DLA CLIFFE DEKKER HOFMEYR

TAX

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IN THIS ISSUE

SUPREME COURT OF APPEAL REVISITS SIMULATION

VALUE-ADDED TAX ON ELECTRONIC SERVICES SUPPLIED BY PERSONS OUTSIDE OF SOUTH AFRICA

SUPREME COURT OF APPEAL REVISITS SIMULATION

Background

In our previous Tax Alerts of 23 and 30 November 2012 we reported on the judgment by the full bench of the Western Cape High Court in the case of *Bosch and another v Commissioner for the South African Revenue Service* 75 SATC 1, which dealt with the issue of simulated transactions and the interpretation of the case of *Commissioner for the South African Revenue Service v NWK Limited* 73 SATC 55.

In short, the judgment in NWK had sparked a debate as to whether it had changed the established legal principles regarding simulation, specifically in the context of tax avoidance.

The view had always been that parties are free to arrange their affairs (or structure their agreements) so as to avoid the application of a statutory provision, for example, a taxing provision. The mere existence of an avoidance motive or purpose, on its own, would not be sufficient to conclude that a transaction is simulated *(Dadoo Ltd and others v Krugersdorp Municipal Council* 1920 AD 530).

The only question is whether the parties truly intended for their agreement to have the legal effect, as between them, in accordance with its tenor or terms *(Zandberg v Van Zyl 1910 AD 302 and Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd 1941 AD 369).*

The NWK judgment has been interpreted by many commentators and practitioners to have established a new rule to the effect that any agreement that has as its purpose the avoidance of tax, or a peremptory provision of law, is simulated (see Broomberg E "NWK and Founders Hill" *The Taxpayer* 2011 Vol 60 p 187).

The paragraph in the NWK judgment responsible for the debate reads as follows:

"In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. <u>If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated.</u> And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation."

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The controversy was most notably canvassed in the Bosch case. Davis J, writing for the majority, held the view that the NWK judgment did not establish a new rule, and should be interpreted as being consistent with established law. It only conveys that the absence of a commercial rationale in respect of a transaction, together with an avoidance motive, can indicate simulation in appropriate circumstances.

Wagley J, in a dissenting judgment, disagreed and was of the view that the NWK judgment fundamentally departed from the established principles as it was specifically held that an avoidance motive gives rise to simulation. However, Wagley J found that the NWK judgment could not be regarded as having created binding legal precedent.

New case on simulation

On 31 March 2014 judgment was handed down by the Supreme Court of Appeal (SCA) in the case of *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC* (49/13) [2014] ZASCA 40.

The appellant required certain modified trucks for its business. Accordingly, it ordered the trucks from a dealer. The dealer, in turn, ordered the trucks from a supplier. The supply of the trucks by the supplier to the dealer was to be financed by a bank.

Certain standing agreements were in place between the dealer and the bank, as well as between the bank and the supplier, governing such transactions.

Essentially, where the dealer ordered a vehicle from the supplier, the supplier would sell the vehicle to the bank, and the bank would pay the supplier. The bank would then on-sell the vehicle to the dealer, subject to the bank remaining the owner until the dealer has paid the bank in full. The supplier could directly deliver the vehicle to the dealer or the dealer's nominee.

This structure allowed for the provision of finance to the dealer in respect of the purchase of the vehicle, while affording the bank security through the retention of ownership.

The dealer could then sell the vehicle and use the proceeds to pay the bank.

In the current instance, the trucks that the dealer ordered on the appellant's request were sold by the supplier to the bank, and by the bank to the dealer. The trucks were delivered by the supplier to the first respondent, being a person nominated by the dealer. The first respondent was to make modifications to the trucks according to the appellant's requirements.

The appellant took possession of two of the trucks from the first respondent, but three trucks remained with the first respondent to undergo further modification. However, the appellant paid the dealer for all of the trucks, and not just for the two that it had received.

When the appellant wanted to take possession of the remaining trucks, the first respondent refused to release them because it had not received payment for the modifications from the dealer. The appellant then paid the first respondent for its work despite the fact that the dealer should have paid for it. Unfortunately, by that time, the dealer had gone into liquidation.

The bank then demanded that the first respondent release the trucks to it because it was the owner. The first respondent complied and released the trucks to the bank and not the appellant.

The appellant, having paid for the trucks, brought an application in the North Gauteng High Court for a declaration of rights.

