DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

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IN THIS ISSUE

DEDUCTIBILITY AND APPORTIONMENT OF HOLDING COMPANY EXPENSES

Background

In our Tax Alert of 19 August 2011 we reported on the judgment of the full bench of the High Court in the case of *Mobile Telephone Networks Holdings (Pty) Ltd V Commissioner for the South African Revenue Service* 73 SATC 315.

Mobile Telephone Networks Holdings (Pty) Ltd (taxpayer) was the holding company of five directly held subsidiaries and a number of indirectly held subsidiaries and joint ventures, within a group of companies. The collective business of the operating companies within the group was the operation of mobile telecommunication networks.

By virtue of the taxpayer's shareholding in its subsidiaries, the taxpayer earned exempt dividend income. In addition thereto, the taxpayer lent money to group companies and accordingly earned interest income.

The taxpayer did not conduct any business activities other than investment holding (equities) and money-lending. However, the exempt dividend income received on shares far outweighed the interest income and made up between 89% and 99% of the taxpayer’s total income in respect in the relevant years of assessment.

To comply with its statutory obligations, the taxpayer employed auditors to audit its financial statements for the 2001 to 2004 years of assessment respectively. In addition thereto, the taxpayer paid an amount to KPMG as a 'training fee' in respect of a computerised accounting system.

The taxpayer sought to deduct the expenditure incurred in respect of the auditing and training fees for the 2001 to 2004 years of assessment. However, the South African Revenue Service (SARS) only allowed between 2% and 6% of the audit fees to be deducted based on the ratio of the taxpayer’s interest income to its exempt dividend income. SARS further disallowed the training fees on the basis that it was capital in nature.

The taxpayer objected but SARS disallowed the objection. The taxpayer then appealed to the Tax Court.

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Decision of the Tax Court

The Tax Court held that:

- the incurral of the audit fees was necessarily attached to the income earning operations of the taxpayer because without the audit the taxpayer could not comply with the Johannesburg Stock Exchange (JSE) requirements and so give confidence to creditors and access loans;

- the audit fees were laid out for a dual purpose, being the earning of interest income and the earning of exempt dividend income, both being equally important to the taxpayer's business;

- a 50% apportionment would be appropriate; and

- the training fees paid to KPMG were capital in nature and should not be deductible.

The taxpayer subsequently appealed to a full bench of the High Court. The taxpayer's argument had always been that 100% of the audit fees should qualify for deduction. However, in the alternative, the taxpayer argued that 94% should be deductible on the basis that 94% of the time spent by the auditors related to the interest income and not the exempt dividend income.

SARS also cross-appealed the Tax Court's findings in respect of the 50% apportionment of the audit fees.

Decision of full bench

The full bench of the High Court held that:

- the expenditure is deductible as it properly relates to and is closely connected to the operation and the income earning activities of the Taxpayer;

- a fair measure for apportionment is the amount of time spent by the auditors in respect of the interest income as against the exempt dividend income;

- a deduction of 94% of the auditing fees should be allowed; and

- the training fees should be allowed in full as a deduction as it was a necessary concomitant of the taxpayer's income-earning operations (it related to the earning of interest income as opposed to exempt dividend income).

Consequently, SARS appealed to the Supreme Court of Appeal (SCA) against the decision of the full bench of the High Court.

Decision of the Supreme Court of Appeal

The SCA gave judgment on 7 March 2014. The SCA set out the law relating to the deductibility of expenditure as follows.

In terms of the general deduction formula contained in s11(a) of the Act, expenditure incurred by a taxpayer is tax deductible if it is:

- actually incurred in the production of income;

- is of a revenue nature; and

- is laid out for the purposes of the taxpayer's trade.

However, it will not be deductible if it is:

- capital in nature (s11(a) of the Act);

- incurred in respect of amounts not constituting income as defined (s23(f) of the Act); or

- not laid out or expended for the purposes of trade (s23(g) of the Act).

To determine whether expenditure is incurred in the production of income, factors to consider are:

- the purpose of the expenditure; and

- what the expenditure actually effects (*CIR v Standard Bank of SA Ltd*, 1985 (4) SA 485 (A)).

The closeness of the connection between the expenditure and the income earning operations must thus be assessed (*CIR v Nemojim* 45 SATC 241).

Also, all expenditure necessarily attached to the income earning operations, as well as all expenditure not necessarily so attached, but which is *bona fide* incurred for the purpose of the income earning operations, can in principle qualify for deduction (*Joffe & Co Ltd v Commissioner for Inland Revenue* 1946 AD 157).

However, where expenditure is incurred for a dual purpose, and cannot be directly attributed to a specific income item, the expenditure must be apportioned on some basis (*SIR v Guardian Assurance Holdings (SA) Ltd* 1976 (4) SA 522; *CIR v Nemojim*, 45 SATC 241).

