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TAX ALERT

IN THIS ISSUE

MARKET VALUE OF SHARES ON VALUATION DATE

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DISCLOSURE TO SARS AND THE TREATMENT OF PAY-AS-YOU-EARN

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Stepney Investments (Pty) Ltd (Taxpayer) owned certain shares in Emanzini Leisure Resorts (Pty) Ltd (Company). The Company was mainly involved in the casino, hotel and leisure sector. At the relevant time the Company was awarded a casino licence for a period of 15 years in respect of a particular area and intended to establish a casino at a particular site. Unfortunately the Company became involved in a litigious dispute with a third party in respect of the development of the casino on the preferred premises, causing a delay in the establishment of the casino. In fact, it had to apply for a temporary licence to establish a casino at an alternative site.

The Taxpayer disposed of its shares in the Company during the 2002 and 2003 years of assessment. For purposes of calculating its base cost in determining its capital gain or loss the Taxpayer decided to use the market value of the shares on the valuation date (1 October 2001) in accordance with paragraph 26(1)(a) and paragraph 29(1)(c) of the Eighth Schedule to the Income Tax Act No 58 of 1962 (Act).

In addition, paragraph 31(1)(g) of the Eighth Schedule to the Act provides that the market value of an asset on a specified date is the price which could have been obtained upon a sale of the asset between a willing buyer and willing seller dealing at arm's length in an open market.

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For this purpose the Taxpayer relied on a valuation that was performed by a third party in respect of the value of the shares in the Company. Based on the valuation, the Taxpayer declared a capital loss in respect of the disposal of the shares in the Company in that the base cost of the shares exceeded the proceeds that was received by or accrued to the Taxpayer upon disposal.

However, the South African Revenue Service (SARS) was not satisfied with the valuation on which the Taxpayer based its calculations and issued additional assessments adjusting the valuation-date value to zero. The Taxpayer objected to the additional assessments but SARS disallowed it. The Taxpayer then appealed to the Tax Court. The Tax Court found in favour of the Taxpayer, but SARS then appealed to the SCA.

At the centre of the dispute was the valuation and in the Tax Court a multitude of evidence was led by the parties, either criticising or defending the valuation. One of the first points of contention was the methodology used in valuing the shares. The valuation was based on the discounted cash flow method, but SARS insisted that the net asset value method

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MARKET VALUE OF SHARES ON VALUATION DATE

CONTINUED

The SCA found that it was clear from the documents that SARS contested the valuation as a whole on the basis that the value of the shares were overstated, and it proffered various reasons for that contention

should have been used. SARS later conceded this point but still had several other criticisms against the valuation and specifically the projections used and assumptions made therein. It was for the taxpayer to prove the market value of the shares, and that the valuation was reasonable.

SARS argued that the forecast amounts from 2001 were used, and not management accounts from 2004 which were available at the time of the valuation. The available figures showed that the forecast amounts from 2001 were out by a substantial number. The Taxpayer argued that this would amount to applying hindsight. However, the SCA held that in the circumstances it was reasonable because the actual figures indicated that the forecasts were unreasonably optimistic. The forecasts couldn't simply be accepted by a valuer, but had to be tested for reasonableness, and for this purpose later information could be taken into account.

In addition, after analysing the evidence and considering SARS's further criticisms, the SCA found that:

- there were problems in the projected tax calculations in that the incorrect statutory rates were used, and that the calculations differed from what was previously submitted to the Gambling Board;
- the capital expenditure forecasts were inaccurate because it did not take into account any construction to be undertaken at the temporary site, and this impacted materially on the valuation;
- the valuation was based on the assumption that the licence would be renewed after the 15 year period and it did not take into account the risk that the licence could potentially not be extended;
- the Company had a licence which it could not put to economic use given the unresolved litigation, and this risk factor was disregarded; and
- in applying the discounted cash flow method, a discount factor was applied across the board for all companies in the group of the Company, and that such "one size fits all" approach was inappropriate in the circumstances.

Accordingly, the SCA rejected the valuation as unreliable.

The Taxpayer raised that SARS only ever attacked the valuation on the basis that the incorrect valuation methodology was used, and couldn't raise further criticisms because that would amount to changing the grounds of assessment. The SCA found that it was clear from the documents that SARS contested the valuation as a whole on the basis that the value of the shares were overstated, and it proffered various reasons for that contention. Interestingly, the SCA noted that, even if that was not the case, the Taxpayer never raised the issue in the Tax Court, and therefore could not subsequently raise it in the SCA.

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MARKET VALUE OF SHARES ON VALUATION DATE

CONTINUED

The SCA upheld SARS's appeal to the SCA with costs, but still allowed the Taxpayer's appeal in the Tax Court on the basis that the matter be remitted to SARS for further investigation and assessment.

Despite the lack of success by the Taxpayer in respect of defending the valuation and proving its base cost in the shares, the Taxpayer did have some success.

Essentially, SARS assessed the Taxpayer on the basis that the base cost of the shares was zero, and that is the assessment against which the Taxpayer objected.

SARS conceded, and the SCA confirmed, that the value of the shares as at the valuation date could not have been zero. The 15 year licence was a valuable asset.

Also, as mentioned, SARS conceded that its initial contention that the net asset value methodology should have been used, was not correct.

Accordingly, the SCA upheld SARS's appeal to the SCA with costs, but still allowed the Taxpayer's appeal in the Tax Court on the basis that the matter be remitted to SARS for further investigation and assessment. The Taxpayer was awarded costs in the Tax Court in terms of s130(1)(a) of the Tax Administration Act, No 28 of 2011 in that SARS's grounds of assessment were unreasonable.

