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TAX ALERT

THE PAYMENT OF DIVIDENDS OUT OF NEGATIVE RESERVES

The issue has often arisen as to whether the payment of a dividend that results in the creation of negative reserves can still be said to be a dividend or whether it is effectively funded from the share capital of a company. For instance, a company can have 100 as equity that is reflected as 100 in assets. However, the company then declares a dividend that results in it effectively having negative reserves of 100 in circumstances where the assets of 100 are used to fund the dividend. For all practical purposes one would think that the dividend is effectively paid out of capital, but no specific decision is made by the board of directors in declaring the dividend that the dividend is in fact funded from the capital account.

In a South African context, a foreign dividend is defined as an amount that is paid or payable by a foreign company in respect of a share in that foreign company where the amount is treated as a dividend or similar payment by the foreign company for the purposes of the laws relating to tax on income on companies of the country in which the foreign company has its place of effective management. It does not include any amount paid or payable that is deductible by the foreign company in the determination of any tax on income on companies of the country in which the foreign company has its place of effective management.

In the English case of *HMRC v First Nationwide*, the issue arose in the context of a Cayman Island company declaring dividends to its shareholder. For purposes of Cayman Island company law, the relevant dividends that were declared in respect of the preference shares constituted dividends.

The Court of Appeal in the UK (13 March 2012) indicated that the dividends in question constituted income. Given the fact that one could distribute share premium as dividends under Cayman Islands company law, the UK Courts had to give effect thereto. This is notwithstanding the fact that share premium can otherwise be seen as the "corpus" of a company.

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In a South African context, the issue becomes that much more relevant given the fact that a dividend is defined in a domestic context as any amount transferred or applied by a company for the benefit of or on behalf of any person in respect of any share in the company. It excludes a reduction of contributed tax capital of the company (CTC). However, the use of CTC can only take place to the extent that it is determined to be a return of CTC by the directors of the company or by some other person or body of persons with comparable authority. If it is not determined as a return of CTC, it follows that it must of necessity be a dividend.

Emil Brincker

PERSONS LIABLE FOR TAX UNDER TAX ADMINISTRATION BILL

The Tax Administration Bill (TAB) is expected to be promulgated during the course of 2012 and although it is unlikely that all sections in the TAB will come into force immediately due to, among others, system constraints, we wish to highlight important aspects pertaining to certain new types of persons potentially liable to tax.

As stated in many South African Revenue Service (SARS) publications, the object of the TAB is to provide a single body of law that outlines common procedures, rights and remedies and to achieve a balance between the rights and obligations of both SARS and taxpayers in a transparent relationship. Essentially, the TAB seeks to consolidate the administrative sections of the various acts administered by the Commissioner for SARS.

Chapter 10 of the TAB, dealing with tax liability and payment, introduces certain new categories of persons liable to tax and the capacity (personal or representative) in which those persons may be liable for tax debts. The categories discussed for purposes of this article are:

- person chargeable to tax;
- representative taxpayer;
- withholding agent; and
- responsible third party.

Person chargeable to tax

Although not technically a new type of person liable for tax, clause 152 of the TAB states that a person chargeable to tax is a person on whom the tax liability for tax due under any act administered by the Commissioner for SARS is imposed and who is personally liable for the tax. In essence, this is the primary person liable to tax (for example, an individual or company).

Representative taxpayer

Clause 153 of the TAB states that a representative taxpayer means a person who is responsible for paying the tax liability of another person as agent, other than a withholding agent (see below). A representative taxpayer includes a representative taxpayer under the Income Tax Act, No 58 of 1962 (Act), a representative employer under the Fourth Schedule to the Act and a representative vendor under the Value-Added Tax Act, No 89 of 1991 (VAT Act). It is important to note that a principal taxpayer is not relieved from any liability where a representative taxpayer has been appointed to pay any tax liability. A representative taxpayer will also be provided with the right to indemnity after paying the relevant tax debt.

A representative taxpayer may, however, be held personally liable for tax payable in a representative capacity if, while the tax debt remains unpaid, a representative taxpayer:

- Alienates, charges, or disposes of amounts in respect of which the tax is chargeable; or
- disposes of or parts with funds or monies, which are or came into the possession of the representative taxpayer after the tax is payable, if the tax could legally have been paid from those funds or monies.

Withholding agent

A withholding agent, under clause 156 of the TAB, is a person required to withhold an amount of tax and pay it to SARS. Pay-As-You-Earn (PAYE) is an example of a tax that must be withheld by a withholding agent. A withholding agent may be held personally liable for an amount of tax:

- withheld and not paid to SARS; or
- which should have been withheld under a tax act but was not so withheld.

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A withholding agent will also be provided with the right to indemnity after paying the relevant amount of tax.

Responsible third party

The final category of person liable to tax is a responsible third party, which is a person who becomes otherwise liable for the tax liability of another person, other than as a representative taxpayer or withholding agent, whether in a personal or representative capacity.

A senior SARS official may, by notice to a person who holds or owes or will hold or owe any money for or to a taxpayer, require that person to pay the money to SARS in satisfaction of the taxpayer's debt. Where a person receiving notice, parts with money contrary to the notice, that person then becomes personally liable.