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The courts usually apply an arithmetic formula or basis, but where this is not possible or leads to inequitable results, an apportionment must be made that is "fair and reasonable, having regard to all the circumstances of the case". General rules catering for each and every set of circumstances cannot necessarily be laid down (*Local Investment Co v Commissioner of Taxes* (SR) 22 SATC 4).

In this regard the SCA confirmed that apportionment "is essentially a question of fact depending upon the circumstances of each case".

Based on the above exposition of the applicable law, and having regard to the facts of the case, the SCA firstly accepted that the incurral of the audit fees was necessarily attached to the performance of the taxpayer's income-earning operations, and could not be wholly disregarded on that basis.

Secondly, the SCA implicitly accepted that the audit fees were incurred for a dual purpose, and that an appropriate apportionment had to be made.

In this regard the SCA rejected the apportionment method based on the time spent by the auditors on auditing the Taxpayer, which the High Court had previously approved. The reasons advanced by the SCA is that:

- an audit is directed at signing off an audit opinion;
- an auditor performs a range of general tasks that cannot necessarily be attributed to a specific income item; and
- it is meaningless to assert that a certain amount of time was spent on one item without knowing how much time was devoted to the other items, in order to make a comparison.

In addition, the SCA noted that any apportionment must be weighted in favour of disallowing any deduction because:

- the greater part of the loans made by the taxpayer was interest-free;
- the interest-earning activities on the one hand were small in relation to the dividend-earning activities and the making of interest-free loans on the other hand;
- the taxpayer's value lay in its principle business as a holding company of 'extremely valuable subsidiaries';
- the time spent by the auditors on the interest entries (mainly in respect of a share incentive scheme) was small compared to the overall audit time;
- the audit involved and audit of the taxpayer's affairs as a whole; and
- the taxpayer's predominant operations were in respect of the earning of dividends and not interest.

The SCA agreed that the application of an arithmetic formula is not necessarily appropriate in this case, but held that a 50% apportionment is overly generous.

The SCA accordingly held that only 10% of the audit fees qualify for deduction.

In respect of the training fees paid to KPMG relating to the computerised accounting system, the SCA held that it is not deductible.

Essentially, the SCA found that the taxpayer had not produced any reliable evidence explaining what the "training fees" were for. The witnesses of the taxpayer had very little personal knowledge of the fees. Accordingly, the taxpayer could not discharge the onus of having to prove that the expenditure, or any portion thereof, qualified for deduction.

Conclusion

We agree with the legal principles set out by the SCA in this case in respect of the deductibility of expenditure.

However, it is respectfully submitted that the reasons advanced for allowing a 10% deduction is unclear and unconvincing.

It appears that there is no objective basis stemming from the evidence or otherwise for arriving at an apportionment of 10%. It seems to be an arbitrary number that subjectively, according to the court, is a fair percentage. This is really no different from the Tax Court's finding that 50% was a fair percentage.

Further, the judgment is not clear as to whether a time-based or effort-based apportionment method may never be applied, or whether such a method was only inappropriate in this specific case.

Accordingly, and with respect, it is submitted that the judgment does not as such constitute a very useful precedent for purposes of tax law.

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Because the SCA did not take a very rigid or objective approach in determining an apportionment percentage, it is expected that similar cases where apportionment is at issue will come before the SCA in future.

Unfortunately, it is expected that SARS will use the outcome of this judgment to aggressively resist deductions for overhead costs claimed by holding companies that mainly receive exempt dividend income.

Heinrich Louw and Nicole Paulsen

NEW DEVELOPMENTS IN OIL AND GAS TAX

Recently there have been some interesting developments with regard to taxation in the oil and gas sector, notably with regard to the disposal of fiscal stability rights and exploration rights.

Disposal of fiscal stability rights

In terms of s26 of the Income Tax Act, No 58 of 1962 (Act) the taxable income of an oil and gas company must be determined in accordance with the provisions of the Act, but subject to the provisions of the Tenth Schedule to the Act (Tenth Schedule).

In terms of paragraph 8 of the Tenth Schedule, the Minister of Finance may enter into a binding agreement (referred to as a 'fiscal stability agreement') with a company in respect of an oil and gas right held by it.

The purpose and the effect of such an agreement are to guarantee that the provisions of the Tenth Schedule (as at the date on which the agreement was concluded) will apply in respect of that right as long as the right is held by the taxpayer. Put differently, in terms of such an agreement, the Minister and the company agree that the fiscus will not change the tax rates or rules of the Tenth Schedule for the duration of the agreement. (There is a similar provision in the Mineral and Petroleum Resources Royalty Act, No 28 of 2008). Essentially, a fiscal stability agreement gives the company certainty as to how it will be taxed in future and 'pegs' the incidence of tax.

In terms of paragraph 8 of the Tenth Schedule, an oil and gas company may, if it disposes of an exploration right or a production right to another party, at the same time assign (transfer) all (and not some) of its rights under a fiscal stability agreement to the other party.

