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TAX & EXCHANGE CONTROL ALERT

IN THIS ISSUE

DISALLOWANCE OF THE UTILISATION OF AN ASSESSED LOSS

In the recent case of *Commissioner for the South African Revenue Service v Digicall Solutions (Pty) Ltd* (927/2017) [2018] ZASCA 137 (28 September 2018), the Supreme Court of Appeal (SCA) was requested to consider whether the Commissioner for the South African Revenue Service (Commissioner) was correct in disallowing the utilisation by Digicall Solutions (Pty) Ltd (Taxpayer) of certain assessed losses, in terms of s103(2) of the Income Tax Act, No 58 of 1962 (Act).

CUSTOMS & EXCISE HIGHLIGHTS

This week's selected highlights in the Customs & Excise environment since our last instalment.

CLIFFE DEKKER HOFMEYR

DISALLOWANCE OF THE UTILISATION OF AN ASSESSED LOSS

Section 103(2) of the Act is an anti-avoidance provision which essentially allows the Commissioner to disallow the setting-off of an assessed loss or balance of an assessed loss against the taxpayer's income if certain requirements are met.

In the recent case of *Commissioner for the South African Revenue Service v Digicall Solutions (Pty) Ltd* (927/2017) [2018] ZASCA 137 (28 September 2018), the Supreme Court of Appeal (SCA) was requested to consider whether the Commissioner for the South African Revenue Service (Commissioner) was correct in disallowing the utilisation by Digicall Solutions (Pty) Ltd (Taxpayer) of certain assessed losses, in terms of s103(2) of the Income Tax Act, No 58 of 1962 (Act).

More specifically, s103 deals with transactions, operations or schemes which have been entered into for purposes of avoiding or postponing liability for or reducing amounts of taxes on income.

By way of background, in order to determine the taxable income of a taxpayer from its trade, s20(1) of the Act provides that a taxpayer may set off (i) a balance of the assessed loss brought forward from the previous year of assessment, and (ii) any assessed loss incurred in the current year in carrying on any other trade.

The following requirements must be met for a taxpayer to set off an assessed loss against taxable income:

- the taxpayer must be carrying on a trade;
- the assessed loss may only be set off against income derived from its trading activities; and
- the taxpayer can only carry forward its assessed loss from the immediately preceding year of assessment if such taxpayer carried on a trade during the current year of assessment.

Section 103(2) of the Act is an anti-avoidance provision which essentially allows the Commissioner to disallow the setting-off of an assessed loss or balance of an assessed loss against the taxpayer's income if certain requirements are met. More specifically, s103 deals with transactions, operations or schemes which have been entered into for purposes of avoiding or postponing liability for or reducing amounts of taxes on income and provides that any assessed loss must be disallowed by the Commissioner if he is satisfied that:

- any agreement has been concluded affecting any company, or that a change in the shareholding of a company has taken place;
- as a direct or indirect result thereof, income has been received by or accrued to that company during the year of assessment; and
- that agreement was concluded or the change in the shareholding effected solely or mainly for the purpose of utilising any assessed loss incurred by the company, in order to avoid or reduce any tax liability.

The tax avoidance as opposed to taxation nature of s103 of the Act was explained in *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 1975 (4) SA 715 (A) at 626 where the court held that:

> "Section 103 of the Act is clearly directed at defeating tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act or to the

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In order to create an exit event for the Australian shareholder that wished to disinvest from South Africa, it was proposed that an investment company named Global Capital would acquire the shares in the Taxpayer and provide services to a rival cellular network provider.

> liability therefor or to the incidence thereof, but rather to schemes designed for the avoidance of liability therefor. It should, in my view, therefore, not be construed as a taxing measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed...The discretionary powers conferred upon the Secretary should, therefore, not be restricted unnecessarily by interpretation."

