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TAX AND EXCHANGE CONTROL ALERT

IN THIS ISSUE

TAX COURT PRONOUNCES ON THE CAPITAL GAINS TAX RULES PERTAINING TO THE REDUCTION OF PROCEEDS

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AN INTEREST(ING) CASE: SECTION 11(A) OF THE INCOME TAX ACT AND THE DEDUCTIBILITY OF INTEREST EXPENSES ON HOME LOANS

On 13 December 2016, the Tax Court (Cape Town) handed down judgment in X v The Commissioner for the South African Revenue Service (Case No: 13791 & 13792).

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TAX COURT PRONOUNCES ON THE CAPITAL GAINS TAX RULES PERTAINING TO THE REDUCTION OF PROCEEDS

Logic dictates that there must be a mechanism in order to cater for such a scenario, so that the taxpayer is not subject to tax on amounts, that are never actually received.

It is a general principle of South African income tax that a taxpayer is taxed on the receipt or accrual of an amount. However, it is often necessary and equitable to take into account certain events arising subsequent to the accrual of an amount in pursuance of the disposal of an asset for capital gains tax (CGT) purposes.

Under the circumstances, the taxpayer argued that paragraph 35(3)(c) of the Eighth Schedule to the Act (Eighth Schedule) should apply, with the result that the proceeds derived from the sale of the shares should be reduced by the amount allegedly embezzled.

One such example is where two parties who enter into a contract for the purchase and sale of a certain asset at a certain price, subsequently amend the terms, resulting in a variation of the proceeds received on the disposal of the subject asset, notwithstanding the fact that such amount has already accrued to the disposing party. Logic dictates that there must be a mechanism in order to cater for such a scenario, so that the taxpayer is not subject to tax on amounts, that are never actually received. Paragraph 35(3)(c) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) attempts to provide for such a scenario. The tax court recently handed down an interesting judgment on this issue (case no. 13935, 14 December 2016, as yet unreported) (Case)."

Facts, issues and judgment of the tax court

In short, the following facts were before the court:

- on 10 August 2010, the taxpayer disposed of shares it held in D Ltd in the open market in terms of a sale agreement;
- the proceeds derived from the sale were paid in full by the relevant purchasers in the market and received by the taxpayer's stockbrokers on its behalf;
- on 7 December 2010, the money held on the taxpayer's behalf was transferred to a certain entity located in the United Arab Emirates (UAE);
- this transfer was undertaken against the taxpayer's will, in what appeared to be a misappropriation of the funds.

Under the circumstances, the taxpayer argued that paragraph 35(3)(c) of the Eighth Schedule to the Act (Eighth Schedule) should apply, with the result that the proceeds derived from the sale of the shares should be reduced by the amount allegedly embezzled. In short paragraph 35(3)(c) sets out certain circumstances in which proceeds may be reduced. It provides as follows:

> The proceeds from the disposal, during a year of assessment, of an asset by a person, as contemplated in subparagraph (1) must be reduced by — (c) any reduction, as the result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event during that year, of an accrued amount forming part of the proceeds of that disposal. [Our emphasis]

CLIFFE DEKKER HOFMEYR

TAX COURT PRONOUNCES ON THE CAPITAL GAINS TAX RULES PERTAINING TO THE REDUCTION OF PROCEEDS

CONTINUED

The main issue before the court, was the meaning and ambit of the words "or any other event" as it was common cause that there was no cancellation termination or variation of the sale agreement nor was there prescription or the waiver of a claim or a release of an obligation.

The main issue before the court, was the meaning and ambit of the words "or any other event" as it was common cause that there was no cancellation, termination or variation of the sale agreement nor was there prescription or the waiver of a claim or a release of an obligation.

The court first referred to a previous case, namely *ITC 1880* 78 SATC 103 which also dealt with the application of paragraph 35(3)(c) of the Eighth Schedule, in which Wepener J held that a narrow interpretation should be given to the words "or any other event" to denote similar categories as those expressed by the preceding words in the paragraph. In particular, Wepener J relied upon the *eiusdem generis* rule which is sometimes expressed as the latin maxim *noscitur a sociis*, which in essence means that the measuring of a word may be ascertained by reference to those associated with it. In other words the all-encompassing general words take their meaning and colour from the other specific words associated or linked to it. On this approach, the court held that while "any" may indicate a broad and unlimited term, in the specific instance it was limited to two broad categories, namely the changing of terms to the sale agreement, or where a person is released from an obligation.

The court in the Case agreed with the narrow interpretation given the words "any other event" in *ITC 1880* and accordingly held:

> Having regard to the context in which the words are used and their clear purpose, it is sufficient to establish that the words apply to situations where the purchaser of an asset is partially or wholly released from the obligation to pay for the asset disposed of. Ultimately, the words were not intended to apply to an embezzlement of the nature alleged in this case, for the reasons stated herein. The set–off or deduction contemplated is one which flows as a consequence of extinguishing the taxpayer's right to receive payment and the payee's obligation to pay. The relevant nexus is to the event that causes such extinguishing not, to a subsequent unrelated event caused by a person who held no obligation to pay for the asset disposed of and who acted outside the agreement to dispose of the asset. The nexus cannot be a broad and vague one between the accrual and the deduction's event, irrespective of how remotely it is connected to the failure to actually retain/receive the funds. If the legislature intended a deduction to be available for any unrelated reason, that would have the consequence of a reduced payment, it would have expressed itself in words conveying that meaning.

