DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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INFORMATION-GATHERING AND TAX AUDITS BY A REVENUE AUTHORITY – COULD THERE BE AN ULTERIOR PURPOSE?

The Canadian Federal Court of Appeal's (FCA) recent judgment in *MNR v RBC Life Insurance Co, 2013 FCA 50* (decided on 21 February 2013) condemned the Canadian Revenue Authority (CRA) for using its audit powers for an ulterior purpose.

The *RBC Life* case involved an insurance product known as the '10-8 plan'. The Minister of National Revenue (MNR) had previously obtained authorisations requiring RBC Life to produce information and documents relating to holders of such plans. The Federal Court (FC) cancelled the authorisations (*Canada (National Revenue) v RBC Life Insurance Company, 2011 FC 1249*). The FC held that the MNR had failed to make full and frank disclosure when making the *ex parte* applications and that they had pursued an improper purpose in seeking the information.

The FC found that the MNR had fallen short of their obligation to make full and frank disclosure when obtaining the authorisations obliging disclosure by insurers of the personal details of 10-8 plan holders. Firstly, the MNR had not disclosed the significant volume of information already provided, prior to them bringing the *ex parte* applications. RBC Life provided much detail regarding the 10-8 plans – however not the identities and personal information of the plan holders. Secondly, and 'more troubling' to the FC was the MNR's failure to disclose internal documentation suggesting that the 10-8 plans were earlier considered by the CRA to comply with the letter of the Canadian Income Tax Act, if not with its spirit. Material had also subsequently come to light of a decision to 'send a message to the industry' and to take measures to 'chill' 10-8 plan business, in part by undertaking an 'audit blitz'. The FC held that the MNR’s decision to undertake an 'audit blitz' to 'send a message to the insurance industry' was clearly relevant to the balancing exercise that the court had to undertake in deciding whether or not the orders should have been granted in the first place. As that information was material, and since it had been omitted from the *ex parte* applications, the authorisations had to be cancelled.

In coming to its decision the FC considered the MNR's stated purpose of requiring the personal information of unnamed persons to "verify compliance by the person or persons in the group with any duty or obligation under this Act." The FC referred to the case of *Minister of National Revenue v Greater Montréal Real Estate Board, 2006 FC 1069, 303 FTR 29* that held: "The language of the Act is clear. The information and documents requested must be for the purpose of verifying whether the persons being investigated have complied with some duties or obligations set out in the Act. The courts have held that the information must be 'relevant' to the inquiry."

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The insurer's submission before the FC was that the information sought by the MNR was for an improper purpose, namely, a fishing expedition intended to put a damper on their 10-8 plan business.

The FC ultimately held: "I do not believe that the Minister's central purpose in issuing the requirements [ie the information requests] is sufficiently tied to her valid audit purpose. Contrary to the Minister's pretension, I did find evidence that the targeted audit of specific 10-8 plan holders was not only done to test the reasonableness of the 10% payable interest rate or the possible application of the GAAR but to send a message to the industry. I am not satisfied that the Minister's attempt to 'send a message' is a valid enforcement purpose such that ss231.2(3)(b) of the Act is satisfied or that this goal is sufficiently connected to the Minister's valid audit purpose."

Although the FC accepted that the MNR had a valid audit purpose, on the evidence this was 'extraneous to her primary goal', which was to 'chill' the respondents 10-8 plan business, a type of business that the MNR disliked on policy grounds. The MNR's "true purpose was to achieve through audits what the Department of Finance refused to do" by enacting that policy "through legislative amendment." The MNR subsequently appealed to the FCA but the FCA dismissed the appeal with costs.

The *RBC Life* case is important in the context of the powers of the South African Revenue Service (SARS) and the Tax Administration Act, No 28 of 2011 (TAA).

The TAA (in s46(1) -(2)) provides that "SARS may, for the purpose of the administration of a tax Act in relation to a taxpayer, whether identified or objectively identifiable, require the taxpayer or another person to ... submit relevant material ... that SARS requires." The TAA specifically extends SARS's information-gathering powers insofar as SARS can now demand from third parties information in relation to unnamed taxpayers. [The issue why exactly the personal detail of the unnamed 10-8 plan holders was really required by the MNR was considered in detail in the *RBC Life* case.]

SARS's ability to conduct a field audit or criminal investigation under the TAA (s48(1)) is likewise confined insofar as the 'relevant material' required for SARS's audit or criminal investigation purposes has to be "... in connection with the administration of a tax Act." [In the *RBC Life* case the FC found that the MNR had an 'extraneous' purpose ie to send an industry-wide message of her dislike of 10-8 plans - something which should rather have been pursued via legislative intervention.]

