DLA CLIFFE DEKKER HOFMEYR

# TAX ALERT

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## POORLY DRAFTED AND IMPLEMENTED TAX PLANNING ARRANGEMENTS: RECTIFICATION V "GRIN AND BEAR IT"?

*CIR v Sunnyside Centre (Pty) Ltd 1997(1)* SA 68 (A) clearly stated that South African taxpayers must sleep in the (contractual) beds they make:

"When a scheme works, no tears are shed for the Commissioner. That is because a taxpayer is entitled to order his affairs so as to pay the minimum of tax. When he arranges them so as to attract more than the minimum he has to grin and bear it."

There are two sides to this coin (or is it bed?).

Where the South African Revenue Service (SARS) senses that the written agreement between contracting parties does not reflect their true intention, it invokes the 'substance over form' doctrine. This would seek to tax the transaction with reference to its 'substance', thereby disregarding what was meticulously set out in writing. To achieve this, SARS must show that the parties had "… a real intention, definitely ascertainable, which differs from the simulated intention." *(Zandberg v Van Zyl 1910 AD 302).*

A substance attack is appropriate where contracting parties deceive in relation to their real intent, aiming to extract some tax advantage not available to them. The deception, constitutes "… a dishonest transaction: dishonest, in as much as the parties to it do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world … The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax." *(Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd, 33 SATC 48)*

*CSARS v NWK Ltd 2011 (2) SA 67 (SCA)* accepted the fundamental principle that a taxpayer is entitled to arrange his affairs as to remain outside of the provisions of a tax Act. Lewis JA held, however, that a court would not be deceived by the form of a transaction but would examine its true nature and substance. In considering whether simulation was present, "[T]he test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose." [par 55] This required that "… there must be some substance – commercial reason – in the arrangement, not just an intention to achieve a tax benefit or to avoid the application of a law. A Court should not look only to the outward trappings of a contract: it must consider, when simulation is in issue, what the parties really sought to achieve."

Under the substance doctrine tax consequences attach to a transaction based on the contracting parties' (unexpressed) 'real intention' (NWK case: *"what the parties really sought to achieve"*) as opposed to the (deceiving) written terms or 'outward trappings' of the contract.

Now to the flipside: What is the position where the taxpayer's written agreement is subsequently found to contain drafting/implementation errors producing unintended adverse tax consequences? In other words, where the written agreement in fact does not represent the parties' consensus.

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But what if a revenue authority, perhaps opportunistically, attempts to extract tax on the basis of such an incorrectly drafted/poorly implemented agreement?

The above would mean that the parties' 'real intention' counts for little with the badly drafted/implemented agreement becoming the sole basis for a tax assessment. This issue was considered in two Canadian cases (subsequently dealt with in single judgment by the Supreme Court of Canada (SCC)).

In *Quebec (Agence du Revenu) v. Services Environnementaux AES inc., 2013 SCC 65 (decided on 28 November 2013)*, the SCC dealt with two appeals where the revenue authority attempted to tax on the basis of written agreements - but where professional advisers had made errors in executing the tax planning documentation. In the one case there was an incorrect valuation; in the other the advisers got the implementation sequence wrong. In both instances there was no dispute regarding what the two sets of transactions set out to achieve and what the original consensus had been.

Both taxpayers used rectification to escape the unanticipated tax consequences.

The SCC (Lebel J.) approached the matter as follows:

- The parties' intended that their agreements should have no tax consequences. This was not achieved due to errors made by professional advisors.

- The two rectification applications were simply for "… the true nature of the agreements to be established and recognised so as to ensure that their declared will, as expressed in their written documents, is consistent with their true intention".

- The formation of a contract is "… subject to the principle of consensualism … no particular form is required except where the legislature intervenes to impose one. The common intention of the parties is not equivalent to the expression – oral or written – of their declared will." According to the SCC "A contract is distinct from its physical medium." In essence: a written agreement might not be an accurate expression of the parties' consensus.

- Where a contract does not reflect the parties' consensus this can be remedied since "… the contract belongs to the parties." Consequently "… they are free as between themselves, although this is subject to any rights acquired by third parties, to amend or annul the contract and the documents recording it. This means there is nothing to prevent them from acknowledging the existence of a common error and agreeing to correct it by mutual consent".

- In the two cases before it the SCC accepted the parties' description of their consensus. Such consensus was, however, not reflected in the wording/implementation of the agreements. The parties therefore agreed to take corrective action.
  This resulted from the actual will of the parties and there was no need to rely on a supposed power to correct based on the implicit powers of the Superior Court.

- It was accepted that the parties agreed to correct the error by amending the documents that recorded and implemented their agreements, including the necessary tax forms, thereby restoring the integrity of their original agreements.

- Regarding the revenue authority the question was "… whether they can rely on acquired rights to have an erroneous writing continue to apply even though the existence of an error has been established and it has been shown that the documents filed with the tax authorities are inconsistent with the parties' true intention.".

- The SCC held: "Under the civil law itself, the [revenue] agencies can also prove that simulation existed and demonstrate the true nature of the transactions they allege to be shams. In addition, tax legislation may recharacterise contractual or economic transactions for its own purposes by overriding the legal categories established by the common and civil law. <u>With the exception of such situations, however, tax law applies to transactions governed by, and the nature and legal consequences of which are determined by reference to, the common or the civil law."</u> (emphasis added)

- Because the above-mentioned exceptions did not apply, the SCC held that, in the civil law, the tax authority did not have an acquired right to benefit from an error made by the parties to a contract after the parties had corrected the error by mutual consent.

