty did not relate to the safety, health or well being of the public. There was no consideration of public policy which required the penalty to be considered as disallowable. In considering the question of whether the loss was connected with the trade, the Tribunal was satisfied that had McLaren not traded the penalty would not have been incurred. The loss arose from McLaren's trade because it was intimately bound up with its only source of income.

Accordingly, McLaren's appeal was allowed.

Alastair Morphet

IMPROVING TAX INCENTIVES FOR RETIREMENT SAVINGS

The Fifth Paper (Paper) in Treasury's Discussion Documents concerning the restructuring of retirement provision in the country deals with tax incentives for retirement savings.

This paper starts from the presumption that there is no evidence that retirement fund contributions need greater tax deduction limits in order to encourage retirement provision. The fundamental issue that comes out of Treasury's research is that employers see the need to provide retirement funds and this element of the system seems to work well. The authors of the Paper are quite correct that the tax regime is very complex and it would be advantageous to streamline the system. One of the policy drivers is that the system permits higher income employees to make much greater tax exempt contributions than Treasury see as necessary to maintain a reasonable standard of retirement. This also enables employees to postpone tax by diverting amounts of income to pension or provident funds which will be taxed later after the retirement date.

The key capping provisions that were set out in the 2012 budget are very much endorsed in the report – that employees should be permitted a deduction in respect of employer and employee contributions to all types of retirement fund equal to 22,5% of the greater of employment or taxable income subject to a cap of R250 000 and in respect of employees who are aged 45 and above that number would be 27,5% of employment or taxable income capped at R300 000. The minimum monetary deduction of R20 000 would apply to allow low income earners to contribute in excess of the above percentage limits. The Paper proposes that this tax regime should be effective from 1 March 2014.

The Paper discusses the scenario where an employer provides employees with risk benefits by purchasing insurance policies outside of the retirement fund (so called unapproved risk benefits) as against the position of arranging such benefits through the retirement fund (approved risk benefits). (For those readers interested the table looking at the efficiency of approved versus unapproved arrangements is set out in Table 7 on page 22 of the Paper). The important part in this regard is the move to tax the contributions to a retirement fund on the basis of a fringe benefit allocated to employees, and permit a deduction in respect of these contributions, to try and retain the tax efficiency of providing approved as opposed to unapproved risk benefits.

But it is this logic, which is driving what I think is probably the most important policy aspect of the Paper, to move away from allowing the present position where an employee cannot get a deduction in respect of contributions made to a provident fund. In other words, Treasury would like to only provide for a tax deduction on contributions where pension fund and retirement annuity fund holders have to annuitise two thirds of their retirement benefits when they retire, and not allow the position where a provident fund member can take a full lump sum. But the outcome of this is that Treasury will be looking for a uniform retirement contribution model so that provident funds get brought into the same tax structure (allowing a deduction for contribution by employers; taxed as a fringe benefit subject to the capped deduction in the hands of the employee) as the quid pro quo for taking away the provident fund's ability to give a total lump sum at retirement.

There is a lengthy discussion in the Paper dealing with defined benefit schemes, but these are of limited significance in the South African market today, as most employers, in order to avoid the accounting issues, have moved their employees towards defined contribution funds. Furthermore, the Treasury would like to simplify the provision of retirement income to not be based on 'taxable income' as defined but to move towards being based purely on the definition of 'remuneration'.

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