Heinrich Louw

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DISCLOSURE TO SARS AND THE TREATMENT OF PAY-AS-YOU-EARN

Recently there has been an increase in the number of employers defaulting on their pay-as-you-earn (PAYE) obligations to SARS.

The disclosure to the South African Revenue Service (SARS) of potential tax defaults can be addressed in various ways. However, the formal Voluntary Disclosure Programme (VDP), as contemplated in the Tax Administration Act, No 28 of 2011 (TAA), is the preferred and recommended option.

The VDP is a formal statutory process, regulated under Part B of Chapter 16 of the TAA, in terms of which a taxpayer can approach SARS voluntarily to regularise its tax affairs with the prospect of obtaining various forms of relief. It is important to note that upon a successful VDP application, the VDP process does provide relief in respect of understatement penalties (which could be up to 200% in severe cases), 100% relief from administrative non-compliance penalties and in addition thereto, SARS will not pursue criminal prosecution.

Recently there has been an increase in the number of employers defaulting on their pay-as-you-earn (PAYE) obligations to SARS. This is especially true where one is dealing with non-resident employees and the obligation on the employer to withhold PAYE.

In general, a 'resident', as defined in s1 of the Income Tax Act 58 of 1962 (Act), is taxed on their worldwide income, irrespective of where the income is earned. Non-residents are only taxed on income from a South African source, subject to the application of a relevant double tax agreement (DTA). Accordingly, where a DTA finds application, South Africa's taxing rights may be limited, notwithstanding the fact that the expatriate employees' income is from a local source.

Where, however, South Africa's taxing rights are not limited by the application of a relevant DTA, the next step is to determine whether the employer concerned has an obligation to withhold PAYE.

Where, however, South Africa's taxing rights are not limited by the application of a relevant DTA, the next step is to determine whether the employer concerned has an obligation to withhold PAYE. Paragraph 2(1) of the Fourth Schedule provides that an employer who is a resident or representative employer in the case of a non-resident and who pays or becomes liable to pay any amount by way of remuneration to any employee, will be required to deduct employee's tax in respect of the normal tax liability of that employee.

The SARS External Reference Guide - Treatment of PAYE for VDP Purposes (Revision 1) (SARS Guide), specifically provides that where employers wish to regularise their employees' tax affairs in terms of the VDP process, the employers must apply in the prescribed manner and in accordance with either one of the following options:

- the employer recovers the employees' tax directly from the employees concerned; or
- the employer does not recover employees' tax directly from the employees concerned but applies the 'gross–up' method.

In relation to the first option, it is important to note that one of the key requirements

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DISCLOSURE TO SARS AND THE TREATMENT OF PAY-AS-YOU-EARN

CONTINUED

The consequence of the employer paying the PAYE on behalf of the employee is that such payment would constitute a 'payment of the employee's debt' which triggers a taxable fringe benefit in the hands of the employee.

that must be present before an employer can rely on the first option in regularising its PAYE affairs is that the employer must have issued a valid IRP5 certificate to the relevant employee. By implication, this would mean that the employee, to whom the IRP5 certificate has been issued, must have a valid South African income tax reference number.

In circumstances where the employee does not have a valid income tax reference number and an IRP5 certificate has not been issued to the employee, the employer should automatically default to the second option in regularising its PAYE affairs. In other words, the employer would not be able to recover the employees' tax from the employee concerned but would by default elect to pay the PAYE on behalf of the employee.

The consequence of the employer paying the PAYE on behalf of the employee is that such payment would constitute a 'payment of the employee's debt' which triggers a taxable fringe benefit in the hands of the employee under the provisions of paragraph 2(h) of the Seventh Schedule to the Act.

The SARS Guide (at page 4) specifically states that the "...benefit due to the payment of the employees' debt will result in another benefit on which tax again becomes payable...". It is important to note that this 'tax-on-tax' benefit is calculated in accordance with the following prescribed formula:

$$\frac{\text{'Taxable amount'} \times 100}{100 - \text{employee's marginal tax rate}}$$

= 'Taxable amount plus tax on tax benefit'

The 'taxable amount' represents the value of the remuneration in respect of which the employer wishes to regularize the PAYE. The full 'taxable amount' plus tax on tax benefit represents remuneration. The difference between the full 'taxable amount' plus tax on tax benefit and the 'taxable amount' represent the tax attributable to the tax-on-tax benefit (payment of employee's debt).

It is further important to note that where the gross-up of the taxable remuneration results in an increase in the tax rate from one tax bracket to the next, the marginal tax rate in the above formula must be increased by 1%. For example, where the marginal tax rate of the independent contractors equal 40%, the increase by 1% will result in a marginal rate of 41%.

The SARS Guide concludes by stating that once the employer has determined the total PAYE amount payable to SARS, the employer must issue one global IRP5 certificate for the total employees' tax not recovered from the employees (including the value of the tax attributable to the tax-on-tax calculation above). Accordingly, once the aforementioned is completed, the relevant EMP501 must be amended and reconciled and submitted together with the new VDP tax certificate to SARS.

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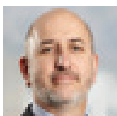

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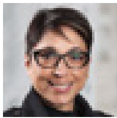

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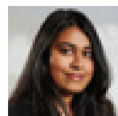

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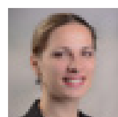

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