TAX

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McLAREN MOTOR RACING TEAM CANNOT DEDUCT A PENALTY NOT INCURRED WHOLLY AND EXCLUSIVELY FOR PURPOSES OF TRADE

The South African Revenue Service (SARS) released Interpretation Note 80 on 5 November 2014 which deals with the income tax treatment of stolen money. Apart from the fact that it is indicated in the Interpretation Note that stolen monies must be included in gross income in the year of receipt, it is indicated further that the stealing of money cannot be described as a trade and that the thief will thus not qualify for a deduction to the extent that the monies must be repaid. It has been indicated that, even though certain elements of a trade, for example the intention to make a profit, repeated activities, planning and organisation, may be present in the case of a thief, the thief's activities lack the key commercial character of a trade when it comes to sourcing the goods. Stolen monies and/or other goods are not obtained through normal commercial means and are not received as a reward for the provision of any goods or services. On that basis the act of embezzlement, fraud or theft does not constitute a trade.

In a South African context a thief has another hurdle to cross, namely s23(o) of the Income Tax Act, No 58 of 1962 (Act), which provides that a taxpayer is not entitled to deduct expenditure that constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in South Africa or in any other country if that activity would be unlawful had it been carried out in South Africa.

The possibility of deducting penalties was recently considered by the Upper Tribunal (Tax and Chancery Chamber) in the United Kingdom in the case of *McLaren Racing Ltd v Revenue and Customs Commissioners [2014] STC 2417*. The McLaren motor racing team participates in the Formula One grand prix events that take place throughout the world. All teams participating in Formula One have concluded an agreement between themselves and the International Automobile Federation (the sport's governing body) and the Formula One Association (a company engaged in the promotion of the Formula One world championship). This agreement is called the so-called Concorde Agreement.

McLaren was held to have breached the International Sporting Code as its chief designer allegedly received confidential information pertaining to another Formula One racing team. Pursuant to this allegation, the McLaren racing team was ordered to pay a penalty of US$100 million in respect of a breach, less income which was lost as a result of it losing points in the so-called Formula One constructors' championship. The ultimate penalty that was paid amounted to approximately £32 million. The question arose whether this penalty was deductible by the McLaren racing team on the basis of it constituting a disbursement or expense wholly and exclusively laid out or expended for the purposes of its trade or profession.

In holding that the penalty was not wholly and exclusively laid out or expended for the purposes of McLaren's trade, it was acknowledged that the penalty constituted a disbursement or expense. However, it was indicated that a deliberate activity which was not an unavoidable consequence of carrying on a trade did not constitute an activity carried on in the course of that trade. It was said:

"In our view, a deliberate activity which is contrary to contractual obligations and the rules and regulations governing the conduct of the trade, which is not an unavoidable consequence of carrying on a trade and which could lead to the destruction of the trade, is not an activity carried on in the course of that trade."

However, McLaren raised a different argument. It submitted that its trade constituted the design, manufacture and racing of motor cars. As part of such trade it employs designers and engineers. It was a so-called 'occupational hazard' that employees might sometimes overstep the mark and act outside their scope of employment. This argument was also dismissed. The court refused to accept that, because an employer incurs a liability as a result of the acts of an employee, such liability is incurred in the course of the employer's trade. This was held on the fact that the use of the confidential information did not constitute a normal or ordinary activity of McLaren. It did not become such an activity simply because it was carried out by an employee.

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It was furthermore held that the reason the McLaren racing team paid the penalty was not because it risked being excluded from the world championship (which might have destroyed its business operations) and because the McLaren racing team engaged in conduct that did not form part of its trade. Accordingly, the deduction of the penalty was refused.

It is probable that a South African court might come to the same conclusion even though s23(g) of the Act, which previously required deductible expenditure to have been laid out 'wholly and exclusively' for purposes of trade, similar to the requirement in the UK, has been amended. The section currently provides that expenses are deductible to the extent incurred for purposes of trade. Given the facts of the McLaren case, it would be unlikely that McLaren would be able to discharge the burden of proof that at least some amount was incurred for purposes of its trade. Since the penalty was intended to be a punishment, it still does not form part of the trade of the taxpayer.

Emil Brincker

RULING ON ASSET-FOR-SHARE TRANSACTION

The South African Revenue Service (SARS) released Binding Private Ruling No 184 (Ruling) on 11 November 2014, which deals with a proposed asset-for-share transaction in terms of s42 of the Income Tax Act, No 58 of 1962 (Act).

The applicant was a resident family trust. The trust held all the issued shares in Company A and Company B.

It was proposed that the applicant dispose of its shares in Company A to Company B so that Company A could become a wholly-owned subsidiary of Company B. It was further proposed that, as consideration for the transfer of the shares in Company A to Company B, Company B would issue an additional equity share to the applicant.

The issue of the equity share to the trust would solely be to bring the proposed transaction within the ambit of s42 of the Act.

Despite the apparent artificiality of issuing an additional equity share to the applicant, which already held all the issued shares in Company B, SARS ruled that the proposed transaction would fall within s42 of the Act.

Section 24BA of the Act is an anti-avoidance provision that potentially applies to transactions where assets are acquired in exchange for the issue of shares as consideration, including asset-for-share transactions in terms of s42 of the Act. Section 24BA will apply where the consideration is different from the consideration that would have applied if the transaction were between independent persons dealing at arm's length. Where the consideration is not arm's length, the application of s24B will result in either a deemed capital gain for the issuing company, or a deemed dividend *in specie* paid by the issuing company.

SARS ruled that s24BA would not apply to the proposed transaction on the basis that it falls within the exclusion provided for in s24BA(4)(a)(ii). The said section provides that s24BA does not apply where the transferor of the asset will hold all the shares issued by the issuing company immediately after the acquisition of the asset by that company.

SARS also ruled that the transfer of the shares in Company A (the assets) and the issue of the equity share to the applicant, would neither constitute a donation for purposes of s54 of the Act, nor a deemed donation for purposes of s58 of the Act (where there is no adequate consideration in respect of the disposal of property), and that accordingly the proposed transaction would not have any donations tax consequences.

Further, SARS ruled that Paragraph 38 of the Eighth Schedule to the Act of the Act would not apply, implying that the proposed transaction would not be seen as a disposal of an asset to a connected person for a consideration not reflecting an arm's length price.

This ruling is interesting in that, on the face of it, the issue of the additional equity share to the applicant as consideration for the transfer of the shares in Company A to Company B, does not appear to constitute:

- an arm's length consideration for purposes of s24BA and Paragraph 38 of the Eighth Schedule to the Act; and
- adequate consideration for purposes of s58 of the Act.

SARS nevertheless ruled that these provisions would not apply.

Heinrich Louw

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

Andrew Lewis
Director
T + 27 (0)11 562 1500
E andrew.lewis@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

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

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

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

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

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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

DLA CLIFFE DEKKER HOFMEYR