The appellant argued that the agreements in place between the supplier, dealer and the bank constituted a simulation. Specifically, the sale of the trucks to the bank, and the immediate further sale of the trucks to the dealer subject to the reservation of ownership (while the supplier directly delivered the trucks to the dealer's nominee), was a disguise.

The true transaction between the parties, according to the appellant, was a direct sale by the supplier to the dealer, coupled with a loan by the bank to the dealer. The loan was intended to be secured by a pledge of the trucks, but such a pledge could not operate because the bank was not in possession of the trucks. The reason for the disguise was therefore to provide the bank with the benefit of security without possession, which the law would otherwise not allow.

Accordingly, the bank was not the owner of the trucks.

The High Court found against the appellant and held that the agreements were genuine and that the bank became the owner of the trucks.

The appellant then appealed to the SCA.

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Judgment by Shongwe JA

Shongwe JA wrote the main judgment, with Maya, Wallis, Petse and Saldulker JJA concurring.

The court noted that there is a long line of case law dealing with simulated transactions but, on the authority of Zandberg, confirmed that detecting simulation depends on the facts of each case.

The court referred to the case of *Nedcor Bank Ltd v Absa Bank Ltd* 1998 (2) SA 830, which appeared to have held that agreements between banks and dealers where ownership of the vehicles is reserved by the bank, similar to the agreement in the present matter, constitute simulated transactions.

However, the court held that this decision was clearly wrong.

On the authority of Dadoo, the court confirmed that "parties may arrange their affairs to avoid statutory provisions, provided their arrangement does not result in a simulated transaction and is consequently in *fraudem legis*".

Further, on the authority of Randles, the court confirmed that the fundamental issue was "whether the parties actually intended that the agreement that they had entered into should have effect in accordance with its terms".

On the facts, the court found that the parties had "no secret understanding between them" and, consequently, concluded that the appellant had "failed to discharge the onus of proving that the agreement is simulated or disguised".

The court also held that the reservation of ownership in this case was "good in law".

The application was accordingly dismissed.

Judgment by Wallis JA

For a case dealing with simulation, Shongwe JA did not make much of the NWK judgment, but merely mentioned it in passing – presumably because the matter did not as such concern tax.

However, Wallis JA, in a separate judgment (with which the full court concurred), seized the opportunity and acknowledged that "there may be a misconception regarding the proper approach to simulated transactions" in the context of the NWK case.

After briefly dealing with the principles established in the Zandberg, Dadoo and Randles cases (referred to above), it was confirmed that "[n]othing said subsequently in any of the judgments of this court dealing with simulated transactions alters those original principles in any way or purports to do so".

However, the court did note that in the cases that the SCA had to deal with relating to tax, a feature of the relevant transactions was often the addition of elements or steps to an underlying transaction that are unrealistic and add no value other than procuring a tax benefit for the parties. Such elements or steps are often self-cancelling. According to Wallis JA, the court in NWK was faced with exactly such a transaction and found it proper to ignore the additional elements or steps.

The court noted that in NWK it was contended on behalf of the taxpayer that, by performing in respect of these additional elements or steps provided for in the agreements, a transaction could be defended from any allegation of simulation. That was the contention to which the problematic *dictum* in NWK (quoted above) was a response.

Wallis JA made it clear that interpreting the NWK judgment to mean that any transaction that has as its purpose the avoidance of tax is simulated is not correct because it fails to read it in context. Entire categories of transactions cannot be condemned simply because there is an avoidance motive. That would be contrary to the Zandberg judgment, in which it was held that "[t]he inquiry...is in each case one of fact, for the right solution of which no general rule can be laid down".

In this regard, the court confirmed Davis J's view expressed in the majority judgment in the Bosch case. Wallis JA summarised the position as follows:

"For those reasons the notion that NWK transforms our law in relation to simulated transactions, or requires more of a court faced with a contention that a transaction is simulated than a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains that the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated."

continued

Conclusion

The judgment by Wallis JA is commended for addressing the controversy surrounding the NWK case and for providing guidance as to the current position regarding simulation and transactions having an avoidance motive.

There are however certain aspects of Wallis JA's judgment that are not entirely clear.

