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TAX & EXCHANGE CONTROL ALERT

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EMPLOYEE SHARE SCHEMES: TAX DEDUCTIBILITY OF EMPLOYER CONTRIBUTIONS

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EMPLOYEE SHARE SCHEMES: TAX DEDUCTIBILITY OF EMPLOYER CONTRIBUTIONS

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As long ago as 2009, the South African Revenue Service (SARS) ruled that an employer who makes cash grants to a share scheme trust may deduct the amount of the grants in terms of the general deduction provision in s11(a) of the Income Tax Act, No 58 of 1962 (Act) (see SARS Binding Private Ruling 050 dated 16 October 2009 (BPR 050)). One should note that BPR050 only applied to its specific facts.

The deductibility of employer contributions or grants was the subject of a recent case in the Cape Town Tax Court, *S G Taxpayer v Comissioner for the South African Revenue Service*, Case No IT 14264.

The facts in the case were the following: The taxpayer, an operating company, (OpCo) established an employee share incentive scheme (Scheme) for its employees. Under the Scheme, a company (HoldCo), the holding company of OpCo, formed a trust (Trust). The Trust was a discretionary trust. HoldCo was the sole beneficiary of the Trust.

A new company was formed by the Trust (NewCo). The employees of OpCo were offered and acquired shares in NewCo. The NewCo shares were subject to certain lock-in provisions in respect of the employees.

OpCo and the Trust concluded a contribution agreement. Under the agreement, OpCo agreed to contribute a non-refundable amount (Contribution) to the Trust. The Trust had to use the Contribution to incentivise eligible employees in accordance with the Scheme rules and, for that purpose, used the Contribution to subscribe for redeemable preference shares (NewCo Prefs) in NewCo.

NewCo, in turn, used the subscription price of the NewCo Prefs to buy shares in HoldCo.

Over time, the value of the shares in HoldCo increased significantly. NewCo decided to redeem the NewCo Prefs by transferring HoldCo shares to the Trust. NewCo sold shares in HoldCo and paid dividends to the Scheme participants.

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The Tax Court heard evidence from the auditor who advised on the Scheme, and from a participant in the Scheme.

OpCo claimed the Contribution as a deduction against its taxable income in terms of s11(a) of the Act. Initially, SARS allowed the deduction. Subsequently, however, it issued an additional assessment disallowing the deduction. SARS's reason for disallowing the deduction was that HoldCo was the sole beneficiary of the Contribution as it (as beneficiary of the Trust) would benefit from the investment in the NewCo Prefs (through redemption and dividends); and the Scheme participants did not benefit from the Contribution. SARS argued that the Contribution paid by OpCo was accordingly not incurred in the production of its income, as required under s11(a) of the Act as there was no direct causal link between the payment of the Contribution and the production of income from the Contribution.

The Tax Court referred to certain well-established principles, namely, that the test is not whether there is a causal link but whether there is a sufficiently close connection between the expense and the income; that it is not necessary for the taxpayer to show that a particular item of expenditure produced any part of the income; and that, provided the taxpayer can show that the purpose of the expense was to produce income, any incidental benefit to a third party does not preclude the taxpayer from deducting the expense.

The Tax Court heard evidence from the auditor who advised on the Scheme, and from a participant in the Scheme.

The Court held as follows (at paragraphs 46 and 49):

> "On the evidence, the dominant purpose in the establishment and implementation of the scheme was to protect and enhance the business of the taxpayer [OpCo] and its income, by motivating its key staff to be efficient and productive and remain in the taxpayer's employ. ...
>
> The mere fact that the taxpayer foresaw that HoldCo would potentially also benefit from the redemption of the NewCo preference shares cannot negate the taxpayer's purpose and intention, which was actually effected by the scheme insofar as the value of the NewCo shares increased significantly, and this benefit, together with the dividends declared by NewCo on the remaining HoldCo shares following the preference share redemption, actually accrued to the scheme participants. The increase in the value of the HoldCo shares is directly attributable to the increase in the turnover and profits of the taxpayer, being the main operating subsidiary of HoldCo."

