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TAX & EXCHANGE CONTROL **ALERT**

IN THIS **ISSUE**

A cautionary tale: Taxpayer liability for capital gains tax on disposal not declared to SARS

In many instances, especially in the context of complex, high-value transactions, a taxpayer may adopt a robust interpretation of tax legislation which results in the deferral or mitigation of their tax liability emanating from such transactions. In doing so, a taxpayer should make absolutely certain that there is a sound basis for the position adopted.

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INCORPORATING
KIETI LAW LLP, KENYA

A cautionary tale: Taxpayer liability for capital gains tax on disposal not declared to SARS

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In many instances, especially in the context of complex, high-value transactions, a taxpayer may adopt a robust interpretation of tax legislation which results in the deferral or mitigation of their tax liability emanating from such transactions. In doing so, a taxpayer should make absolutely certain that there is a sound basis for the position adopted.

In *Mr A v The Commissioner for the South African Revenue Service* SARSTC 13395 (IT) [2021] (as yet unreported), a taxpayer failed to disclose to the South African Revenue Service (SARS) a disposal in circumstances in which he was undoubtedly under a legal obligation to do so. The taxpayer's justification for not making such disclosure, notably that he viewed the fact that the sale was subject to a number of suspensive conditions as an indication that the purchase price had not yet accrued was held by the court to be "*untenable*". Fortunately for the taxpayer, the facts of the matter were favourable and did not result in materially adverse consequences due to a gross error by SARS in calculating the taxpayer's tax liability.

Background

During the 2009 year of assessment, the taxpayer had disposed of his shares in BCD (Pty) Limited (BCD SA), making him liable for capital gains tax in addition to interest and additional penalty taxes.

On 30 August 2012, SARS issued the taxpayer with a revised assessment to adjust the taxpayer's assessed income for the 2009 tax year to take into account the disposal mentioned above.

In terms of the revised assessment, the taxpayer was held liable for additional taxes and the total amount of his tax liability, including the additional taxes, amounted to R23,124,966, of which R10,618,223 related to a "*capital gain on disposal of business interest[s]*".

On 2 November 2012, the taxpayer objected to the revised assessment, which was disallowed by SARS in respect of the capital gains tax levied and the related interest imposed in terms of section 89(2) of the Income Tax Act 58 of 1962 (Act) and additional penalty taxes.

In 2003 the taxpayer used the amnesty available in terms of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 in order to repatriate his assets and wealth back to South Africa, which at that stage was residing offshore (amnesty application).

The taxpayer's assets included his shareholding in an offshore company, registered and incorporation in the British Virgin Islands (BCD Corporation) valued at R95,389,436 (as per the amnesty application – US$11,937,258 multiplied by the agreed US$/ZAR foreign exchange rate of 7,9909). This valuation was accepted by the South African Reserve Bank in the amnesty application.

A cautionary tale: Taxpayer liability for capital gains tax on disposal not declared to SARS*...continued*

In this tax court appeal, the court had to determine whether the taxpayer is liable for capital gains tax as a result of the sale of the BCD SA shares.

The transactions under the spotlight

On 29 January 2009, a sale of shares agreement was entered into between all the shareholders of BCD SA (including the taxpayer) and Sail Group Limited (purchaser), in terms of which the purchaser would acquire 100% of the issued share capital of BCD SA, 53.1% of which was owned by the taxpayer at the time.

The aggregate purchase price due and payable to the taxpayer for the sale of his BCD SA shares was the sum of R66,364,587, payable as follows:

- R27,944,485 in cash on the implementation date – that being 8 January 2009 and seven days after fulfilment of all of the suspensive conditions of the agreement.
- R15,264,000 – by the allotment and issue to the taxpayer of the equivalent of shares to the value of R16,591,304 in the purchaser.
- R23,156,102 – on the third anniversary of the implementation date, being during January 2012, subject to certain warranty clauses and breach provisions in the agreement.
- At the same time, and as part of the same agreement of sale dated 29 January 2009, the taxpayer also sold to the purchaser all of his shares in BCD Corporation.