Firstly, after clarifying the legal position, the court briefly analysed the facts and concluded that there was a "clear commercial purpose" and the arguments of the appellant "ignores the commercial legitimacy" of the transaction. The presence of a commercial purpose therefore seemingly vindicated the transaction from any contention of simulation, even though the court specifically noted that a commercial purpose is only one of many factors that should be taken into account. Whereas the presence of a commercial purpose could perhaps fend off any argument to the effect that there is an avoidance purpose, it is not clear whether it would always automatically legitimise a transaction otherwise.

Secondly, Shongwe JA decided the matter on the basis that, on the facts, the appellant failed to show on a balance of probabilities that the transaction was simulated. The court came to this conclusion without relying on the NWK judgment – probably because the court was not dealing with a matter involving tax avoidance. It is therefore not entirely clear whether the comments made by Wallis JA on the NWK judgment forms part of the *ratio decidendi* of the court.

Heinrich Louw

continued

VALUE-ADDED TAX ON ELECTRONIC SERVICES SUPPLIED BY PERSONS OUTSIDE OF SOUTH AFRICA

Background

Section 7(1)(a) of the Value-added Tax Act, No 89 of 1991 (VAT Act) makes provision for the levying of Value-added Tax (VAT) in respect of the supply by any vendor of goods and services in the course or furtherance of any enterprise carried on by that vendor.

The VAT Act defines an 'enterprise' with reference to a "person in the Republic or partly in the Republic" supplying goods or services.

Accordingly, a person or business that is not in South Africa would not ordinarily be seen as carrying on an enterprise and supplying goods or services in the course or furtherance of that enterprise.

Such a person or business outside of South Africa would therefore not become liable to register as a vendor and account for VAT under s7(1)(a) of the VAT Act in respect of supplying any goods or services.

Nevertheless, s7(1)(c) of the VAT Act provides for VAT to be levied in respect of the supply of any 'imported services'.

'Imported services' is defined in the VAT Act as services supplied by a person who is not resident in South Africa or who carries on business outside of South Africa, to a person who is resident in South Africa and uses or consumes such services in South Africa.

In terms of s14 of the Act, the person receiving the services is obliged to account for the VAT, and not the person or business supplying the services.

New dispensation in respect of electronic services

The Taxation Laws Amendment Act, No 31 of 2013 has introduced amendments to the VAT Act that alters the above position in respect of the supply of electronic services.

Specifically, the definition of an 'enterprise' has been amended to include the supply of electronic services by a person or business outside of South Africa to a recipient in South Africa (or where payment for the services comes from a South African bank).

In other words, persons or businesses outside of South Africa supplying electronic services to South Africans, will be seen as conducting an enterprise.

As a consequence, such foreign person or business could become liable to register as a vendor in terms of s23 of the VAT Act and to account for VAT in terms of s7(1)(a) of the VAT Act on the supply of electronic services to South Africans.

Specifically, in terms of s23(1A) of the VAT Act, the person or business will become liable to register as a vendor "at the end of any month where the value of taxable supplies by that person has exceeded R50 000".

To the extent that VAT is levied on the supply of electronic services in terms of s7(1)(a), the transaction would be excluded from also attracting VAT under s7(1)(c).

However, s7(1)(c) of the VAT Act otherwise still remains in place in respect of the importation of services.

S14(5)(e) provides that VAT does not have to be accounted for under s7(1)(c) of the Act (ie on the importation of services) where the value of the supply is less than R100 per invoice (the so-called *de minimus* rule).

Unfortunately, to the extent that VAT must now be levied under s7(1)(a) in respect of electronic services, the *de minimus* rule will not apply. This effectively means that smaller transactions, such as the purchase of a music track from a foreign on-line store, would not be excluded from the VAT net.

These amendments are effective as of 1 April 2014.

Definition of 'electronic services'

The VAT Act defines 'electronic service' as "those electronic services prescribed by the Minister by regulation..."

On 28 March 2014 National Treasury published (Government Gazette No 37489, Notice R 221) regulations listing various 'electronic services'.

These services are divided into categories, including education, games and games of chance, Internet-based auction services, miscellaneous services including e-books, audio-visual content, still images and music and subscription services. It includes the provisions of these services "by means of an electronic agent, electronic communication, or the Internet".

It is quite clear that 'electronic services' encapsulates services provided by many industry giants such as E-bay, Apple, Netflix, Amazon and Google.