Further, to the extent that negligence or fraud is present, a person who controls or is regularly involved in the management of the overall financial affairs of a taxpayer may be held personally liable for the tax debts of a taxpayer. The aforementioned is similar to provisions already contained in the Fourth Schedule to the Act.

Shareholders of a company (which excludes a listed company or its shareholders) may also incur a personal liability for a company's tax debts under the TAB. Clause 181 of the TAB, dealing with shareholder liability, applies where a company is wound up other than by means of an involuntary liquidation without satisfying its tax debts including its liability as a responsible third party, representative taxpayer, withholding agent, employer or vendor.

Persons who are shareholders of the company within one year prior to its winding up are jointly and severally liable to pay the unpaid tax to the extent that:

- Those shareholders receive assets of the company in their capacity as shareholders within one year prior to the company's winding up.
- The tax debt existed at the time of receipt of the assets or would have existed had the company complied with its obligations under a tax act.

A final aspect we wish to note under this section is the liability of a transferee for tax debts, which could be applicable in the case of an asset sale / disposal of a business. In essence, a transferee who receives an asset from a taxpayer who is a connected person in relation to the transferee without consideration or for consideration below the fair market value would be liable for the tax debts of the taxpayer.

It is clear the TAB will have a significant impact on the daily administrative interactions with SARS and taxpayers are cautioned to familiarise themselves with these provisions.

Ruaan van Eeden

THE APPLICATION OF GENERAL ANTI-AVOIDANCE PROVISIONS

In a recent decision of the Supreme Court of Ireland in the case of *O'Flynn Construction Limited v the Revenue Commissioners (case no 264/06)*, the court was called on to decide, for the purposes of the general anti-avoidance rule, whether a particular tax avoidance scheme resulted in the misuse or abuse of a tax relief provision.

In 1958, the legislature in the United Kingdom sought to encourage the manufacture of products for export by introducing an Export Sales Relief Scheme (ESR Scheme). In terms of the ESR Scheme, profits earned from qualifying exports would be exempt from corporation tax and, furthermore, dividends declared from such profits would also be relieved from income tax in the hands of all shareholders until ultimately the dividend is received into the hands of an individual.

Simplified, the facts were that a certain company that had an Export Sales Relief (ESR) reserve apparently did not have the cash with which to pay a dividend that might be declared in respect of such reserve. A scheme was thus devised by the taxpayers which in essence involved various loans to enable ESR tax free dividends to be declared up the group structure but ultimately into the hands of various shareholders who were not shareholders in the ESR earning company or a related company at the time when the ESR profits were earned.

The issue before the court was whether, applying the general anti-avoidance rule, the scheme resulted directly or indirectly in the misuse or abuse of the ESR provision having regard to the purpose for which it was provided.

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In a split decision, the majority of the judges having regard to both its substance and its form stated that the transaction was highly artificial and contrived. According to the judges, the scheme allowed the shareholders in a non-exporting company to benefit from ESR on the profits of the non-exporting company and as such was surely a misuse or abuse of the ESR scheme having regard to the purpose for which provision is provided.

The minority, in arguably a more lucid judgment, said that legislative policy must be anchored in the language used by the legislature and that recourse should, where appropriate, be had to its context as disclosed by the statute (or provision) as a whole. The minority commented that since its promulgation, the ESR provision was amended numerous times over a lengthy period but no attempt was made to restrict or otherwise curtail the benefit of the exemption, as dividends percolated through into the hands of the ultimate recipient. The minority were thus of the view that the scheme did not result in a misuse or abuse of the ESR provision, even though the dividends flowed ultimately to shareholders who were not shareholders of the exporting company at the time the profit was derived.

It should be appreciated that the general anti-avoidance rule contained in section 80A of the Income Tax Act, No 58 of 1962 (Act) also contains a 'misuse or abuse' provision. However, unlike its United Kingdom counterpart, it does not expressly provide for regard to be had to the purpose for which the provision of the Act (alleged to have been misused or abused) was provided. In other words, there is no express statutory obligation to have regard to the purpose for which a particular provision of the Act was enacted when determining whether a scheme results in a misuse or abuse of such provision.

Nevertheless, SARS, in its Draft Comprehensive Guide to the General Anti-avoidance Rule, states that the misuse or abuse provision "clearly requires a purposive approach to interpreting the provisions of the Act, which is already the accepted approach to legislative interpretation in South Africa." In this regard, SARS states that a mere literal interpretation of the provisions will no longer safeguard a taxpayer who applies the provisions of the Act in a context or manner which is not intended by the Act.

But, in reiterating the sentiments of the minority judges in the *O'Flynn* case, establishing the purpose of a particular provision will generally not be an easy task. In doing so, the following words of the minority judges will serve as a reminder to judges of the limits of their judicial authority:

"Any suggestion that the courts could, having identified the legislative policy by whatever means, apply that policy to influence, modify or alter the wording of a taxation provision, would be tantamount to judicial intrusion into this key legislative sphere, and would be an usurpation of such legislative power. Neither the formation of taxation policy nor the creation of a taxation charge are matters for the judiciary. Such would be quite an inappropriate exercise of judicial function."

As yet, there is no South African case law that deals with the misuse or abuse provision in s80A of the Act. It is considered that the proper implementation thereof will cause many a sleepless night for SARS officials, advisors and to a greater extent the members of the judiciary charged with giving effect thereto.

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