DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

BANKING SECRECY: THE END OF THE WORLD AS WE KNOW IT...

The hit song "*It's the End of the World as We Know It (And I Feel Fine)*" is featured on the 1987 album *Document* by the rock band R.E.M. The band's guitarist Peter Buck says the lyrics were inspired by Bob Dylan's "*Subterranean Homesick Blues*". [Real pedigree stuff ... unfortunately, it gives away one's age.]

For bank secrecy across the globe it's also *the end of the world as we know it*. For High Net Worth Individual (HNWI) taxpayers impacted by this, there's unfortunately no reason to feel fine.

A quick stock-take of recent events, evidencing the crumbling of the impenetrable bank secrecy offered in glossy marketing brochures, reveals the havoc:

- In 2009 the United States (US) Justice Department and Internal Revenue Services (IRS) settles with UBS. The Swiss bank has to pay $780 million and hand over thousands of client names.
- In early 2011 four Credit Suisse bankers are prosecuted under a US tax evasion investigation. It is said that the bank maintained thousands of secret accounts holding $3 billion in untaxed assets.
- The IRS investigation soon expands to include Israeli and Asian banks. It seems Swiss banks merely told clients to move assets to other countries rather than disclose same to the US.

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- March 2011 sees the Swiss bank regulator reprimand HSBC's Geneva-based private bank for "*deficiencies in its internal and IT controls*". This after the theft of data covering thousands of international clients.

- In early February 2012 Swiss Wealth Manager, Julius Baer announces that it was looking to gain assets because a tax evasion crackdown in the US and Europe had forced fund withdrawals. Julius Baer earlier paid Germany €50 million to end an investigation over undeclared client assets. Baer also expects to hand over client data to US authorities as part of a final settlement.

- On 2 February 2012 Wegelin & Co (the oldest Swiss bank founded in 1741) becomes the first overseas bank facing criminal charges in the US (despite it having no branches in the USA). Wegelin is accused of enabling wealthy Americans to evade taxes on some $1.2 billion since 2002.
  On 10 February Wegelin is declared a fugitive after its no-show at a Manhattan Federal Court hearing.

- Currently the US Justice Department's criminal investigation involves 11 Swiss banks. A Swiss-American lobby group has urged restraint. Swiss officials are hoping for a settlement covering the entire Swiss banking industry, ie more than 300 banks.

Wegelin is no more. It has since broken itself up. Apparently US Justice officials were really annoyed when the bank wrote a "Farewell, America" letter to its clients following the 2009 UBS settlement.

One has recently seen approaches by South Africans who did not enter the 2010/11 Tax and Exchange Control Voluntary Disclosure Programs (Tax and Excon VDP's). Their question: what is really the risk, and where do we go from here?

The bad news: The South African Revenue Services (SARS) and the South African Reserve Bank (SARB) entertain no "late" VDP applications. The 31 October 2011 cut-off was in terms of statute (for the Tax VDP) and Regulation 24 (for the Excon VDP) and hence no "extension" by officialdom is possible.

But there is some good news ... unfortunately, it comes at a price. SARB's Financial Surveillance Department's Investigations Division does allow for the administrative regularisation of previously undisclosed Excon contraventions. SARB's guideline at the moment is a penalty of between 20 – 40% of the Excon contravention amount. No set-off of the unutilised portion of the R4 million Foreign Investment Allowance is, however, allowed.

On the tax front there is currently not a formal VDP available. Any disclosure to SARS in relation to previously undeclared off-shore income/capital gains will thus depend on SARS waiving penalties and/or interest in terms of its normal statutory discretions. Such disclosure would have to be made at the local SARS office where the taxpayer is on register. It will require presentation of the matter to the relevant SARS Committee(s) at that particular office. Recent experiences show this to be quite cumbersome and the outcome somewhat unpredictable.

But there is hope.

The current Tax Administration Bill (TAB) provides in Chapter 16, Part B, ss225 – 233 for a permanent voluntary disclosure mechanism. The TAB's disclosure dispensation by and large follows the model of the statutory Tax VDP which terminated on 31 October 2011. Taxpayers would be able to declare previously undisclosed off-shore income/capital gains under the Tax Administration Act (TAA), once signed into law. However, the penalty and/or interest relief will certainly be less generous than for past VDP's. [Promulgation of the TAA can probably be expected during the first quarter of 2012 with same taking effect towards the middle of the year.]

