DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

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IN THIS ISSUE

REPORTABLE ARRANGEMENTS – A BAD MOON RISING

Draft Public Notice

The South African Revenue Service (SARS) recently issued a Draft Public Notice (Draft Notice) listing transactions that constitute reportable arrangements (RA's) for purposes of s35(2) of the Tax Administration Act, No 28 of 2011 (TAA). The Draft Notice, once finalised, is intended to be supplementary to any previous notices issued with regard to RA's and serves as an extension of the existing listed RA's. Existing reportable arrangements include certain arrangements qualifying as hybrid equity instruments in terms of s8E and 8F of the Income Tax Act, No 58 of 1962 (ITA).

The Draft Notice lists various RA's including:

- share buy-backs for an aggregate amount of at least R10 million, if the company issued any shares within 12 months of entering into the buy-back agreement;
- any arrangement that is expected to or has given rise to a foreign tax credit exceeding an aggregate amount of R10 million;
- an arrangement in which a resident contributes to or acquires a beneficial interest in a non-resident trust, where the value of contributions or payments to the trust exceed R10 million, with certain exclusions;
- an arrangement where one or more persons acquire a controlling interest in a company that has or expects to carry forward an assessed loss exceeding R20 million from the preceding year of assessment or expects an assessed loss exceeding R20 million in the year of assessment in which the relevant shares are bought; and
- an arrangement involving payments by a resident to an insurer exceeding R1 million, if any amounts payable to any beneficiary, are determined with reference to the value of particular assets or categories of assets held by or on behalf of the insurer or another person.

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VAT and permanent establishment detection

Of particular interest, however, is the RA listed in paragraph 2(a) of the Draft Notice, related to possible permanent establishment (PE) and Value-added Tax (VAT) enterprise detection. Paragraph 2(a) provides that any arrangement where fees relating to technical, managerial and consultancy services in excess of R5 million are or become payable, by a resident to a non-resident, will be a RA where the non-resident:

(i) has an office in South Africa; or

(ii) has a physical address in South Africa; or

(iii) has established or maintains a bank account in South Africa; or

(iv) is registered as an external company in terms of the Companies Act, No 71 of 2008.

Commentary on paragraph 2(a)

Paragraph 2(a) of the Draft Notice will likely place the onus on the resident paying the fees (as the 'participant'), to establish whether one or more of the above factors may be present to determine whether a reporting obligation arises. The relatively low threshold of R5 million will likely result in a number of transactions becoming reportable, provided that at least one of the other requirements referred to above is also satisfied.

In general, non-residents are taxed on South African source income, subject to the application of any relevant Double Tax Agreement (DTA) that South Africa has entered into. On the assumption that the fees relating to technical, managerial and consultancy services are from a South African source, the more difficult aspect to consider is whether a PE has been created. The determination of the existence of a PE requires the application of complex international tax principles and one could expect this type of early detection mechanism, through a RA, would result in an increase in SARS audit activity.

However, one suspects that VAT may be the first target under this early detection mechanism as it is widely accepted that it is easier to trigger a VAT presence in South Africa than, say, an income tax presence. Save for the the new rules on e-services, South Africa's VAT legislation is woefully inadequate in terms of 'place of supply' rules, which ultimately results in a number of interpretive issues and disputes with SARS on the concept of an 'enterprise'.

In determining whether a person is liable to register as a VAT vendor in South Africa, the basic test, apart from the compulsory R1 million per annum turnover criteria, is to determine whether such person conducts an 'enterprise' as defined in section 1 of the Value-Added Tax Act, No 89 of 1991. The most problematic aspect of the 'enterprise' definition, as it relates to the potential RA, is for SARS to determine whether the person is carrying on a continuous or regular activity in, or partly in, the Republic, which will always be a question of fact.

What needs to be borne in mind is that the reporting of a transaction will not automatically result in an income tax or VAT liability. For example, with regard to the registration of an external company, SARS issued Binding Private Ruling 102 on 4 May 2011, in which it examined whether registration as an external company by a non-resident company that did not have its place of effective management in South Africa would constitute a PE in South Africa. SARS ruled that registration of an external company in itself would not create a PE in South Africa.

Essentially, SARS is attempting to utilise the above factors, as indicative of the potential presence of a PE or a VAT enterprise in South Africa, however, no single factor can be considered as being decisive.

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CAPITAL GAINS TAX – METHOD OF VALUATION ON THE DISPOSAL OF SHARES

Capital Gains Tax (CGT) is payable on the disposal of capital assets which were in the seller's possession on, or were acquired after 1 October 2001 (valuation date). A capital gain or loss is determined by calculating the difference between the proceeds and the base cost of the disposed asset.

In relation to pre-valuation date assets, paragraph 25(1) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) provides that the base cost of an asset will be its valuation date value plus allowable expenditure. To determine the valuation date value, paragraph 26(1) gives the taxpayer an election. The following options are available for determining the valuation date value:

- the market value of the asset as at the valuation date;
- 20% of the proceeds from the disposal of the asset, after deducting from those proceeds an amount equal to the expenditure allowable in terms of paragraph 20 incurred on or after the valuation date; or
- the time-apportionment base cost of the asset.

Paragraph 26(3) of the Eighth Schedule to the Act further provides that where a person has adopted the market value as the valuation date value of an asset and the proceeds from the disposal of the asset do not exceed that market value, that person must substitute for the valuation date value of that asset, the proceeds received or accrued in respect of the asset less any expenditure allowable in terms of paragraph 20 of the Eighth Schedule to the Act incurred on or after the valuation date. This effectively prevents the claiming of losses in respect of such assets.

