DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

TRUST REFORM – IS THERE SOMETHING IN THE OFFING?

SARS' focus on High Net Worth Individuals (HNWI's) and their trusts has been a recurring theme in previous Tax Alerts.

The topic featured in the latest Budget Speech. Then, at the beginning of April, when SARS announced that it had over-shot the revenue target, the Commissioner mentioned that SARS research showed that a potentially significant number of HNWI's "... abused trusts to hide their tax liability".

In April, Mr Bob Head joined SARS as special adviser to the Commissioner. In a Business Day article titled "SA strikes right tax balance to address its challenges" (2 April 2012) he wrote: "Sadly I have never inherited anything and whatever I have I made. I have seen a lot of it disappear in tax. That is just the way it is. I find inherited wealth more difficult to stomach and when the income on that wealth is hidden in trusts and structures to avoid tax, then I really do see red."

That SARS found HNWI's and their trusts irksome, was clear. What SARS was going to do was, however, not so clear?

Perhaps the latest SARS Strategic Plan (2012/13 – 2016/17) holds the answer?

Under "Risks facing SARS" there is mention (at page 19) of the "Compliance risk posed by high-net worth individuals and the use of trusts to conceal their income." It says that under-declaration of income by persons in the HNWI category (annual income in excess of R7 million, alternatively R75 million in assets) was wide-spread with "only a fraction" having actually declared their income to SARS.

The really interesting bit comes a little later (at page 33). Under the heading "High-net worth individuals - Trusts" there is the following: "The interventions will focus on SARS's efforts on the auditing and risk profiling of individuals and associated companies together, as the expansion of third party data to identify individuals with disproportionately expensive assets, *as well as to prioritise trust reform*."

Will SA taxpayers soon face some reform related to the taxation of trusts? There is an ominous ring to the highlighted phrase at the end of the above-quoted passage.

Johan van der Walt

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SENT PACKING

Mr Eduard Sent (Sent) was sent packing by the Federal Court of Australia (FCA) on 16 April 2012, in an appeal against a decision by the Administrative Appeals Tribunal (Tribunal) on whether some or all of a payment of $11,600,000 to an executive share trust (Trust) was assessable as income in the hands of Sent (*Sent v Commissioner of Taxation [2012] FCA 382*). While the taxation of share incentive schemes in Australia differs from the position in South Africa, the case does highlight certain principles that are equally applicable in South Africa.

Sent was the managing director and chief executive officer of a public company (Employer). In about October 2001, it was determined that Sent was entitled to three bonus payments that fell into three categories, being bonuses that:

- Had accrued and were payable;
- were accruing, relating to periods which had been part performed; and
- related to future periods which had not accrued in any sense (ie related to the future financial performance of the Employer).

Sent and the Employer entered into an arrangement, that in consideration for Sent waiving his entitlements to any remuneration or bonus payable to him, the Employer will issue him or his nominee with five million fully paid ordinary shares in the Employer (the Shares). Shareholder approval was obtained on 30 November 2001 for the issue of the Shares to Sent or his nominee.

However, the Trust was only created in December 2001. As part of establishing the Trust, an arrangement was entered into where among others, the Employer would settle money on the trustees (ie the $11,6 million payment to the Trust (the Payment)), which would be used to make loans to eligible employees (Sent in this case) for the purpose of applying to the trustees for units in the Trust. Monies received by the trustees for units in the Trust were to be used exclusively to acquire the Shares. The units could not be cancelled at the instigation of a unit holder (Sent) within 12 months of their issue.

The issue for determination was whether the $11,6 million Payment to the Trust by the Employer, in whole or in part, should be assessable as ordinary income. The Tribunal had found that only a portion of the payment was assessable as ordinary income in the 2002 year of assessment.

The FCA found that the entire Payment was assessable as ordinary income and stated the following:

- The fact that some of Sent's bonus entitlements were contingent and subject to claw back in that they were based on the Employer's future performance, and may be viewed as having been paid before the services were provided, does not mean that the Payment loses its character as income. The timing of a payment as against the provision of the services is not determinative of its character (at paragraph 44).

- It is not correct to describe Sent's entitlements as contingent or subject to claw back at the time of the Payment. Some of Sent's bonus entitlements were contingent insofar as they related to the future financial performance of the Employer. However, once the share issue deed was executed and approved by the shareholders on 30 November 2001, Sent had an unconditional entitlement to be issued the Shares in substitution of these bonus entitlements (at paragraph 48).

- Even though there were a number of restrictions on Sent's ability to receive the benefit from the Trust (eg the existence of a vesting period, his inability to cancel units), it did not accept that these matters bear on whether he derived income when Payment was made on 21 December 2001. The dealings between Sent, the Trust and Employer after that date are dealings with income already derived (at paragraph 90).