Any taxpayer deciding "*to take his/her chances*" should take cognisance of s78 (1A), (1B) and (1C) of the Income Tax Act No 58 of 1962.

Those sections apply where the Commissioner has reason to believe that any resident has not declared or accounted for any funds held in a foreign currency or any assets owned outside South Africa, alternatively any income or capital gain attributable to such resident. Ss(1A) empowers SARS to estimate ("*shall estimate*") the amount in foreign currency of any such funds or the market value in foreign currency of such assets. In making the said estimate SARS could take into account, amongst others, the funds or assets originally transferred from South Africa

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and the period elapsed since transfer. Under s78 (1B) SARS shall estimate an amount of taxable income derived from such off-shore funds and/or assets by applying the "official rate of interest" (normally used for fringe benefit tax purposes) to such funds or to the value of such assets. [Taking into account the low interest rates that have prevailed off-shore the last number of years, this basis of calculation would definitely be hugely prejudicial to a South African taxpayer.] The estimated amount is then converted into Rands at the ruling exchange rate for inclusion in the taxpayer's taxable income for assessment purposes (ss(1C)). SARS' estimate(s) as set out above are subject to objection and appeal.

What should South Africans exposed to the above-mentioned risks do?

- Firstly, accept that bank secrecy no longer guarantees non-detection – simply: *it's the end of the world as we have known it.*
- Secondly, to move monies/assets to another bank or jurisdiction might just heighten the detection risk taking into account banks' strict "know your client" rules and the controls that apply to cross-border currency flows.
- Thirdly, be aware that any head-in-the-sand strategy could trigger SARS' use of its powers to estimate the undisclosed overseas income/capital gain once SARS becomes aware of any concealed off-shore funds and/or assets.
- Fourthly, should there be a real risk of detection (eg date theft), consider approaching the SARB and/or SARS under the available (and soon to be available) disclosure regimes for Excon contraventions and Tax defaults respectively. And manage such process carefully.
- If none of the above is appealing, put on a R.E.M. CD, take some Valiums, turn up the volume ... and wait.

The rules of the game have changed. Individuals resident in South Africa for Excon and tax purposes take note.

Johan van der Walt

NATURE OF A PREMIUM IN ADDITION TO A PURCHASE PRICE

An interesting judgement was handed down in the United Kingdom's (UK) First-tier Tribunal (Tax Chamber) recently in the case of *Bluesparkle Limited v The Commissioner for Her Majesty's Revenue and Customs [2012] UKFTT 45 (TC)*.

Largeflag Limited (Largeflag) was a wholly-owned subsidiary of Bluesparkle Limited (Bluesparkle). Largeflag owned a piece of land and had contracted a third party to build a hospital on the land. Bluesparkle contracted with Largeflag to purchase the land, with the hospital built thereon, on the day the hospital was completed.

Initially the parties agreed that the sale price would be payable in instalments over a few years. An initial amount would be payable followed by the instalments, each instalment having a fixed component and a component expressed as a percentage of a determined purchase price.

Subsequently the parties varied the agreement to the effect that the purchase price would be payable earlier and that the total amount would include an initial payment, followed by a determined purchase price together with a premium and interest.

Bluesparkle paid the total amount, inclusive of the premium, and claimed the premium as a deduction for tax purposes. However, the revenue authorities denied the deduction.

The legal questions that the court had to consider was whether the premium was capital or revenue in nature, and if revenue in nature, whether it was deductible. It was common cause that the amount was not interest.

On the evidence, the witnesses had different views on the nature of the premium, some were uncertain while others said it was an early settlement premium intended to compensate for interest that would have been payable had the purchase price been payable over a longer period as initially agreed. They all agreed, however, that the premium was not intended to be part of the purchase price.

The documentary evidence, however, indicated that the premium (as well as the fixed components to the instalments in respect of the initial agreement) was to ensure that Largeflag would make a profit out of the sale. Apparently the initial agreement whereby

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the purchase price would be payable in instalments was inspired by a scheme for the avoidance of Value-Added Tax. A premium would therefore give commercial credence to the transaction should it ever be attacked as an avoidance scheme.