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The judgment is good news for taxpayers.

The Court accordingly held that there was a sufficiently close link between OpCo's expenditure of the Contribution and its income-producing operation.

The judgment is good news for taxpayers. However, the following should be noted:

- The Court quoted extensively from the Contribution agreement. It was apparent that the agreement was carefully drafted and set out the rationale for the Scheme and the Contribution in detail. In other words, when setting up an incentive scheme, it is critical that employers document the purpose and operation of the scheme meticulously.
- In the Tax Court case, the advisors on, and the participants in, the Scheme clearly had a good understanding and recollection of the way the Scheme worked and the purpose of the Scheme. Accordingly, it is important that taxpayers, when setting up a share incentive scheme for employees, obtain and retain comprehensive written advice from professionals in relation to the manner in which the scheme should operate and what the incidence of tax will be for all parties in the scheme.
- A contribution or grant in such cases must be spread over the period of the anticipated benefit to be derived by participants in terms of 23H of the Act (as pointed out by SARS in BPR 050 and as was done by OpCo in the Tax Court case).

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INDIAN REVENUE AUTHORITY GETS POLE POSITION AGAINST FORMULA ONE

There is no single infallible test of invariable application regarding what constitutes a PE, however in most tax treaties, a PE is generally considered to be a fixed place of business through which the business of an enterprise is wholly or partly carried on.

The concept of a permanent establishment (PE) is a fundamental concept in international tax law as it establishes the right to tax business profits of non-resident entities in the country where business activities are carried out. There is no single infallible test of invariable application regarding what constitutes a PE, however in most tax treaties, a PE is generally considered to be a fixed place of business through which the business of an enterprise is wholly or partly carried on.

The question of what may constitute a PE has been the subject of various judicial decisions worldwide.

Typically, a tax treaty defines a PE using the following two general tests:

- whether the corporation has a fixed place of business within the target country, as defined under the language of a specific treaty (fixed place PE); or
- whether the corporation operates in the target country through a dependent agent, other than a general agent of independent status acting in the ordinary business as such, that habitually exercises the authority to conclude contracts on behalf of the corporation in the target country (dependent agent PE).

The definition of a PE is typically similar under the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (OECD MTC), the United Nations Model Double Taxation Convention between Developed and Developing Countries and the United States Model Income Tax Convention.

For the purposes of the OECD MTC, a PE is defined in paragraph 1 of Article 5 as "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and specifically includes a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. It also includes a building site or construction or installation project which lasts for more than 12 months.

The question of what may constitute a PE has been the subject of various judicial decisions worldwide. For example, an interesting decision was handed down by the Supreme Court of India (Supreme Court) on 24 April 2017 in the case of *Formula One World Championship Ltd v. Commissioner of Income-tax, International Taxation Delhi* [2017] 291 CTR 24 (Delhi), where the Supreme Court confirmed that Formula One World Championship Limited (FOWC) had a PE in India in respect of the Grand Prix Motor Racing event conducted at the Buddh International Circuit in India. It was held that FOWC was liable to pay tax on the business income attributable to such PE in India.

The relevant facts, key issues, arguments made by the respective parties and decision of the Supreme Court are summarised below.

Facts

FOWC is a company incorporated and tax resident in the United Kingdom (UK). In terms of multiple agreements entered into between the Federation Internationale de l' Automobile (FIA), an association of the

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FOWC is authorised to exploit the commercial rights in the F1 Championship directly or through its affiliates.

world's leading motoring organisations and the governing and regulatory body for all motorsports worldwide, Formula One Asset Management Limited (FOAM) and FOWC, FOAM licensed all commercial rights in the FIA Formula One World Championship (F1 Championship) to FOWC for a period of 100 years with effect from 1 January 2011. As a result, FOWC, being the Commercial Rights Holder (CRH) in relation to the F1 Championship, is entitled to enter into contracts with promoters for purposes of hosting, promoting and staging the Grand Prix Formula One (F1) racing events. Stated differently, FOWC is authorised to exploit the commercial rights in the F1 Championship directly or through its affiliates. In addition, FOWC nominates such promoters to the FIA for inclusion in the official F1 racing calendar.

