DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

AUGUST 2014

IN THIS ISSUE

DISPOSALS BY SHARE INCENTIVE TRUSTS

The South African Revenue Service (SARS) issued Binding Private Ruling 174 (Ruling) on 29 July 2014.

The applicant was a share incentive trust established by a local company for the benefit of its employees in senior management. It was proposed that the company would make cash contributions to the trust and the trust would use the cash to purchase shares in the company on the open market.

In terms of the incentive scheme, the trust would award the shares in tranches to the employees over a period. When the shares vest, the trust would transfer the shares to the employees.

In this regard, SARS made two interesting rulings.

Firstly, SARS ruled that the receipt of the cash contribution by the trust would not constitute gross income for the trust. SARS does not provide any reasons for its conclusion, but it is assumed that the cash contributions are received as capital amounts by the trust and therefore cannot be included in the trust's gross income. This would also be in accordance with *CIR v Pick 'n Pay Employee Share Purchase Trust 54* SATC 271 where the court held that contributions to an incentive trust were capital in nature as opposed to having been solicited for purposes of making a profit. No ruling was made as to whether the company would be entitled to a deduction in respect of the cash contributions.

Secondly, SARS ruled that the vesting of the shares by the trust in the employees would constitute a disposal for capital gains tax purposes, and specifically in terms of paragraph 11(1)(d) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act).

Paragraph 11(d) provides that a disposal includes "the vesting of an interest in an asset of a trust in a beneficiary".

However, SARS ruled that no capital gain would arise for the trust or employees because of the application of paragraph 20(1)(h)(i) of the Eighth Schedule to the Act, as well as paragraph 80(1).

Essentially paragraph 20(1)(h)(i) provides that, in respect of an equity instrument where the vesting of that instrument results in a gain or loss in terms of s8C of the Act, the value used to determine the gain or loss must be used to determine the base cost of that equity instrument.

For example, where there is a gain for an employee in terms of s8C, that gain must be used to determine the base cost of the equity instrument.

Paragraph 80(1) provides that where a capital gain is determined in respect of the vesting (for trust law purposes) of an asset by a trust in a beneficiary, that gain must be disregarded in the hands of the trust and attributed to the beneficiary.

It is not clear from the Ruling whether the reason why no gain would result for the trust is because of the determination of the base cost of the shares in the hands of the trust in terms of paragraph 20(1)(h)(i) or the application of paragraph 80(1).

Paragraph 20(1)(h)(1) of the Eighth Schedule to the Act is generally understood to only be applicable

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to the determination of the base cost of the equity instrument in the hands of the employee after it has vested in terms of s8C of the Act, and to not apply to the determination of the base cost of the equity instrument in the hands of the share incentive trust.

Ordinarily, and in accordance with SARS's Comprehensive Guide on Capital Gains Tax, share incentive schemes are structured on the basis that paragraph 11(2)(j) of the Eighth Schedule to the Act would apply. Paragraph 11(2)(j) provides that there would be no disposal for capital gains tax purposes to the extent that the asset disposed of constitutes an equity instrument as contemplated in s8C of the Act which has not yet vested (for purposes of that section).

In other words, care is taken that the equity instrument does not vest until after it has been disposed of by the share incentive trust, as this would guarantee a non-disposal for capital gains tax purposes by the trust.

However, it appears from this Ruling that where an equity instrument is disposed of by a share incentive trust after it has vested in an employee beneficiary, there would be a disposal for capital gains tax purposes, but such disposal would not result in any capital gain for the trust and the employee because of the application of paragraph 20(1)(h)(i) and/or paragraph 80(1) of the Eighth Schedule to the Act.

Heinrich Louw

SARS MUST GIVE PROPER REASONS AND HAVE PROPER GROUNDS

The Tax Administration Act, No 28 of 2011 (TAA), together with the new rules for dispute resolution promulgated under the TAA on 11 July 2014 (Rules), govern the resolution of disputes between taxpayers and the South African Revenue Service (SARS).

Generally, and in terms of s104 of the TAA, a taxpayer who is aggrieved by an assessment may object to that assessment.

However, in terms of rule 6(1), the taxpayer may, before lodging an objection, "request SARS to provide reasons for the assessment required to enable the taxpayer to formulate an objection…".

In terms of rule 9(1), after considering the objection, SARS must notify the taxpayer of the allowance or disallowance of the objection "and the basis thereof". Rule 9(1) overlaps to an extent with s106(4) of the TAA which provides that SARS must, by notice, inform the taxpayer of its decision to disallow or allow the objection in whole or in part. S106(5) states, in part, that SARS's notice "must state the basis for the decision".