Section 103(4) of the Act, which imposes the onus of proof on the taxpayer, provides that when it is proved that an agreement or change in shareholding has resulted in the avoidance or postponement of liability for payment of any tax or in the reduction of the amount thereof, it will be presumed that the agreement or change in shareholding has been entered into or effected solely or mainly for the purpose of utilising any assessed loss, in order to avoid or reduce any tax liability. It follows therefore that the taxpayer bears the onus of rebutting the abovementioned presumption by proving that an agreement or change in shareholding was entered into or effected for a commercial objective and not solely or mainly for avoiding or reducing any tax liability.

Considering the above background, the relevant facts, arguments made by the respective parties, findings of the lower courts and decision of the SCA are summarised below.

Facts

The Taxpayer, a South African resident company and wholly-owned subsidiary of an Australian company, established a call centre facility in Cape Town, which sold cellular network service provider contracts for two cellular network providers, via the call centre to customers. In December 2001, the Taxpayer, which had an assessed loss of approximately R48 million, terminated its service provider contracts and disposed of its subscriber bases (which were its main source of business) to the two cellular network providers.

In order to create an exit event for the Australian shareholder that wished to disinvest from South Africa, it was proposed that an investment company named Global Capital would acquire the shares in the Taxpayer and provide services to a rival cellular network provider. During the financial and legal due diligence commissioned by Global Capital in relation to the Taxpayer, it was revealed that one of the cellular network providers (mentioned above) had instituted proceedings against the Taxpayer. As a result, Global Capital could not take over the Taxpayer. As Global Capital always intended to buy the shares directly in the Taxpayer, it was decided that Global Capital would set up a new company for this purpose.

Global Capital acquired a shelf company, Selldirect Marketing Pty Ltd (SDM). The plan was for SDM to acquire the assets and employees of the Taxpayer and take over the lease in respect of the call centre. In

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During the period 2004 to 2008, Glasfit was able to inject income from the Venture located in the consolidated call centre into the Taxpayer, enabling the Taxpayer to utilise the existing assessed loss in the Taxpayer.

addition, SDM would be granted an option to acquire all the shares in the Taxpayer, to be exercised once the litigation had been resolved. The option would endure for 18 months from the date of the sale agreement, the purchase price being the par value of the shares. It is important to note that based on evidence presented to the SCA, SDM was aware:

- of the Taxpayer's assessed loss in respect of the tax year ending 30 June 2001, which had not as yet been assessed; and
- that in terms of s20 of the Act, any assessed loss could only be carried forward to a future year of assessment, where the company in question (ie Taxpayer) traded. Accordingly, in order to utilise the assessed loss, the Taxpayer would *"as it were, have to be brought back from the grave and start trading again"*.

SDM conducted the Taxpayer's business in Cape Town and took over the lease from the Taxpayer. It is stated that once SDM started conducting the business, it realised that the facilities in the call centre exceeded what was required by SDM. Consequently, SDM decided that it would need to sell the call centre and lease back only the facilities it required (ie 30 seats out of the 120 seats available in the call centre) from the relevant purchaser. Global Capital initiated the sale process of the Taxpayer and the call centre and was in discussions with a company named Glasfit. Glasfit, together with its rival PG Glass, were looking to set up a business process outsourcing venture (Venture), which would require a call centre. Glasfit made multiple offers to SDM for the acquisition of the Taxpayer and call centre, however SDM did not accept these on the basis that the offers substantially undervalued the Taxpayer.

Having ensured that the Taxpayer was trading at 30 June 2002, the assessed loss was carried forward to the 2003 year of assessment. SDM then exercised the option to purchase all the shares in the Taxpayer on 19 September 2002, although at such time, there was nothing left in the Taxpayer, other than the assessed loss. It is important to note that although the option was exercised on 19 September 2002, SDM only purchased the shares by way of a formal agreement entered into on 5 March 2003. A further agreement was concluded on 7 May 2003 between SDM and the Taxpayer, where the Taxpayer reacquired its business from SDM.

SDM and Glasfit resumed negotiations for the sale of the shares in the Taxpayer and on 3 October 2003, SDM accepted the offer of Glasfit to acquire the shares in the Taxpayer to Glasfit. The sale agreement was being concluded on 25 November 2003.