Issues to be determined

In this tax court appeal, the court had to determine whether the taxpayer is liable for capital gains tax as a result of the sale of the BCD SA shares.

If the taxpayer was found to have been liable for capital gains tax on the sale of the BCD SA shares, then the court had to determine how the capital gains tax should have been calculated, namely:

- what were the proceeds from the sale of the shares, and
- what was the base cost of the shares?

Did the proceeds accrue to the taxpayer?

The primary argument of the taxpayer in disputing the tax imposed by the revised assessment was that the purchase price was only payable upon the fulfilment of certain suspensive conditions. As a result, the taxpayer adopted the position that he would only include the sale proceeds in his taxable income in the year of assessment in which all the suspensive conditions had been fulfilled.

The court considered well-established jurisprudence in determining whether the proceeds had accrued to the taxpayer and stated that the words in the Act "*has accrued to or in favour of any person*", simply means "*to which he has become entitled*" as outlined *in Lategan v CIR* 1926 CPD 203.

Similarly, in *Mooi v SIR* 34 SATC 1, it was held that a contingent right conditional upon the fulfilment of certain conditions cannot be regarded as an "*amount*" for the purposes of the definition of "*gross income*", even though such a right possesses a monetary value at the time it is acquired by a taxpayer. Such a contingent right does no more than "*set up the machinery for creating a benefit*", and the benefit accrues only when all conditions attaching to the right are fulfilled.

A cautionary tale: Taxpayer liability for capital gains tax on disposal not declared to SARS*...continued*

The court found that there was merit in the approach proposed by the taxpayer, that being that all of the shares held by the taxpayer in the group of companies should, for purposes of the assessment of capital gains tax, be treated as one *"asset"* as defined in the Eighth Schedule.

The court, however, found this argument to be fatally flawed in that on the taxpayer's own evidence, he received the first payment from the purchaser in February 2009. Accordingly, the court stated that *"the ineluctable inference to be drawn is that all of the suspensive conditions were fulfilled. If not, there would not have been payment to him of the first instalment payable."*

The court concluded that the purchase price of R66,364,578 had indeed *"accrued"* to the taxpayer when he sold his shares in BCD SA on 29 January 2009 and the amount represented *"the proceeds received or accrued"* in respect of the disposal of the BCD SA shares.

How was the capital gains tax liability calculated?

Having found that the purchase price had accrued to the taxpayer and that he was liable for capital gains tax on the sale of the BCD SA shares, the court turned to the issue of the quantum of the capital gain that should have been included in the taxpayer's income. This enquiry required the court to establish the base cost of the BCD SA shares and entailed the considerations set out hereunder.

The taxpayer argued that the valuation done for the amnesty application of the BCD Corporation shares constitutes a valuation which should be accepted and, as a result, there was a capital loss when the BCD Corporation shares were disposed of.

SARS argued that the base costs should simply be calculated on the basis that the taxpayer acquired the BCD Corporation shares at R1 par value, therefore R531, and the capital gain assessed on that basis.

The court found that there was merit in the approach proposed by the taxpayer, that being that all of the shares held by the taxpayer in the group of companies should, for purposes of the assessment of capital gains tax, be treated as one *"asset"* as defined in the Eighth Schedule.

Therefore, the base cost of that asset should be determined on the basis that it was acquired on the date on which the shares in BCD SA were issued to the taxpayer and, importantly, the market value of those shares should be established with reference to the amount declared to and accepted in the amnesty application. In terms of this declaration, the taxpayer had an 82% shareholding in the BCD Group of Companies – that being the BCD Corporation at that stage – valued at R95,389,436.60.

A key point in determining the base cost of the shares (both the BCD SA shares and the BCD Corporation shares) was that at 28 February 2003 the taxpayer owned 82% of the shares in BCD Corporation. On 29 January 2009 only a 53,1% shareholding in the group (consisting of BCD SA and BCD Corporation shares) was disposed of, meaning that the base cost of 53,1% of the shareholding should be determined by pro-rating the value resulting in a 53,1% shareholding being valued at R61,763,519.70.