National Treasury has recognised that oil and gas companies enter into joint venture agreements in terms of which one party transfers only a part of its exploration right or production right to another party and, accordingly, may wish to assign only some (and not all) its rights under a fiscal stability agreement so that both parties are covered by the original fiscal stability agreement.

The 2014 Budget includes a proposal that part assignments of fiscal stability rights be allowed in future.

Disposal of exploration rights

On 3 March 2014, the South African Revenue Service (SARS) issued a Binding Private Ruling (BPR 162).

At issue was the capital gains tax (CGT) consequences on the sale of an oil and gas right and the timing of payment of value-added tax (VAT) in respect of the consideration accruing on the disposal of the exploration right.

The facts of the ruling were that the taxpayer owned an exploration right which it had acquired in terms of the Mineral and Petroleum Resources Development Act, No 28 of 2002. The exploration right constituted an 'oil and gas right', as defined in paragraph 1 of the Tenth Schedule. The taxpayer held the exploration right as a capital asset.

The taxpayer wished to develop the exploration right. To do so, it wished to conclude an agreement with another party. Under that agreement, the taxpayer would sell a participating interest in the exploration right to the other party.

In return for the participating interest in the exploration right, the other party undertook to pay certain agreed amounts to the taxpayer.

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Put simply, paragraph 7 of the Tenth Schedule provides that if an oil and gas company disposes of an oil and gas right held as a capital right to another company, and if the parties so agree, the company disposing of the right will suffer no CGT; instead, the company acquiring the right 'takes over' the base cost of the right. In other words, there is a 'rollover' for CGT purposes.

In the ruling, SARS held that (despite the fact that the taxpayer was only selling a participating interest in the exploration right to the other party) the taxpayer would qualify for rollover relief, as referred to in paragraph 7(1) and (2) of the Tenth Schedule. SARS ruled further that a letter by the taxpayer submitted to SARS, stating that both parties are in agreement that the rollover provisions must apply, would constitute the taxpayer's election for rollover relief as required in paragraph 7 of the Tenth Schedule.

Accordingly SARS held that the rollover relief would apply and, that no capital gain will be realised and no amount of CGT will be payable by the taxpayer on the disposal of the interest in the exploration right.

As to VAT, SARS ruled that the disposal of the participating interest in the exploration right constituted a disposal of 'fixed property' as defined in s1(1) of the Value-Added Tax Act, No 89 of 1991 (VAT Act) as the exploration right is a real right in land. Accordingly, the time of supply in respect of that supply for VAT purposes had to be determined in accordance with s9(3)(d) of the VAT Act. That provision states that the time of supply of fixed property under a sale is deemed to take place on the earlier of:

1. the date of registration of transfer in a deeds registry (which did not apply in this case); or

2. the date that consideration is paid for the supply.

SARS accordingly ruled that the taxpayer was required to account for output tax when payment of any consideration for the participating right in the exploration right was made.

Ben Strauss

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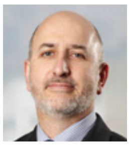
DLA CLIFFE DEKKER HOFMEYR

CONTACT US

For more information about our Tax practice and services, please contact:

Emil Brincker
National Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@dlacdh.com



Ben Strauss
Director
T +27 (0)21 405 6063
E ben.strauss@dlacdh.com

Ruaan van Eeden
Director
T +27 (0)11 562 1086
E ruaan.vaneeden@dlacdh.com

Lisa Brunton
Senior Associate
T + 27 (0)21 481 6390
E lisa.brunton@dlacdh.com

Andrew Lewis
Senior Associate
T + 27 (0)11 562 1500
E andrew.lewis@dlacdh.com

Heinrich Louw
Senior Associate
T +27 (0)11 562 1187
E heinrich.louw@dlacdh.com

Danielle Botha
Associate
T + 27 (0)11 562 1380
E danielle.botha@dlacdh.com

Tessmerica Moodley
Associate
T +27 (0)21 481 6397
E tessmerica.moodley@dlacdh.com

Carmen Moss-Holdstock
Associate
T + 27 (0)11 562 1614
E carmen.moss-holdstock@dlacdh.com

Nicole Paulsen
Associate
T + 27 (0)11 562 1386
E nicole.paulsen@dlacdh.com

BBBEE STATUS: LEVEL THREE CONTRIBUTOR

JOHANNESBURG

1 Protea Place Sandton Johannesburg 2196, Private Bag X40 Benmore 2010 South Africa
Dx 154 Randburg and Dx 42 Johannesburg
T +27 (0)11 562 1000 **F** +27 (0)11 562 1111 **E** jhb@dlacdh.com

CAPE TOWN

11 Buitengracht Street Cape Town 8001, PO Box 695 Cape Town 8000 South Africa
Dx 5 Cape Town
T +27 (0)21 481 6300 **F** +27 (0)21 481 6388 **E** ctn@dlacdh.com