It should be noted that the list of electronic services in the regulations is limited and many potential electronic services have not been included. Most notably excluded are the supply of software applications and many cloud-based services such as on-line storage or virtual servers. For example, the supply of applications through Apple's App Store or Google Play (excluding games), and the provision of storage through Google Drive, Dropbox or Amazon S3, would seemingly not constitute the supply of "electronic services".

The reason for limiting the scope of what constitutes an electronic service is as follows.

VAT levied under s7(1)(c) of the VAT Act in respect of 'imported services' is limited in that it does not extend to the importation of services by local vendors (as opposed to end-consumers) for purposes of making taxable supplies.

The reason for this limitation is presumably to reduce the administrative burden on local businesses to have to account for VAT on the importation of services in circumstances where they would in any event be entitled to an input VAT deduction. The broad policy has therefore been that business-to-consumer (or B2C) supplies should be subject to import VAT while business-to-business (or B2B) supplies should be excluded.

However, where the supply of an electronic service will now be taxed under s7(1)(a) of the VAT Act, no such exclusion exists and local business would have to pay VAT to the foreign supplier and then claim an input VAT credit.

In response to this, National Treasury stated in a press release published simultaneously with the regulations that it purposefully reduced the scope of the definition of electronic services by attempting to exclude such services that would mainly or generally be supplied in a business-to-business context, as opposed to a business-to-consumer context.

However, services that are excluded from the ambit of electronic services would still be subject to import VAT under s7(1)(c) of the VAT Act to the extent that they are not used by a vendor for the purposes of making taxable supplies, and consumers have to account for such VAT.

Enforcement

An obvious concern regarding the imposition of obligations on foreign persons or businesses is the issue of compliance and enforcement.

The new provisions effectively shift the compliance burden in respect of electronic services from the local recipient to the foreign supplier.

One of the reasons given for this change is the low level of compliance by local recipients in respect of the importation of services. The question that arises is whether the foreign persons or businesses (over which the South African authorities have no jurisdiction), woud more readily comply than the local recipients (over which the South African authorities do have jurisdiction).

The administrative compliance burden on foreign suppliers of electronic services in respect of VAT could be quite onerous.

The person or business would need to register as a vendor in South Africa, and meet various registration requirements. Special requirements have not yet been announced, but could include, for example having a local bank account. A local representative may also need to be appointed. Other than registration requirements, the person or business would have to have systems in place identifying transactions with South Africans that attract VAT, accounting for VAT, submitting returns, and making payment to the South African Revenue Service (SARS).

A foreign service provider may very well decide to not supply services to South Africans in order to avoid any complications or incurring compliance costs.

Be that as it may, because of the nature of providing electronic services in an on-line environment, a foreign service provider might not even know that it is providing services to a person in South Africa. Even if the service provider does know, there is a good chance that it might not be aware of South African VAT laws at all.

For whatever reason, should a foreign service provider not comply with the VAT Act, it is not clear how SARS intends to enforce compliance with the extra-jurisdictional application of South African law.

In the United States we have seen the introduction of the Foreign Account Tax Compliance Act through which that government attempts to enforce compliance by foreign financial institutions with United States law by withholding payments emanating from the United States. The VAT Act has no similar 'penalty' system and it is not certain whether the introduction of such a system would be effective at all.

Earlier this year judgment was handed down in the North Gauteng High Court in the case of *Commissioner of South African Revenue Service v Krok and another* (case no 1319/13 - as yet unreported). That case dealt with an international treaty between South Africa and Australia which, *inter alia*, provided for mutual assistance between the two countries in respect of enforcing tax debts. The Australian tax authorities had assessed the taxpayer (who had assets in South Africa) for tax and requested SARS to assist it with enforcement in terms of the treaty. SARS applied for a preservation order against the taxpayer in the High Court and the court granted the order.

In light of this case, SARS may very well intend to rely on current or future international treaties to enforce the VAT Act in other jurisdictions.

Conclusion

It is not clear whether the amendments regarding the supply of electronic services is merely an experiment on the part of National Treasury and SARS to see how far they can push the application of South African tax law and relentlessly assess, and enforce against, even the smallest foreign service provider, or whether it is a calculated move to widen the VAT net just a little by getting at least a few of the big industry players to comply.

It will be interesting to see how many foreign service providers register as vendors over the coming months and what SARS will do if they don't.

Heinrich Louw and Danielle Botha

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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

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

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

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

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

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

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

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

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

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