Having regard to the legal principles set out above, it is important to take note of the recent case of *ITC 12466*, decided on 12 March 2014 in the Tax Court (Cape Town). In this case the court was asked to determine whether the valuation of certain shares disposed of, and for purposes of determining a capital gain, were in fact reasonable.

By way of background, the appellant (taxpayer) was an entity incorporated in 1996, with its main business described as 'investments in all aspects by the principal'. Prior to the 2002 and 2003 years of assessment, the taxpayer acquired a shareholding in an entity D.

The value of those shares held by the taxpayer in D as at the valuation date was determined by obtaining a valuation of the total share value of D as at that date, based on the 'discounted cash flow methodology'. The taxpayer's shares in D constituted 23.73% of the total shares in D, and thus the value of the taxpayer's shares could easily be deduced.

During the 2002 and 2003 tax years, the taxpayer disposed of 4.37% of the shares it held in D. The taxpayer disposed of 2.37% of its shares during the 2002 year of assessment for R2 million and the remaining 2% during the 2003 tax year, for R2,2 million.

The taxpayer argued that the aggregate market value of D as at the valuation date was an amount of approximately R198 million. The taxpayer disposed of 4.37% of the shares in D. Therefore the market value at valuation date of the shares disposed of was an amount of approximately R8 million.

Since proceeds of only R4.2 million was received by or accrued to the taxpayer in respect of the shares, and the base cost was R8 million (being the valuation date value), the taxpayer would have made a loss.

However, because the taxpayer elected to use the market value of the shares as its valuation date value, paragraph 26(3) of the Eighth Schedule to the Act applied and limited the valuation date value to the proceeds. The valuation date value of R8 million was greater than the proceeds of R4.2 million and the taxpayer could therefore not claim a loss. The taxpayer accounted for the transaction accordingly and did not claim a loss.

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In 2007, the Commissioner of the South African Revenue Service (Commissioner) raised additional assessments in respect of the taxpayer's 2002 and 2003 years of assessment. The Commissioner adjusted the value at which the shares in D had been valued by the taxpayer from just over R8 million to nil. The Commissioner subsequently assessed the taxpayer for capital gains of R2 million in the 2002 year of assessment and R2.2 million in the 2003 year of assessment in respect of the disposal of the shares in D.

In this regard it is important to note that the Commissioner was of the view that the discounted cash flow method should not have been used to value the shares, but rather a 'net asset value' method of evaluation should have been used.

The taxpayer objected to the additional assessment raised by the Commissioner in respect of the 2002 and 2003 years of assessment on the grounds that the Commissioner's rejection of the valuation furnished by the taxpayer was misguided and flawed in material respects. The Commissioner disallowed the taxpayer's objection and the taxpayer lodged an appeal against the disallowance of its objections.

The issues for determination before the Tax Court were as follows:

- whether the Commissioner was correct in disallowing the taxpayer's objection;
- whether the taxpayer had established the market value, as at 1 October 2001, of the shares disposed of; and
- whether the valuation of the assets disposed was reasonable.

The court noted that each of the shares disposed of by the taxpayer were pre-valuation date assets and consequently, the taxpayer had an election regarding the valuation date value of an asset. The taxpayer chose the market value and obtained a valuation.

The court referred to paragraph 29(1)(c) of the Eighth Schedule to the Act and held that the market value of the shares disposed of by the taxpayer ought to have been the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller at arm's length in an open market, as at the valuation date.

The court had regard to the 'discounted cash flow methodology' used by the taxpayer to value the shares in D and held that two essential elements emerged in the methodology used in the evaluation of the market value of the shareholding in D, these being a determination of:

- the future forecast free cash flows; and
- the appropriate discount factor.

The court determined that the valuation compiled on behalf of the taxpayer was inadequate in relation to the two essential elements mentioned above, in that:

- the future forecast free cash flows were not established by any admissible evidence; and
- the person who prepared the evaluation did not establish that an appropriate discount factor was applied by him.

The figures used by the taxpayer were prepared by an independent third party for purposes of an application for a temporary licence which would have enabled D to operate a temporary casino. The Commissioner assessed the taxpayer on the disposal of shares using a nil base cost value on the shares sold in 2002 and 2003. However, this value of shares, according to the court, had not been determined by looking at the reasonableness of the figures submitted by the taxpayer but rather at the method used to arrive at a value. Further, the taxpayer was not asked to submit any information to support the reasonableness of the figures used in the valuation submitted.

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The court criticised the Commissioner for requesting that the valuation provided by the taxpayer should be rejected on the basis that the figures used to prepare the valuation had been prepared by a third party, when in actual fact the Commissioner rejected the valuation because the Commissioner considered that the net asset value method should have been used. This, according to the court, amounted to a 'shifting of goal posts'.

The court held that the taxpayer obtained a valuation of the market value of shares in D as at the valuation date. That valuation was done by an expert in the field and the method used, the assumptions made, the information used and the calculations done, were set in great detail in the valuation. During the course of trial, the Commissioner had conceded that the 'discounted cash flow methodology' applied was the appropriate methodology as opposed to the 'net asset value methodology'.

The court found in favour of the taxpayer and the additional assessments in respect of the 2002 and 2003 years of assessment were set aside.

What is clear from the decision of the Tax Court is that in deciding on a method of valuation for a pre-valuation date asset, a taxpayer should be mindful of the fact that although there may be flaws in the valuation, a court is inclined to look at the specific facts of the case and determine whether the information upon which the valuation is based is reliable and reasonable.

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