Allie J thereafter expressed that the purpose behind paragraph 35(3)(c) of the Eighth Schedule was to provide relief in the form of a deduction from the proceeds of a disposal of an asset in certain circumscribed instances. The particular instance he had in mind was where proceeds had not been paid but had already accrued to the taxpayer, yet the provision for payment of the funds

TAX COURT PRONOUNCES ON THE CAPITAL GAINS TAX RULES PERTAINING TO THE REDUCTION OF PROCEEDS

CONTINUED

It is clear that the courts have thus far been loath to extend the meaning of the words "any other event" as an all-encompassing phrase.

had been varied, extinguished, waived or cancelled. In summation, the facts did not fall within the ambit of paragraph 35(3)(c) of the Eighth Schedule due to the fact that the funds were already received by the taxpayer and furthermore, the alleged embezzlement was committed by a party that was unrelated to the transaction for the disposal of shares.

Comment

It is clear that the courts have thus far been loath to extend the meaning of the words "any other event" as an all-encompassing phrase. Importantly, "any other event" not only envisages an event which falls within the two broad categories first introduced in *ITC 1880*, but there must also be a link or causal nexus between the reduction of the proceeds and the taxpayer's right to receive payment (or conversely the purchasers obligation to make payment).

What is interesting to note, is that the judgment is silent on whether the taxpayer could claim an ordinary capital loss which would have placed him in a similar tax position, notwithstanding the non-application of paragraph 35(3)(c) of the Eighth Schedule. Perhaps, the hurdle in that regard was that there was in essence a loss of cash which does not fall within the meaning of "asset" in the Eighth Schedule thereby prohibiting the taxpayer from a claiming a capital loss. Having said that, Interpretation Note No. 80 issued by the South African Revenue Services (SARS) in November 2014 states as follows in respect of the potential loss of a capital nature:

> In contrast [to cash/currency], a bank account is an asset for CGT purposes, being a debt claim against the bank. It follows that embezzlement, fraud or theft involving a bank account may give rise to a capital loss assuming that it does not represent a loss of floating capital allowable under s11(a). To the extent that the expenditure on the bank account is allowable under s11(a) it will result in the reduction in the base cost of the bank account under paragraph 20(3)(a) of the Eighth Schedule. Similarly, the expenditure on the bank account must be reduced under paragraph 20(3)(b) of the Eighth Schedule by any portion of that expenditure that has been recovered or has become recoverable from any other person (for example, the thief or an insurer).

Ultimately, however, it appears the taxpayer in this Case not only paid tax on the disposal of his shares, but also suffered a loss of his after-tax profit which could not have been compensated for by allowing a reduction of proceeds or the claiming of a capital loss. Nevertheless, issues often arise subsequent to entering into transactions,

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TAX COURT PRONOUNCES ON THE CAPITAL GAINS TAX RULES PERTAINING TO THE REDUCTION OF PROCEEDS

CONTINUED

It is therefore vital to carefully consider the specific facts and circumstances in each case in order to ensure that no unintended consequences arise in the hands of taxpayers while undertaking sale transactions.

which require the technical application of certain tax rules. In particular, the cancellation of contracts may result in certain unintended consequences. The Taxation Laws Amendment Act, 2015 (TLAA 2015) introduced several new rules in respect of the cancellation of contracts in an attempt to deal with some of the anomalies arising in practice. In particular, the TLAA 2015 introduced the following:

- A new non-disposal event was introduced in the form of para 11(2)(o) which applies when a sale is cancelled in the same year of assessment.
- Paragraph 20(4) was introduced to reinstate the base cost when the sale is cancelled in a subsequent year of assessment. In addition, to reflect actual economic value/expenses incurred post entering into the contract, the base cost of the asset reacquired will take into account any subsequent expenditure incurred by the new owner as allowed under paragraph 20 of the Eighth Schedule.
- Further additional paragraphs 3(c) and 4(c) were included in the Eighth Schedule to reverse the original capital gain or loss in the year of cancellation.

It is therefore vital to carefully consider the specific facts and circumstances in each case in order to ensure that no unintended consequences arise in the hands of taxpayers while undertaking sale transactions.

Jerome Brink

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AN INTEREST(ING) CASE: SECTION 11(A) OF THE INCOME TAX ACT AND THE DEDUCTIBILITY OF INTEREST EXPENSES ON HOME LOANS

Mr X, the taxpayer, is a qualified solicitor in England and Wales, currently in the employ of Y Attorneys, an incorporated firm of attorneys.