If SARS decides to disallow an objection, a taxpayer may appeal against the decision.

In *ITC 1811* 68 SATC 193 the court considered the provisions of rule (3)(1)(a) of the repealed rules dealing with procedures promulgated under s107 of the Income Tax Act, No 58 of 1962. Those rules entitled a taxpayer aggrieved by an assessment to ask for reasons for the assessment. The rules implied that SARS had to provide "adequate reasons".

The court endorsed the findings of a previous judgment which held that, in respect of the phrase "adequate reasons", the act in question:

"…requires the decision maker to explain his decision in a way which will enable a person aggrieved to say, in effect: 'even though I may not agree with it, I now understand why the decision went against me. I am now in a position to decide whether that decision has involved an unwarranted finding of fact, or an error of law, which is worth challenging'.

This requires that the decision-maker should set out his understanding of the relevant law, any findings of fact on which his conclusions depend (especially if those facts have been in dispute) and the reasoning process which led him to those conclusions. He should do so in clear and unambiguous language, not in vague generalities or the formal language of legislation. The appropriate length of the statement covering such matters will depend upon considerations such as the nature and importance of the decision, its complexity and the time available to formulate the statement. Often those factors may suggest a brief statement of one or two pages only.

The court accordingly directed the Commissioner for SARS "to structure his reasons so as to motivate his assessment clearly dealing with the exercise of each statutory power and setting out…" -

- "…the relevant statutory provisions…";
- "… the findings of fact on which his conclusions depend…"; and
- "…the reasoning process which led him to those conclusions…"

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The words "adequate reasons" are not used in the TAA or the Rules.

Instead, rule 6(1) states that SARS must provide reasons for the assessment "required to enable the taxpayer to formulate an objection".

However, it is submitted that the guidelines provided in *ITC 1811* should still be helpful when determining whether the reasons provided by SARS are sufficient for purposes of the Rules.

As to the reasons why an objection has been disallowed, s106(4) of the TAA as read with rule 9(1) states that SARS must notify the taxpayer of its "decision" as well as "the basis thereof".

It would have been better if the words "required to enable the taxpayer to formulate an appeal" had been used in s106(4) of the TAA as read with rule 9(1) as this would have provided guidance as to what the decision should state. However, despite the terminology used, it is submitted that the notice of SARS's decision to disallow an objection should also comply with the principles set out in *ITC 1811*.

Practically, this means that SARS cannot, for example, simply refer a taxpayer to previous correspondence or to the legislative provision in terms of which it is acting (see L Olivier "SARS has to provide adequate reasons for its decisions – *ITC 1811* 68 SATC 193" Tydskrif vir die Hedendaagse Romeins-Hollandse Reg 72 at p507).

As Olivier points out, when providing reasons for its decision, SARS must act in accordance with the principles of just administrative action laid down in the Constitution and the Promotion of Administrative Justice Act, No 3 of 2000.

In this context, it is also appropriate to consider the judgment in *Commissioner For The South African Revenue Services v Pretoria East Motors (Pty) Ltd* (291/12) [2014] ZASCA 91 (previously discussed in our Tax Alert of 20 June 2014).

In that judgment the court held as follows in respect of an additional assessment -

"The raising of an additional assessment must be based on proper grounds for believing that, in the case of VAT, there has been an under declaration of supplies and hence of output tax, or an unjustified deduction of input tax. In the case of income tax it must be based on proper grounds for believing that there is undeclared income or a claim for a deduction or allowance that is unjustified. It is only in this way that SARS can engage the taxpayer in an administratively fair manner, as it is obliged to do. It is also the only basis upon which it can, as it must, provide grounds for raising the assessment to which the taxpayer must then respond by demonstrating that the assessment is wrong."

In other words, where an additional assessment is raised, even at the time the assessment is raised (before SARS is asked for reasons for the assessment) SARS must have properly formulated the grounds for the additional assessment – if only internally.

Ben Strauss

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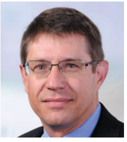

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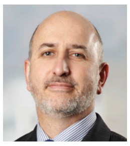

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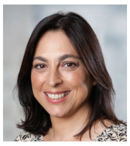

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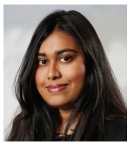

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