So, the taxpayers prevailed. Following the retroactive rectification, tax could not be levied on the basis of agreements that were inconsistent with the taxpayers' intent.

The SCC did sound a warning though: "Taxpayers should not view this recognition of the primacy of the parties' internal will — or common intention — as an invitation to engage in bold tax planning on the assumption that it will always be possible for them to redo their contracts retroactively should that planning fail."

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The approach of the SCC confirms that a transaction's tax consequences should be determined with reference to the contracting parties' real intention. Where the written agreement is inconsistent with the parties' consensus rectification should happen, followed by the determination of the tax consequences on the basis of the agreement correctly reflecting the parties' consensus.

The position in South Africa is similar. In *Rane Investment Trust v CSARS [2003] 3 All SA 39 (SCA), 65 SATC 333* the Supreme Court of Appeal (SCA) dealt with tax consequences of a so-called 'film scheme'. The SCA pointed out: "... we are not concerned in this matter with a dispute between the parties. It is a third person – the Commissioner – who seeks to place a different interpretation on the agreements." The SCA held that "... when a third party is questioning the meaning of a contract, regard may be had to the parties' conduct in executing their obligations." Despite certain 'obscure' clauses in the parties' contract, the SCA gave effect to the agreement since the parties' subsequent conduct was aligned with what they really intended to achieve. The tax consequences in *Rane Investments* followed the tenor of the agreement because the agreement was accepted as evidencing the parties' real consensus – despite SARS's misgivings.

The bottom-line, for both revenue authority and taxpayer, is that tax consequences should take their cue from the contracting parties' 'real intention'. Where there is deception SARS can apply "substance over form" and ignore the simulation. On the other hand, where the taxpayer's agreement is inconsistent with the parties' real intention, rectification should happen, and only thereafter the determination of the tax consequences (if any).

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## ASSUMPTION OF CONTINGENT LIABILITIES

The South African Revenue Service (SARS) recently released its discussion paper (Discussion Paper) on the tax implications of the assumption of contingent liabilities in the context of a sale of business as a going concern and where the assumption of the contingent liabilities is in part settlement of the purchase price of the assets.

Whereas the purchase price can generally be settled by, for example, a cash payment, the assumption of unconditional liabilities, loan account, or the issue of shares, the Discussion Paper specifically deals with the assumption of contingent liabilities.

A contingent liability is a conditional liability that will only become unconditional should an uncertain future event occur or not occur.

A further distinction should be drawn between embedded liabilities and free-standing liabilities.

An embedded liability inherently depresses the value of the business asset sold and its assumption by the purchaser does not constitute consideration. For example, the potential obligation to upgrade a building in order to comply with health and safety legislation could be seen as an embedded liability that reduces the value of the asset.

A free-standing liability is a separately identifiable contingent liability that does not affect the market value of the asset but the assumption thereof by the purchaser constitutes consideration for the asset(s) bought. Common examples include employees leave pay, bonuses, post-retirement medical aid contributions, and warranties on which claims may arise.

The Discussion Paper focuses only on the tax consequences in respect of the assumption of free-standing contingent liabilities.

In order to accurately determine the tax consequences for the seller and the purchaser, it is important that the purchase consideration be properly allocated. A value should be attached to each asset, the unconditional liabilities and the contingent liabilities. It is not a requirement that these values be recorded in the sale agreement (but it is recommended). According to the Discussion Paper, the tax treatment should be the same irrespective of whether the sale agreement reflects a net purchase price, or lists assets, liabilities and contingent liabilities separately with a value allocated to each item. However, if no allocation is stipulated (or a fictitious allocation is made), it is anticipated that SARS will make an allocation based on the available information, which allocation could be contrary to the intention of the parties.

According to the Discussion Paper, the tax consequences involve the following:

### Seller

The assumption of a free-standing contingent liability by the purchaser constitutes consideration in respect of the sale of the assets. Accordingly, the value attached to the assumption of the contingent liabilities must be taken into account in determining the income, proceeds or any recoupments in the hands of the seller in respect of the assets sold.

Since a contingent liability cannot be seen as expenditure actually incurred, the seller will not be entitled to any deduction.

SARS does however warn that the parties could, for example, agree that the seller separately pays the purchaser to take over the contingent liabilities, and that the assumption of the contingent liabilities does not then constitute consideration for the business assets. Such an alternative transaction could have different tax consequences even though it may have the same economic effect. In this regard it is submitted that parties should word their agreements carefully and with due appreciation for the consequences.

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### Purchaser

At the date of sale, the purchaser will not incur any expenditure in respect of the assumption of the contingent liabilities, whether for purposes of claiming deductions or determining the base cost of an asset. This is so because the liability has not yet become unconditional.

Only once the contingent liability becomes unconditional will the purchaser incur expenditure. The Discussion Paper notes that the expenditure that the purchaser incurs at that point in time will relate to the particular asset for which the assumption of the contingent liability constituted consideration. It is not the character of the contingent liability that determines the availability of a deduction, but the asset for which the assumption of the contingent liability constituted consideration.

It is therefore vital that the parties clearly indicate to which asset(s) the assumption of the contingent liability relates, and how the value is allocated.

SARS has invited taxpayers to submit comments by 31 March 2014. The Discussion Paper notes that SARS will consider issuing interpretation notes once comments have been received.

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