- If Sent had been made a direct payment of his future bonus entitlements, subject to the condition that his services be provided in the future (and if that amount was repayable if he did not do so), then it might be that the payment would not be assessable as income on the basis of the principle in Arthur Murray (NSW) Pty Ltd FCT (1965) 114 CLR 314 - because it was not yet derived (similar to the accrual principle in South Africa) (at paragraph 101).

- However, once the share issue deed was entered into and approved by the shareholders his contingent entitlement was replaced by an unconditional right to be issued the Shares. Even more clearly, any contingencies were no longer operative on 21 December 2001 when the Payment was actually made without any conditions related to future financial performance being attached (at paragraph 102).

The case illustrates the importance of carefully implementing a transaction. If the share incentive scheme had be implemented carefully (ie an appropriate contingency or restriction was placed on the receipt of the Shares), Sent may at least have been able to defer a portion of his income tax liability to a later year of assessment.

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In South Africa, s8C of the Income Tax Act, No 58 of 1962 (Act) provides that the income tax treatment will only arise on the vesting of the equity instrument (ie generally when all the restrictions placed on the equity instrument cease to have an effect).

However, it is unlikely that the provisions of s8C of the Act would have been able to assist Sent if the transaction was implemented in South Africa as there would already have been an accrual before the receipt of the units in the Trust. Employees looking to substitute their bonus entitlements for shares in a share incentive scheme must thus ensure that the scheme is implemented with care, taking into account s8C and the general taxing provisions of the Act, so as not to trigger adverse tax consequences.

Andrew Lewis

BASE COST OF DIVIDEND *IN SPECIE*

The advent of dividends tax came with (and in some instances was preceded by) a host of concomitant changes to the Income Tax Act, No 58 of 1962 (Act) in respect of distributions made by companies.

Some of these changes include:

- A new definition of "dividend";
- introduction of the term "contributed tax capital";
- introduction of the term "return of capital"; and
- amendments to Part XI of the Eighth Schedule to the Act in respect of the capital gains tax consequences of company distributions.

Essentially, the new regime pertaining to company distributions separates company distributions into dividends and returns of capital. Where a distribution constitutes a dividend, it is dealt with under the dividends tax provisions in Part XIII of Chapter 2 of the Act, and where a distribution constitutes a return of capital it is dealt with under Part XI of the Eighth Schedule to the Act.

It would, however, appear that in the rush to bring about the new regime an important element was left out in respect of distributions of assets *in specie*.

Obviously, the distribution of an asset *in specie* can constitute either a dividend or a return of capital. However, irrespective of the nature of the distribution, a base cost will have to be determined in respect of that asset in the hands of the recipient (assuming the asset is held on capital account by the recipient).

Previously, irrespective of whether the distribution of an asset *in specie* constituted a dividend or a capital distribution, its base cost in the hands of the recipient was determined by paragraph 76(3) of the Eighth Schedule to the Act, which read:

> Any distribution of an asset *in specie* received by or accrued to a shareholder must be treated as having been acquired on the date of distribution and for expenditure equal to the market value of that asset on that date, which expenditure must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

However, paragraph 76(3) was amended by the Taxation Laws Amendment Act, No 24 of 2011 with effect from 1 April 2012, and now reads:

> Where a return of capital is effected by way of a distribution of an asset *in specie*, that asset must be treated as having been acquired by the person to whom the distribution is made on the date of distribution and for expenditure equal to the market value of that asset on that date, which expenditure must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

It is clear from the above that paragraph 76(3) no longer deals with the case where the distribution of an asset *in specie* constitutes a dividend but only where it constitutes a return of capital.

Accordingly, there is no specific provision dealing with the base cost of a dividend *in specie* in the hands of the recipient. The general provisions under paragraph 20 of the Eighth Schedule to the Act cannot be employed as no expenditure will have actually been incurred by the recipient of the dividend *in specie*. In fact, if paragraph 20 is applied, it could yield a base cost of zero.

In the absence of a provision deeming the base cost of the dividend *in specie* in the hands of the recipient to be market value, there could potentially be double taxation. This is so because the company making the distribution will have already had to account for capital gains tax calculated using deemed proceeds equal to the market value of the asset in terms of paragraph 75. This is despite the fact that the company would also be liable for dividends tax in respect of the dividend *in specie* in terms of s 64EA(b).

It is therefore submitted that there is a *lacuna* in the tax legislation as it stands, and that the legislature should correct it in the 2012 amendment legislation.

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