One of the requirements to claim an expense as a deduction, is that the expense must be incurred in the production of income in terms of s11(a) of the Act.

On 13 December 2016, the Tax Court (Cape Town) handed down judgment in *X v The Commissioner for the South African Revenue Service* (Case No: 13791 & 13792) (as yet unreported). The case dealt with an interesting issue, namely whether expenses incurred on a home loan in producing interest income is deductible for income tax purposes.

Facts

Mr X, the taxpayer, is a qualified solicitor in England and Wales, currently in the employ of Y Attorneys, an incorporated firm of attorneys. Although he is not an equity partner with the law firm as he has not been admitted as an attorney in South Africa, he enjoys the same remuneration as an equity partner and therefore has to assist with on-going working capital requirements of the firm. He does this by maintaining a credit balance on his loan account (Firm Loan Account) for which he is then remunerated by his employer at the prime rate of interest. The amount that must be kept in the Firm Loan Account is deducted proportionately from the taxpayer's monthly remuneration, meaning that the source of the funds paid towards the Firm Loan Account is his remuneration. The interest on the Firm Loan Account accrues to him and therefore constitutes taxable income in his hands. Occasionally, the firm would make a distribution in the form of interest to loan account holders. However, the taxpayer is not entitled to withdraw the outstanding balance on the Firm Loan Account unless he resigns.

The other important fact is that the taxpayer purchased property, which he uses as his residence and is secured by a mortgage bond access facility (Home Loan) which he had drawn on to fund a variety of his expenses. The taxpayer claimed in his income tax returns for the 2010, 2011 and 2012 years of assessment that certain interest incurred on the mortgage bond was incurred in the production of interest income received from the law firm, but the South African Revenue Service (SARS) disallowed these deductions to which the taxpayer then objected.

Issue

The key issue was whether the taxpayer is entitled to deduct from the interest income earned on the Firm Loan Account, a portion of the interest incurred on the Home Loan. This would depend on whether the interest was incurred in the production of income, in terms of s11(a) of the Income Tax Act, No 58 of 1962 (Act).

Judgment

One of the requirements to claim an expense as a deduction, is that the expense must be incurred in the production of income in terms of s11(a) of the Act. The taxpayer's case largely relied on Practice Note 31 (PN 31), which states that even if a person does not carry on a trade

AN INTEREST(ING) CASE: SECTION 11(A) OF THE INCOME TAX ACT AND THE DEDUCTIBILITY OF INTEREST EXPENSES ON HOME LOANS

CONTINUED

The court pointed out that although the taxpayer changed the Home Loan from a bond account into an access facility over time, he could not prove that the purpose of the Home Loan was to earn interest from the Firm Loan Account.

as a moneylender and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless SARS's practice to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income. PN 31 states that the "...practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed..."

In the court's view, interest earned on capital or surplus funds invested, as contemplated in paragraph 2 of Practice Note 31, contemplates interest earned on capital or surplus funds which would have accrued to the investor. However, once such capital or surplus funds are received, the investor, of his own volition, invests such capital or surplus funds on interest and, any interest incurred as a consequence of investment of such capital or surplus funds, is incurred in the production of interest income from the capital or surplus funds so invested. The court referred to the judgment in *PE Electric Tramway Company Limited v CIR* 1936 CPD 241, where it was held that expenditure has been incurred in the production of income, if the expenditure is so closely related to the trade that it can be said that it is part of the costs of running the business. It also referred to the judgment in *CIR v Genn & Company (Pty) Ltd* 1955 (3) SA 293 (A), where it was held that one must look at the purpose of the expenditure and to what it actually effects to determine whether the expense was incurred in the production of income. Lastly, the court referred to the judgment in *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd* 1985 (4) SA 485 (A), which the taxpayer relied on to argue that a portion of the interest on the Home Loan was deductible. In the latter case, the court found in favour of Standard Bank, but also stated that to determine whether interest was deductible, "...a distinction may in certain instances have to be drawn between the case where a taxpayer borrows a specific sum of money and applies it to identifiable purpose, and the case where, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his (or its) business."

On the facts of the current matter, the court held that the taxpayer acquired the Home Loan for purposes of purchasing his residence and that this was an instance where the money was borrowed for an identifiable purpose, as stated in the Standard Bank judgment. The proceeds of the Home Loan were utilised for the payment of the purchase price. That was the taxpayer's intention in acquiring the Home Loan and there is no indication on the record of evidence of a change of intention or, if his initial intention had changed at some point, at what point there was a change of intention. Therefore, the interest paid on the Home Loan was incurred in the acquisition of a capital asset and, as such, the expenditure thus incurred was expenditure of a capital nature as it was not borrowed for the purpose of earning interest income. The expenditure also did not have the effect of earning interest income. The court pointed out that although the taxpayer changed the Home Loan from a bond account into an access facility over time, he could not prove that the purpose of the Home Loan was to earn interest from the Firm Loan Account.

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Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 3 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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