It was also stated that the reason for the variation of the agreement (ie to accelerate payment of the purchase price) was to place the shareholders of Bluesparkle in a more favourable position to sell their shares.

Nevertheless, it was submitted on behalf of Bluesparkle that the premium was additional to the purchase consideration and it was to induce Largeflag to agree to early settlement. It did not bring any enduring asset into existence and it did not divest Bluesparkle of any capital asset. The premium was therefore revenue in nature.

Also, the premium was deductible because it was wholly and exclusively expended for the purpose of Bluesparkle's trade. Similar to what is provided in s23(g) of the Income Tax Act No 58 of 1962, the tax laws of the UK disallow the deduction of expenditure not incurred for the purposes of trade, with the added qualification that it will only be allowed if wholly and exclusively incurred for the purposes of trade.

However, the court found that the premium payable in terms of the subsequent agreement could not have been an additional sum because the purpose of the variation was simply to reconfigure the payment timetable (that is, allow for earlier payment) and not to change the character of the payments. The premium was really nothing more than the "rolling up" of the fixed components attaching to the instalments in the initial agreement.

The court remarked that: "*On the face of it, any payment under a sale agreement must in the hands of the payer be presumed to be in the nature of capital, unless it is clearly otherwise.*" The premium may have been intended to reflect an amount of profit in addition to the base price of the asset, but this did not change the fact that it was clearly consideration for the disposal of the asset.

The question was "*what was the premium paid for?*". Undoubtedly the land with the hospital thereon was a capital asset for Bluesparkle and the premium formed part of what was given in return.

The court also found that, even if it was wrong in characterising the premium as a capital amount, it would not have been deductible because the premium had a dual purpose. The transaction was beneficial to Bluesparkle's financial position, but the premium (in the sense that it reflected the fixed components of the instalments in the initial agreement) was also to "enhance the commerciality" of the transaction if it was ever attacked as an avoidance scheme. The expenditure could therefore not have been wholly and exclusively incurred for the purposes of trade.

Heinrich Louw

WHEN CAN SARS ISSUE A "JEOPARDY ASSESSMENT"?

The Tax Administration Bill (TAB) will soon be signed into law as the Tax Administration Act (TAA).

Although the TAA introduces the concept of "self-assessment" (refer to s1 for the definition), the TAA by-and-large retains the well known concepts related to the assessment process.

Assessments (defined in s1), original assessments (s91), additional assessments (s92), reduced assessments (s93) and estimated assessments (s95) are all old-timers, but they've been given a slight face-lift in the TAA (for example, refer to paragraph 2.2.8 of the Explanatory Memorandum to the TAB).

The "jeopardy assessment" is the new kid on the block (s94).

According to the Explanatory Memorandum (refer paragraph 2.2.8.4), a jeopardy assessment may be issued in advance of the date on which the tax return would normally be due, in order to secure the early collection of tax that would otherwise be in jeopardy or where there is some danger of tax being lost by delay. It will be made where a senior SARS official (a defined term) is satisfied that such an assessment is necessary to secure the collection of tax that would otherwise be at risk, eg a taxpayer attempts to place assets beyond the reach of SARS' collection powers once an investigation starts.

The raising of a jeopardy assessment at a stage <u>before any tax return is due</u> is clearly a drastic measure. That's the reason for the involvement of a senior SARS official. Used in conjunction with the "pay now, argue later" approach, a jeopardy assessment potentially enables SARS to quantify, assess and collect in respect of an alleged tax debt before the taxpayer has even rendered any return related to the income/gain that SARS has subjected to tax via such assessment.

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The recent United Kingdom (UK) case of *Revenue and Customs Commissioners v Ali [2012] STC 42 / [2011] EWHC 880 (Ch)* does not deal directly with jeopardy assessments. But it does give some insight how UK courts regard the interplay between the assessment process and the risk that a taxpayer might dissipate assets.