On 3 September 2011, FOWC entered into a race promotion contract (RPC) with Jaypee Sports International Limited (Jaypee), a company incorporated and tax resident in India, in terms of which Jaypee was granted the right to host, stage and promote the Formula One Grand Prix of India event at the Buddh International Circuit in India (Indian Grand Prix). FOWC and Jaypee also entered into an artwork license agreement whereby FOWC permitted Jaypee to use certain marks and intellectual property belonging to FOWC. On the same day, Jaypee entered into back-to-back agreements with three companies affiliated with FOWC, namely Formula One Management Limited (FOM), Beta Prema 2 Limited (Beta Prema 2) and Allsports Management SA (Allsports) in terms of which Jaypee transferred various rights pertaining to the Indian Grand Prix (ie Jaypee engaged FOM to generate the television feed, transferred circuit rights to Beta Prema 2, and paddock rights to Allsports). Various other agreements in relation to the Indian Grand Prix were concluded between the parties.

FOWC and Jaypee approached the Authority for Advance Rulings (AAR) for confirmation of the tax treatment of the consideration payable by Jaypee to FOWC under the RPC. The AAR confirmed that the consideration received by FOWC would constitute a 'royalty' in terms of the provisions of the Income Tax Act, 1961 (Act) and the double tax treaty entered into between India and the United Kingdom (India-UK treaty). The AAR further confirmed that the FOWC did not have a fixed place PE or dependent agent PE in India.

FOWC approached the Delhi High Court (High Court) to challenge the AAR's ruling in respect of the royalty, while the Union of India (Revenue Authority) challenged the determination by the AAR that FOWC did not have a PE in India. The High Court reversed the findings of the AAR on both the abovementioned issues and held that the amount received by FOWC would not be deemed to be a royalty. It also held that FOWC had a fixed place PE in India and therefore, the consideration received in terms of the RPC was taxable in India.

FOWC, Jaypee and the Revenue Authority appealed to the Supreme Court.

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Only Jaypee was liable for all acts and obligations, from construction of the circuit until conclusion of the Indian Grand Prix.

Key issues

The Supreme Court had to determine whether a PE of FOWC existed in India. In interpreting the provisions of Article 5 of the India-UK tax treaty (which follows the OECD MTC), the Supreme Court had to decide whether:

(i) the Buddh International Circuit was at FOWC's 'disposal' (that is, whether it was a fixed place of business of FOWC); and

(ii) FOWC generated business income through conducting the Indian Grand Prix from that fixed place.

Arguments made by respective parties

FOWC and Jaypee made, *inter alia*, the following contentions:

- the Buddh International Circuit was not at the disposal of FOWC as Jaypee had constructed the circuit at its own expense, with its own engineers, architects and was responsible for conducting the Indian Grand Prix. Further, Jaypee was using the circuit for other events that were being organised on a regular basis. In addition, the amount of time for which the limited access to the race venue was granted to FOWC was not of sufficient duration to constitute the degree of permanence necessary to establish a fixed place PE in India;
- only Jaypee was liable for all acts and obligations, from construction of the circuit until conclusion of the Indian Grand Prix. The provisions of the RPC enabled FOWC to exploit the commercial rights to the Indian Grand Prix. However, the RPC did not give FOWC the right to conduct / host the Indian Grand Prix;
- even if one could argue that FOWC had control over the circuit, the Indian Grand Prix was a temporary model for three days (in a year) only and possession of a site for three days could not constitute a PE; and
- as the commercial rights to hold the event were granted in the UK, the consideration received by FOWC in terms of the RPC was taxable in the UK.