During the period 2004 to 2008, Glasfit was able to inject income from the Venture located in the consolidated call centre into the Taxpayer, enabling the Taxpayer to utilise the existing assessed loss in the Taxpayer.

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Similar to the Tax Court, the High Court found that the first change in shareholding did not directly or indirectly result in income being received by or accruing to the Taxpayer.

The Commissioner issued additional assessments against the Taxpayer, during November 2010 in respect of the 2005-2008 income tax periods, disallowing the utilisation by the Taxpayer of the assessed loss, in terms of s103(2) of the Act. The Taxpayer lodged an objection which was disallowed by the Commissioner, against which disallowance, the Taxpayer appealed to the Tax Court.

Arguments made by the relevant parties

The Taxpayer contended that the income injected by Glasfit and received after the second change in shareholding (ie when Glasfit purchased the shares in the Taxpayer from SDM), was beyond the scope of s103(2) of the Act, as this income did not result directly or indirectly from the first change in shareholding (ie when SDM acquired the shares from the Australian shareholder). More specifically, the Taxpayer provided that the income against which the assessed loss was set-off by the Taxpayer in the 2004 to 2008 tax years, resulted directly or indirectly from the second change in shareholding, upon which the Commissioner could not rely.

The Commissioner was of the view that if the Taxpayer's contention were to be followed, taxpayers could simply artificially effect more than one change in shareholding to circumvent the provisions of s103(2) of the Act. It was submitted that to permit such an interpretation *"would be contrary to the principle that the subsection should be considered in a manner that advances the remedy and suppresses 'trafficking' in shares of companies, with assessed losses"*.

Findings of the Tax Court

The Tax Court found that the first change in shareholding did not directly or indirectly result in income being received by or accruing to the Taxpayer. The Tax Court submitted that the income was derived not from the first change in shareholding, but from a later intervening event, being the second change in shareholding and the income was not contemplated at the time when SDM acquired the shares from the Australian shareholder. The Tax Court, while referencing the breaking of the chain of causation referred to in delictual cases as a *nova causa interveniens*, reasoned that income was not the 'result' of the first change in shareholding.

Accordingly, the Tax Court granted an order setting aside the assessments and referred the matter back to the Commissioner for reassessment on the ground that the taxpayer was entitled to set-off the assessed loss against its income during the relevant years. The Commissioner appealed against this decision to the full court of Western Cape Division of the High Court (High Court).

Findings of the High Court

Similar to the Tax Court, the High Court found that the first change in shareholding did not directly or indirectly result in income being received by or accruing to the Taxpayer. The High Court was even more explicit in its reliance upon the delictual test of causation, concluding that although the first change in shareholding may have been the *sine qua non* of the receipt of income by the taxpayer, it was

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The SCA held that "the direct or indirect receipt of income by the taxpayer, does not have to occur in the same tax year as the change in shareholding of the taxpayer".

not the *causa causans*. The High Court concluded that it was the second change in shareholding that was the effective cause and dismissed the appeal with costs on the ground that the requirements of s103(2) of the Act were not satisfied.

Decision of the SCA

The SCA provided that s103(2) states that the change in shareholding must result, directly or indirectly, in income being received by, or accruing to the taxpayer, during *any* year of assessment. Finding in favour of the Commissioner, the SCA held that:

> "the direct or indirect receipt of income by the taxpayer, does not have to occur in the same tax year as the change in shareholding of the taxpayer. It may occur in any year of assessment, provided it results directly or indirectly from the change in shareholding.
>
> The first change in shareholding therefore resulted indirectly in income being received by or accruing to the taxpayer during the 2005 to 2008 years of assessment. The Commissioner was accordingly correct in concluding that the provisions of s103(2) of the Act were satisfied and in disallowing the taxpayer's claim to set-off the assessed loss against such income, during these years of assessment."

Conclusion

Considering the above, it is evident that the determination of whether an assessed loss was utilised for purposes of reducing or avoiding tax is an entirely factual enquiry and accordingly the necessary evidence (eg board minutes, correspondence and other documentation) to support the commercial objective must be documented.

