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TAX ALERT

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DISPOSAL OF SHARES IN LAND RICH COMPANIES

Earlier this year, the Federal Court of Australia issued the judgment of *Resource Capital Fund III LP v Commissioner of Taxation [2013] FCA 363 (26 April 2013).* The case related to a challenge by the Resource Capital Fund (RCF), a non-resident of Australia, to a decision by the Australian revenue authorities to impose capital gains tax (CGT) on the disposal of shares in an Australian gold mining company. The principles discussed in the *Resource Capital* case may be relevant in a South African context when considering inbound and outbound investments in land-rich companies.

RCF was a limited partnership (LP) formed in the Cayman Islands. The general partner of RCF was a LP formed in Cayman Islands with its affairs managed by a company in Delaware in the United States of America. More than 97% of the contributed capital of RCF was held by US residents. RCF had acquired shares in St Barbara Mine Ltd (SBM), which conducted mining operations on mining tenements it owned in Australia, using plant, equipment, mining information and other assets held by it. SBM's shares were listed on the Australian securities exchange.

When RCF, a non-resident of Australia, disposed of its shares in SBM in 2007/2008, the Australian revenue authorities issued RCF with an assessment on the basis that the capital gain from the disposal of the shares is subject to CGT in Australia. Australia's domestic tax legislation is similar to South Africa's tax legislation in that a non-resident may be subject to CGT on the disposal of shares in a land-rich company, subject to any applicable treaty relief.

The Federal Court of Australia had to consider the following two issues:

- whether the assessment could properly be issued to RCF (the LP) or should the assessment have been issued to the limited partners of RCF since the country of residence treated RCF as being transparent for tax purposes; and
- whether any capital gain can be disregarded on the basis that the market value of SBM's "taxable Australian real property" (TARP) did not exceed the sum of the market value of SBM's non-TARP assets.

On the first issue, the Court dismissed the Commissioner's contentions that it was entitled to issue the assessment to RCF. Edmonds J specifically referred to, and accepted, the OECD Commentary which indicates that *"[w]here a State considers that a partnership does not qualify as a resident of a Contracting State because it is not liable to tax and the partners are liable to tax in their State of residence on their share of the partnership's income, it is expected that that State will apply the provisions of the Convention as if the partners had earned the income directly so that the classification of the income for purposes of the allocative rules of Articles 6 to 21 will not be modified by the fact that the income flows through the partnership."*

continued

Accordingly, Edmonds J held that while the treaty may authorise Australia, through its domestic law, to tax the US resident limited partners in RCF on their respective distributive shares of the gain, it does not authorise Australia to tax the gain in RCF's hands.

The second issue decided on by the Court (even though the Court found in favour of RCF on the first issue) was whether RCF (or the partners) may disregard any capital gain in Australia on the basis that the sum of the market values of the SBM's TARP assets did not exceed the sum of the market values of SBM's non-TARP assets at the date of the disposal of the shares.

Both parties called expert witnesses on matters of gold mining geology and valuation to assist with identifying which assets need to be valued, the hypothesis upon which the valuation is to be made and the appropriate valuation methodologies to be applied. Some of the interesting points advocated by the experts and accepted by the Court included the following:

- Under the Australian domestic law one is not concerned with the value of SBM or all the assets of its business as a going-concern, but the values of its underlying assets. The test requires a separate determination of the market value of each of the entity's assets.

- It is trite that the value of a business on a going-concern basis, valued with reference to the present value of predicted earnings of the business, may be greater than the sum or aggregate of the individual market value of each identifiable asset comprising the business. Thus, for purposes of the case:

  - if the difference was goodwill in the legal sense, and therefore the property of SBM, it would constitute a non-TARP asset;
  - if the difference was not goodwill in the legal sense and therefore not the property of SBM, it would neither be a TARP asset nor a non-TARP asset; and
  - if a going-concern valuation of all of SMB assets is used for allocating market values to individual assets of SBM, an overstatement of those values would result.

- In determining the market value of the relevant assets it was accepted that the assets should be valued with reference to the hypothetical price that would be agreed between willing, but not anxious, parties acting at arm's length, as if no other assets were offered for sale. Edmonds J added that the formulation needs to go further and include the assumption that the hypothetical purchaser shall use the assets for the most advantageous purpose or its 'highest and best use'.