The Revenue Authority contended, *inter alia*, that:

- Jaypee's only role was to host the Indian Grand Prix, while it was FOWC and its affiliates who had complete access to the circuit at the time of construction thereof as well as at the time of the Indian Grand Prix. The Revenue Authority relied extensively on a number of agreements executed between the different stakeholders to demonstrate the flow of commercial rights in relation to the events;
- rights granted by FOCW to Jaypee were transferred in turn to FOCW's affiliates by way of separate back-to-back agreements which were entered into simultaneously with the RPC. Also, FOWC engaged FOM, an affiliate, to provide specified services, which indicates physical management of the business activity; and
- the RPC was entered into so as to give an impression that Jaypee was vested with real control of the affairs of the India Grand Prix, whereas the factual circumstances were different.

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The Supreme Court placed reliance on a number of examples of fixed place PEs as expounded upon by various authors and the OECD MTC.

Ruling of the Supreme Court

The Supreme Court placed reliance on a number of examples of fixed place PEs as expounded upon by various authors and the OECD MTC. The Supreme Court also had regard to a number of judicial decisions in India and abroad.

In order to determine which entity had the ultimate control over the India Grand Prix, the Supreme Court examined, in great detail, the manner in which commercial rights in relation to the Indian Grand Prix were exploited by FOWC. The Supreme Court found that the Buddh International Circuit was a fixed place, from where the Indian Grand Prix was conducted and this constituted an economic and business activity of FOWC.

With reference to the enquiry of whether the circuit was put at the disposal of FOWC, the Supreme Court held, *inter alia*, that:

- the various agreements entered into between the relevant parties indicated that the Indian Grand Prix was completely controlled by FOWC and its affiliates and FOWC earned income therefrom. Accordingly, the construction of the circuit by Jaypee could not extinguish the fact that FOWC controlled the Indian Grand Prix (ie the business activity). In this regard, the Supreme Court stated:

  > "There cannot be any race without participating/competing teams, a circuit and a paddock. All these are controlled by FOWC. Event has taken place by conduct of race physically in India. Entire income is generated from the conduct of this event in India. Thus, commercial rights are with FOWC which are exploited with actual conduct of race in India. Even the physical control of the circuit was with FOWC from the inception, ie inclusion of event in a circuit till the conclusion of the event. Omnipresence of FOWC and its stamp over the event is loud, clear and firm."

- the rights relating to the Indian Grand Prix outsourced by Jaypee to FOWC's affiliates were critical to the success of the event and depended not only on the circuit and participation by teams, but also on the services that were aimed at ensuring maximum public viewership such as paddock seating, media advertising, television broadcasting etc. The income generated from these services solely accrued to FOWC's affiliates which strengthened the view that the entire event had been taken over and controlled by FOWC and its affiliates;

- the argument that the duration for which the circuit and the associated infrastructure at the disposal of FOWC was too short was unfounded. The fact was that the race was to be held for only three days in a year and as the control of the entire event was with FOWC, this duration was sufficient to constitute a fixed place PE; and

- the construction of the circuit by Jaypee, ownership and use thereof for hosting other events at its expense was insufficient to mask the fact that the business activity was controlled by FOWC. The Buddh International Circuit was under the control and at the disposal of FOWC through which it conducted its business as the CRH.

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In conclusion, the Supreme Court held that the fixed PE test had been satisfied.

In conclusion, the Supreme Court held that the fixed PE test had been satisfied. The Buddh International Circuit was a fixed place where the commercial/economic activity of conducting the Championship was carried out, and "was a virtual projection of the foreign enterprise, ie ... FOWC" on the soil of India.

Accordingly, FOWC was liable to pay tax in India on the income earned from the Indian Grand Prix, as it had conducted business in India through a fixed place PE. The relevant portion of FOWC's business income which was attributable to the PE, would therefore be subject to deduction of tax in terms of s195 of the Act, which was a statutory obligation for the payer, ie Jaypee. The Supreme Court found that the quantum of business income attributable to FOWC's PE in India would have to be determined separately during its assessment proceedings.

Conclusion

This judgment is in line with the multitude of international commentary and judicial decisions relating to fixed place PEs. In addition, the judgment confirms that if the place of business is fixed, the permanence of such place must be evaluated having regard to the nature of the business and other relevant factors.

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