The reality is that the concept of 'administration of a tax Act' has been defined in very broad terms in s3(2) of the TAA. Despite this SARS's powers are not unfettered. A pivotal provision of the TAA can be found in s6(1), which provides: "The powers and duties of SARS under this Act may be exercised for purposes of the administration of a tax Act." In the SARS Short Guide to the TAA (paragraph 2.3) it is furthermore stated that the Promotion of Administrative Justice Act, No 3 of 2000 has 'overriding application'. SARS is a 'creature of statute'. In *A M Moolla Group Ltd & others v Commissioner, SARS & others [2005] JOL 15456 (T)* it was specifically stated that: "Clearly it is the first respondent who is entrusted with this task by virtue of the provisions of the Act. Being a creature of statute the first respondent must perform his task as laid down in the Act and not by will." Abuse by SARS of its statutory powers for ulterior purposes is accordingly reviewable.

The *RBC Life* case shows that, under appropriate circumstances (and where there are indications of ulterior purpose), taxpayers and / or third parties should consider questioning and challenging why certain information is being demanded, on what grounds a specific taxpayer (or constituency of taxpayers) has been identified for audit, etc. Section 48(2)(b) of the TAA requires that the SARS audit / investigation 'notice' should 'indicate the initial basis and scope of the audit or investigation'. This subsection could be used to good effect where there are suspicions regarding the real motives for an audit or investigation.

The *RBC Life* case sends a strong message that a revenue authority, and the Minister to whom it reports, have to act with strict regard to the parameters of applicable statutory provisions – or risk judicial scrutiny of their motives.

Johan van der Walt

PREFERENCE SHARES CONSTITUTING EQUITY SHARES

A very interesting binding private ruling was released by the South African Revenue Service (SARS) on 2 May 2013.

Binding Private Ruling 143 (BPR 143) dealt with the question of whether preference shares would qualify as 'equity shares' for purposes of applying the definition of 'headquarter company' in s1 of the Income Tax Act, No 58 of 1962 (Act).

The 'equity share' definition has been subject to a number of amendments in recent years. The current 'equity share' definition, which is similar to that applicable in BPR 143, provides that an 'equity share' is:

> "any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution."

The 'equity share' definition thus excludes any share that 'neither as respects dividends nor as respects returns of capital', carries any right to participate beyond a specified amount in a distribution. In other words, any share that both in respect of dividends and returns of capital does not carry a right to participate beyond a specified amount in distribution will not constitute an 'equity share'.

It follows, that if a share either as respects dividends or as respects returns of capital has an unlimited right to participate in distributions of the company, one still has an 'equity share'. Many of the provisions in the Act are only applicable to 'equity shares' and many consultants have used the above interpretation to structure transactions to fall within the 'equity share' definition.

South Africa's headquarter company regime provides a number of tax and other benefits, which include *inter alia*:

- exemptions from withholding taxes;
- controlled foreign company rules;
- transfer pricing provisions; and
- exchange control regulations.

A requirement to qualify for the headquarter company regime is that 80% or more of the cost of the total assets of the company was attributable to *inter alia* an interest in 'equity shares' (see s9I(1)(b) of the Act). Thus, in BPR 143, the applicant was concerned that if the preference shares it held in the offshore company did not constitute 'equity shares', it would not satisfy the aforementioned provision. The salient terms of the preference shares were that:

- the holder has the right to participate in a return of capital only to the extent of the subscription price, as well as any arrear dividends;
- the right to participate in dividends, although expressed in the articles of association as a rate on the subscription price, is effectively unlimited and unrestricted to a pre-determined amount or coupon; and
- in effect, the directors are entitled to declare the same dividend on preference shares as on ordinary shares and thus the right to participate in dividends is not restricted.

SARS confirmed in BPR 143 that the preference shares in question, subject to the rights and limitations mentioned above, would be regarded as 'equity shares' for purposes of the Act. This ruling will give some comfort to consultants and taxpayers who have sought to implement transactions using shares with similar features and the Act specifically requires the use of 'equity shares'.

The other interesting aspect of BPR 143 is that the applicant, should it qualify as a 'headquarter company' and the attendant tax relief afforded by the regime applies, intends to list a certain percentage of its shares on an international stock exchange. This may be an indication that taxpayers are starting to consider using South Africa's headquarter company regime as a preferred headquarter company for investments into Africa over other jurisdictions.

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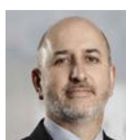

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