DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

HIGH NET WORTH INDIVIDUALS INCREASINGLY ON SARS' RADAR

SARS recently announced that, following a year-long investigation, it had uncovered thousands of local High Net Worth Individuals (HNWI's) who were not on the tax register.

Apparently South Africa (SA) has 9 300 HNWI's earning more than R7 million per annum, alternatively who have assets of more than R75 million. SARS records only reflect 360 individuals in this taxpayer category. The loss to the fiscus is estimated to be R48 billion.

Group Executive Jonas Makwakwa says SARS will bolster its investigations unit with 70 top-end accountants. A risk intelligence team is being set up. To uncover non-compliant HNWI's SARS will cross-reference data relating to, for example, property registrations, trusts, vehicle and aircraft ownership, JSE share ownership, investments, private school enrolments and media reports. People with a penchant for race horses, gambling, jewellery, artwork, exotic holiday destinations and the finer things in life – be warned.

The Italian example comes to mind: Although Italy is one of the world's 15 richest nations based on per-capita GDP, only 0.2% of Italian taxpayers declare income in excess of US$250,000 per annum. Hence Italian undercover tax inspectors have lately been looking for well-to-do tax cheats at beaches, yacht clubs and on ski slopes. In Capri, a person was found on a luxury yacht – officially he was listed as having no assets and in need of welfare.

Looking at the Credit Suisse Global Wealth Report 2011, SARS might well be onto something. The Report states: "*Since last year's inaugural report, global wealth has increased to USD231 trillion from 195 trillion in 2010, led by growing wealth in South Africa, India, Australia, Chile and Singapore.*" Credit Suisse expects the number of US dollar millionaires in SA to increase from the 71 000 in 2011 to a

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forecasted 243 000 by 2016 (ie an increase of 242% over the next five years!). According to the bank, 116 000 South Africans are currently members of the global top 1% of wealth holders.

What this means with regard to tax compliance is a more vexing issue.

It is to be expected that globally the tug of war between tax authorities (with reduced tax revenues due to the 2007-08 financial crisis) and HNWI's (probably feeling that they're being singled out as easy prey) would intensify.

Undeniably, some HNWI's have a unique take on tax compliance. Others simply believe government is inherently incapable of properly managing the public purse.

Leona Helmsley, businesswoman and real estate entrepreneur, was convicted of federal income tax evasion in the USA in 1989. A former housemaid testified that Helmsley said: "*We don't pay taxes. Only the little people pay taxes ...*" Helmsley spent 19 months in prison and two under house arrest. Seemingly her "naked greed" alienated jurors.

In 1991, the late Australian businessman Kerry Packer defended his companies' tax-minimisation strategies before Parliament: "*Of course I am minimising my tax. And if anybody in this country doesn't minimise their tax, they want their heads read, because as a government, I can tell you you're not spending it that well that we should be donating extra!*"

Deep-pocketed individuals and their sometimes extravagant life-styles juxtaposed with their approach to paying taxes can be emotive — more so in SA with its GINI coefficient of 0.68, one of the highest in the world. At the start of 2011 Minister of Finance, Pravin Gordhan told SA business that he was looking to private industry to create more jobs and to reduce inequality: "*If you want stability in our country and if you want growth in our country then people need money in their pockets ... Inequality is not sustainable. We're not talking about charity, we're talking about self-interest.*"

So what drives tax compliance, or non-compliance for that matter?

The "social contract" theory of Hobbes, Locke and Rousseau argues that taxation is necessary for a proper functioning state and society. The notion is that a person living in a community enters into some type of "social contract" with fellow members of that community and he/she must accordingly share the burden to keep that community functioning (eg by paying taxes). So far, so good.

Research shows, however, that certain factors do enhance, and others do diminish, tax compliance (including at the level of the better-off members of society):

- A 2007 study found that: "*The fiscal exchange between the state and its citizens requires that citizens' tax payments are met by public services provided by the government. According to the benefit principle of taxation, taxes are prices for certain public goods. However, the benefit principle does not necessarily imply that income redistribution becomes impossible, and only infrastructural goods as well as public consumption goods are provided by the state. Citizens may perceive their tax payments as contributions to the bonum commune such that they are willing to declare their income honestly, even if they do not receive full public good equivalent to their tax payments. Income redistribution is more likely to be accepted by affluent citizens when the political process is perceived to be fair and the policy outcomes legitimate*".