Taking into account the above, the court stated that this approach accords with the letter and the spirit of the relevant provisions of the Eighth Schedule and performed its own calculation, which resulted in capital gains tax payable by the taxpayer in the amount of R3,641,339.58

A cautionary tale: Taxpayer liability for capital gains tax on disposal not declared to SARS *...continued*

The concept of accrual in the definition of gross income has extensively been traversed in our law and the position adopted by the taxpayer was plainly incorrect.

Order

The court held that:

- The assessment did not correctly reflect the capital gain realised by the taxpayer and accordingly, SARS was ordered to alter the assessment.
- Interest would therefore need to be re-calculated based on the correct tax liability amount.
- Additional tax imposed was reduced by the court from 200% to 25% on the basis that the court found extenuating circumstances to be present. This was premised on the fact that the assessment was in excess of what the court determined such liability to be (i.e. the basis of SARS' calculation was grossly incorrect).

Comment

This judgment is an example to taxpayers of the importance of, firstly, obtaining good tax counsel when entering into material transactions, and secondly, being able to justify and substantiate any tax position being adopted, especially where that position results in the mitigation or deferral of the taxpayer's tax liability.

The concept of accrual in the definition of gross income has extensively been traversed in our law and the position adopted by the taxpayer was plainly incorrect. In fact, the court took great exception to the taxpayer's failure to disclose to SARS that he disposed of an asset and realised a substantial sum of money running into tens of millions of rand – the court stated that there is no justification for this position.

In addition to the above, were it not for the gross error by SARS in calculating the taxpayer's liability, the court may well have confirmed the additional tax penalty of 200% as there would not have been any extenuating circumstances present to reduce the penalty.

Keshen Govindsamy

OUR TEAM

For more information about our Tax & Exchange Control practice and services in South Africa and Kenya, please contact:

Emil Brincker
Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

Sammy Ndolo
Managing Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E sammy.ndolo@cdhlegal.com

Mark Linington
Private Equity Sector Head
Director
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com

Gerhard Badenhorst
Director
T +27 (0)11 562 1870
E gerhard.badenhorst@cdhlegal.com

Jerome Brink
Director
T +27 (0)11 562 1484
E jerome.brink@cdhlegal.com

Petr Erasmus
Director
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com

Dries Hoek
Director
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

Heinrich Louw
Director
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com

Howmera Parak
Director
T +27 (0)11 562 1467
E howmera.parak@cdhlegal.com

Stephan Spamer
Director
T +27 (0)11 562 1294
E stephan.spamer@cdhlegal.com

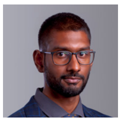
OUR TEAM

For more information about our Tax & Exchange Control practice and services in South Africa and Kenya, please contact:

Louis Botha
Senior Associate
T +27 (0)11 562 1408
E louis.botha@cdhlegal.com

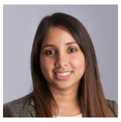
Louise Kotze
Associate
T +27 (0)11 562 1077
E louise.Kotze@cdhlegal.com

Ursula Diale-Ali
Associate Designate
T +27 (0)11 562 1614
E ursula.diale-ali@cdhlegal.com



Keshen Govindsamy
Senior Associate
T +27 (0)11 562 1389
E keshen.govindsamy@cdhlegal.com

Tsanga Mukumba
Associate Designate
T +27 (0)11 562 1136
E tsanga.mukumba@cdhlegal.com



Varusha Moodaley
Senior Associate
T +27 (0)21 481 6392
E varusha.moodaley@cdhlegal.com

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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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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@cdhlegal.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@cdhlegal.com

NAIROBI

CVS Plaza, Lenana Road, Nairobi, Kenya. PO Box 22602-00505, Nairobi, Kenya.
T +254 731 086 649 | +254 204 409 918 | +254 710 560 114 E cdhkenya@cdhlegal.com

STELLENBOSCH

14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com

CLIFFE DEKKER HOFMEYR

INCORPORATING
KIETI LAW LLP, KENYA