- The above hypothesis would require different methodologies in relation to different assets. For instance:

  - in the case of mining rights, their market value would be the value which could be extracted from them (using the discounted cash-flow method), less the cost of re-creating the mining information and replacing the plant and equipment which is assumed not to be owned by the owner of the mining rights and not otherwise available for purchase; and
  - in the case of the mining information, the hypothetical sale price, and therefore the market value, would be the range between the nominal price that that would be obtained on the sale to a purchaser not the owner of the assets and the cost of re-creating the mining information. A similar approach can be adopted in the case of plant and equipment.

Having applied these principles the Court found that the sum of the market values of the SBM's TARP assets did not exceed the sum of the market value of SBM's non-TARP assets and Australia was not entitled, in terms of its domestic legislation, to impose CG Ton the disposal of the shares in SBM by PCF.

In South Africa, a non-resident may be subject to CGT on the disposal of 'immovable property' situated in the Republic, which definition includes equity shares held by a person in a company where 80% or more of the market value of those equity shares is directly or indirectly attributable to immovable property and that person holds at least 20% of the equity share capital of the company.

The test under Australian domestic law requires a separate determination of the market value of each of the entity's assets, which is different from the test that would be applied under South African domestic law referred to above. However, the *Resource Capital* case does give some insight in that when one has to consider whether a company constitutes a land-rich company, whether for purposes of domestic tax law or the application of the relevant tax treaty, much may depend upon the market valuation methodology that is applied by the taxpayers and the tax authorities concerned.

Andrew Lewis

DEDUCTIBILITY OF EMPOWERMENT COSTS – PART 2

In the Tax Alert of 6 July 2012, we considered the deductibility of advisory costs in the context of black economic empowerment transactions (BEE transactions). The general argument being that costs associated with empowerment transactions are akin to obtaining a license to operate and on this basis, these costs should form part of the income earning operations of the company.

Generally, the Income Tax Act, No 58 of 1962 (ITA) contains various provisions relating to deductibility of specific expenditure and certain of these have been identified as possibilities for the deduction of expenditure relating to indirect BEE empowerment measures, such as s12H learnership allowances, s12I additional investment and training allowances, s18A donations to public benefit organisations and various capital allowance provisions. If one of the specific deduction provisions does not apply, the general deduction formula contained in s11(a) read together with s23(g), must be applied. It must therefore be determined whether any such empowerment expenditure was incurred in the production of income and that it is not of a capital nature.

It was confirmed in the case of *CIR v Pick 'n Pay Wholesalers (Pty) Ltd [1987], 49 SATC 132*, that expenditure incurred for general philanthropic purposes, would most likely not be regarded as being incurred in the course of carrying on a trade and would therefore not be deductible under s11(a) read with s23(g). In the matter of *Warner Lambert SA (Pty) Ltd v Commissioner for SARS [2003], 65 SATC 346*, the court dealt with the deductibility of social responsibility expenditure and found that the relevant expenditure incurred was deductible. The company that had incurred the expenditure was a subsidiary of a US company and adhered to the Sullivan Code, which is very similar to the current empowerment principles in South Africa.

As mentioned previously, SARS has issued two rulings dealing with the deductibility of similar expenditure. Binding Class Ruling 2 (BCR 2) dealt with expenditure in respect of corporate social responsibility, indicating that such expenditure would be deductible (this expenditure related to bursary payments). Binding Private Ruling 113 (BPR 113) likewise indicated that expenditure associated with Broad Based Black Economic Empowerment, would be deductible.

Recently, BCR 2 has created some concern amongst taxpayers, given that its period of validity, dated 28 August 2009 to 27 August 2013, had expired and many taxpayers sought to rely on the ruling in deducting similar expenditure. In light of the above, it must be borne in mind that the application of BCR 2 was specifically limited to a class of taxpayers and could not be seen to be generally applicable to every taxpayer. SARS has no obligation to apply a class or private ruling to any other particular set of facts in the same way. We therefore suggest that the taxpayer always apply the provisions of the ITA, namely either specific deduction provisions or the general deduction formula contained in s11(a), read with s23(g), to their individual set of facts and does not rely blindly on rulings in determining the deductibility of empowerment or similar expenditure. This evaluation should have been completed both during the application of BCR 2, as well as after its expiry and as such, the expiry of the ruling is not a cause for great concern. SARS can only be bound by the provisions of general rulings and when it comes to empowerment expenditure, it is always best not to count one's deductibility chickens before they hatch.

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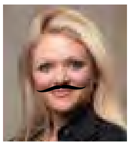

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