- A fairly recent study on *"Tax Evasion, Corruption, and the Social Contract in Transition"* looked at the reasons why tax evasion was distressingly high in countries like Russia, the Czech Republic, Croatia and Poland (often as much as 40% of the total economy). One of the findings: *"Tax evasion is part of a more general syndrome of corruption, impotent legal systems, shaky economies, and especially inefficient governments that fail to provide essential services. New democratic institutions did not ensure smoothly functioning states and reduced corruption. Parliamentary elections and promises of the rule of law did not turn Romania or Russia into Sweden ... When people believe that public officials steal their tax payments – and especially when they believe that they don't get high quality services for their taxes, they are most likely to evade paying their taxes"*.

- A study that considered appropriate mechanisms for taxing the informal sector in developing countries (and specifically in Ghana), opines: *"Legitimate taxpayers in the formal sector perceive the state as being unfair in pursuing them for taxes while the informal sector continues to operate untaxed. Ignoring informal sector activities will lower compliance morale and increase the risk of generalized non-compliance. There is some evidence from Latin America suggesting that tax compliance in the formal sector is higher in countries which have a relatively small informal sector"*.

True to human nature, members of society will have differing attitudes to tax compliance. As the saying goes: "*To each his own.*"

Is SARS interested in what's going on in the minds of its HNWI constituency? Unlikely.

Is SARS interested in what's lurking in the (bulging?) pockets of those HNWI's? You bet.

Johan van der Walt

GOODWILL – CAPITAL OR REVENUE?

A United Kingdom court (Upper Tribunal – Tax and Chancery Chamber) recently handed down the judgment of *Countrywide Estate Agents FS Limited v Commissioner for Her Majesty's Revenue and Customs* [*2011 UKUTS 470 (TCC)*].

A group of companies conducted various business activities. The group included an estate agency, a financial services provider and a life assurance provider.

These businesses were closely related. Generally, clients would approach the estate agency to purchase property. The estate agency would introduce the clients to the financial services provider in respect of financial services relating to the purchase of property. The financial services provider would, in addition to securing mortgages, advise on related life assurance products. In this regard, the clients would be referred to the life assurance provider.

At some point the decision was taken that the life assurance provider would cease its operations. The financial services provider then entered into an agreement with an external life assurance provider to the effect that it would exclusively refer clients to the external life assurance provider for 15 years.

As consideration the financial services provider would receive an up-front payment of £25 million as well as commission on each product sold as a result of the referral.

The financial services provider (Taxpayer) accounted for the £25 million as being capital in nature but Her Majesty's Revenue and Customs (HMRC) contended that the amount should have been taxed as a revenue profit.

The court framed the question as being whether the taxpayer parted with its property for a purchase price or whether it was a method of trading by which it acquired the £25 million as a trade profit. It had to be determined what the £25 million consideration was for.

The taxpayer contended that it had parted with its goodwill, being a capital asset. Its goodwill was its customer base, which rested on its name and reputation, its association with the estate agency and its geographical spread. The taxpayer's view was that it gave up the right to exploit its own customer base.

The court, however, disagreed. It could not see how the taxpayer had parted with any significant portion of its goodwill. The taxpayer's goodwill depended on its position in the market and its association with the estate agency. The agreement with the external life assurance provider left those elements unchanged. The fact that the taxpayer would exclusively refer clients to the external life assurance provider did not detract from its goodwill as it had always referred clients to only one life assurance provider.

The court also commented that the taxpayer's profit-making apparatus was not depleted or destroyed by entering into the agreement and thus it could not be said that it had parted with any capital asset.

What had actually happened is that, without parting with it, the taxpayer had used its goodwill in order to generate a revenue profit. That is, the taxpayer had engaged in a method of trading.

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