Gigi Nyanin

CLIFFE DEKKER HOFMEYR

CUSTOMS & EXCISE HIGHLIGHTS

Please note that this is not intended to be a comprehensive study or list of the amendments, changes and the like in the Customs and Excise environment, but merely selected highlights which may be of interest.

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

This week's selected highlights in the Customs & Excise environment since our last instalment.

1. Amendments to Schedules to the Customs & Excise Act, No 91 of 1964 (Act) (certain sections taken from the SARS website):

   1.1 Schedule 1 Part 1:

   1.1.1 The substitution of tariff subheadings 1001.91 and 1001.99 as well as 1101.00.10 and 1101.00.90 to reduce the rate of customs duty on wheat and wheaten flour from 64,06c/kg and 96,09c/kg to 29,85c/kg and 44,77c/kg respectively;

   1.1.2 The substitution of tariff subheadings 1701.12, 1701.13, 1701.14, 1701.91, and 1701.99 to increase the rate of customs duty on sugar from 419.52c/kg to 460.86c/kg;

   1.2 Schedule 2:

   1.2.1 The insertion of safeguard item 250.02/0207.14.9/01.07 to implement safeguard duty of 35.3% on frozen bone-in chicken portions of fowls of the species Gallus domesticus (28 September 2018 up to and including 11 March 2019);

   1.2.2 The substitution of safeguard item 250.02/0207.14.9/01.07 to phase down safeguard duty from 35.3% to 30% on frozen bone-in chicken portions of fowls of the species Gallus domesticus (12 March 2019 up to and including 11 March 2020);

   1.2.3 The substitution of safeguard item 250.02/0207.14.9/01.07 to phase down safeguard duty from 30% to 25% on frozen bone-in chicken portions of fowls of the species Gallus domesticus. (12 March 2020 up to and including 11 March 2021); and

   1.2.4 The substitution of safeguard item 250.02/0207.14.9/01.07 to phase down safeguard duty from 25% to 15% on frozen bone-in chicken portions of fowls of the species Gallus domesticus. (12 March 2021 up to and including 11 March 2022).

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In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

2. SARS issued a circular dated 28 September 2018 relating to the customs deferment scheme wherein external stakeholders were advised as follows (certain sections quoted from the circular):

   2.1 The deferment policy currently states that in the case of non-payment by the agreed date:

      2.1.1 For a first default, the account holder will be suspended from the deferment facility for one month;

      2.1.2 For a second default, the account holder will be suspended from the deferment facility for two months; and

      2.1.3 For a third default, the account holder's facility will be cancelled or terminated, and the account holder may not be re-instated for a period of 12 months.

   2.2 The suspension and termination functionalities will be automated from 18 January 2019 and defaulters will be automatically suspended or terminated by the system.

   2.3 Accountholders unable to make payment on the agreed date (due to genuine disputed amounts) are advised to approach the relevant customs branch office within seven days from the statement date to avoid suspension or cancellation.

3. Please advise if additional information is required.

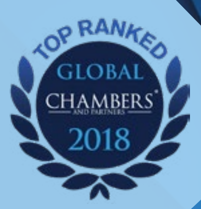
Petr Erasmus

Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory & Controversy for 2018.

Mark Linington has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory for 2018.

Ludwig Smith has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory for 2018.



CHAMBERS GLOBAL 2018 ranked our Tax & Exchange Control practice in Band 1: Tax.

Gerhard Badenhorst ranked by CHAMBERS GLOBAL 2014 - 2018 in Band 1: Tax: Indirect Tax.

Emil Brincker ranked by CHAMBERS GLOBAL 2003 - 2018 in Band 1: Tax.

Mark Linington ranked by CHAMBERS GLOBAL 2017- 2018 in Band 1: Tax: Consultants.

Ludwig Smith ranked by CHAMBERS GLOBAL 2017 - 2018 in Band 3: Tax.

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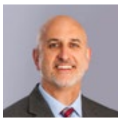

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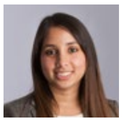

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BBBEE STATUS: LEVEL TWO CONTRIBUTOR
Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 2 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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