Mr Ali was a director and employee of a company that during 2001 received nearly £3 million from the UK Department of Education and Skills for its purported participation as a learning provider in a vocational scheme operated by the Department. The company in turn paid £2,5 million to Ali. Her Majesty's Revenue and Customs (HMRC) alleged that the company had wilfully failed to deduct the correct amount of PAYE in respect of said payments, during 2002. In 2011, HMRC anticipated making a direction which meant that Ali would become liable for income tax of well over £1 million. HMRC did not wish, however, to serve the direction and the associated assessment because it feared that Ali would hide his assets or remove same from the jurisdiction. HMRC was also concerned that it might not have a cause of action sufficient to support a freezing order unless it had first issued the assessment. In the end HMRC served the direction and assessment on Ali as well as the freezing order on the same day (17 February), so very little time elapsed between the two events.

The issue before the Chancery Division was the fact that the serving of the assessment and the freezing order happened virtually simultaneously. [Ali intended to contest the merits of the assessment in a separate process.]

In court the following argument was raised on Ali's behalf: the assessed amount was only due in 30 days from the day on which the notice of assessment was given (ie the debt under the assessment did not become due until 30 days after 17 February). In Ali's view HMRC therefore had no existing cause of action at the stage the freezing order was made.

Warren J put it thus: "*... there does exist a present right, that is to say the payment of tax, albeit payable in future, but there is an accrued right and a threatened breach...*" The Judge consequently considered many well known UK cases addressing the "*no cause of action*" point. He also referred to Australian case law dealing with Mareva injunctions.

Warren J held as follows (at [51]):

"*In my judgment, the court clearly has jurisdiction in the strict sense to grant these injunctions against Mr Ali. More importantly, it is not, in my judgment constrained from doing so by the authorities. I consider that HMRC have a sufficient immediate and present interest to support this relief. The particular important point is that HMRC are properly to be seen as a creditor. Their debt is not contingent, albeit it is payable, as I have said a couple of times already, at a time, and a short time at that, in the future. The special feature of this debt makes it right that where it is just and equitable to grant the relief the court should be able to do so. It does not seem to me that the factors which have led the courts to refuse Mareva injunctions where there is no cause of action or anything like a cause of action apply in the present case.*"

He continued (at [53]):

"*I see no reason not to find support in that when applied to the statutory functions of HMRC to collect tax and if they can see a taxpayer who is going to dissipate his assets to avoid compliance with an assessment on which they cannot, because of the 30-day time limit, yet sue him to judgment, I see no reason why that is not a factor properly to be taken into account.*"

Warren J then mentioned the following factors to be taken into account when considering the making of a freezing order:

- The chances of success of the taxpayer's tax appeal.
- The risk of dissipation which, in turn, strongly hinges on the taxpayer's honesty, alternatively dishonesty ("*If he has been dishonest, that may colour the view of the court about the risk of dissipation. But just as dishonesty is not an essential element to the exercise of the jurisdiction, so dishonesty is not by itself enough. The dishonesty relied on must be sufficient to justify, together with the other evidence, the inference of a risk of dissipation and this requires an examination of the facts of course.*").
- The delay in seeking relief ie the party fearing dissipation should act expeditiously ("*A failure to seek relief promptly might be seen as indicating a lack of concern, suggesting that there is really no risk of dissipation at all.*").

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The manner in which the court applied the above-mentioned principles suggests that the following would be some of the factors that a senior SARS official would have to consider before raising a jeopardy assessment:

- The merits of the tax case to be contested later on
- Pointers regarding the taxpayer's honesty or dishonesty in past dealings with SARS
- Transparency, or the lack thereof (eg evasive and/or contradictory answers)
- The taxpayer's historic general compliance record
- The quantum of the assessment and how this stacks up against the taxpayer's resources
- Whether the taxpayer's actions might possibly have involved criminality (eg fraud)
- Non-disclosure or concealment of assets eg bank accounts
- The ease with which the taxpayer could dispose of assets and externalise the proceeds (eg multiple passports, access to off-shore bank accounts, relatives overseas, etc).

This is by no means an exhaustive list. Each case will depend on its particular facts.

The raising of a jeopardy assessment is an invasive step which could be highly prejudicial to a taxpayer.

Section 94 (2) does provide for a review application to the High Court on grounds that (1) the amount is excessive; and (2) the circumstances justifying such assessment are non-existent. The reality is that any review application is a reactive (and costly) remedy.

The publication of detailed guidelines governing this important aspect of the TAA might be a better safe-guard, thereby pro-actively ensuring that a jeopardy assessment would only be raised in appropriate circumstances in the first place.

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