TAX & EXCHANGE CONTROL

ALERT

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CLIFFE DEKKER HOFMEYR

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Restraints on your returns: A recent Tax Court judgment on restraint of trade payments

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Restraints on your returns: A recent Tax Court judgment on restraint of trade payments

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When these employees look to leave the business, it may cause a decrease in its value in relation to what those employees do with the confidential information they had access to in the course of their employment. In an attempt to protect this value, employers may enter into restraint of trade agreements with exiting employees where the employees will receive financial compensation in exchange for refraining from engaging in a particular activity in a particular area for a period of time. The importance of the categorisation of these payments in one's tax returns was highlighted in the case of *Mr Taxpayer v the Commissioner of the South African Revenue Service* (IT45628) [2022] ZATC 8 (17 August 2022) in which the Tax Court was tasked with determining whether a sum of money received in consideration of a restraint of trade agreement amounted to capital or gross income, in terms of the "*gross income*" definition in paragraph (cB) in section 1 of the Income Tax Act 58 of 1962 (ITA). The answer to this question, as this article will demonstrate, hinged on the determination of a link between the restraint of trade and the employment of the appellant at the company in question.

FACTUAL BACKGROUND

Mr. Taxpayer (the appellant) was previously employed by Holdings as a director. When he terminated his employment with Holdings, and after a period of four and a half years had passed, the appellant and Holdings entered into a restraint of trade agreement (restraint agreement) to safeguard against the potential exposure of confidential information that the appellant had access to during his tenure as a director. Upon the conclusion of the agreement, a sum of R60 million was paid over to the appellant.

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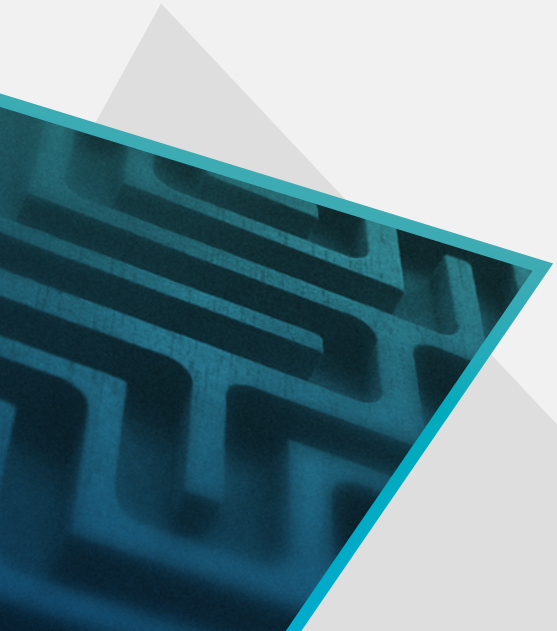

Following receipt of this sum, the appellant declared it as a capital gain in his annual return and paid over R8 million to the South African Revenue Service (SARS) as capital gains tax. Once SARS assessed the appellant's return, it disagreed with the categorisation of the payment as a capital gain, rather finding the sum to be gross income and taxed him accordingly. The appellant objected to this adjustment but his objection was disallowed and ultimately led to his filing of an appeal in court. The key issues for determination were:

- was the payment received in consideration of a restraint of trade agreement gross income as defined in section 1 of the ITA; and
- was the understatement penalty imposed in terms of sections 221 and 223 of the Tax Administration Act 28 of 2011 warranted and reasonable.

LEGAL ANALYSIS

The court first considered the definition of gross income in the ITA which is defined as "*the total amount, in cash or otherwise, receive by or accrued to or in favour of such resident*" in any year of assessment. To determine whether the payment fell under this definition, the court further dissected the definition of gross income into smaller parts. Firstly, it had to determine whether the payment was received by a natural person. The restraint agreement was between Holdings and the appellant, with the appellant being the recipient of this payment. Suffice to say, the amount was paid to a natural person. Secondly, the court had to determine if the money was received in respect of or by virtue of his employment or holding office. To determine this, the court needed to consider whether a causal link existed between the restraint agreement and the employment contract between Holdings and the appellant.

SARS argued that because the appellant was a former employee and director of Holdings, this created a link between the restraint agreement and the appellant's employment. However, the appellant argued that there was no causal link as he terminated his employment with Holdings four and a half years earlier.

The court sided with SARS on this point and found that there was indeed a causal link between the employment and position of the appellant as a director of Holdings on the one hand, and the restraint agreement on the other. The logic was that the restraint agreement existed because during the appellant's tenure as director of Holdings, he had acquired confidential information which, if divulged to members outside of Holdings, would decrease the value of the company's shares. The amount received by the appellant arising from the restraint agreement was in connection with his past employment with Holdings. This, the court found to be a sufficient qualifier to regard the amount received as gross income.

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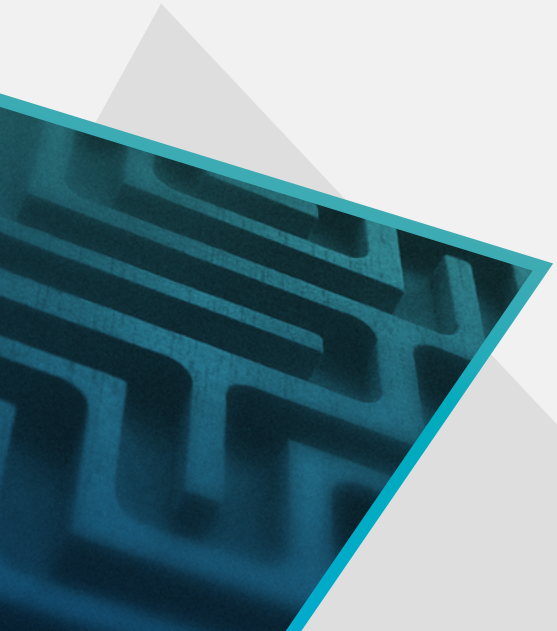

ASSESSING THE PENALTY

Now viewing the amount to be income, the court had to then determine if the penalty imposed on the appellant by SARS was reasonable, which it found to be so. The appellant claimed that the reason he categorised the amount as capital in his return was due to a tax directive issued to him by SARS on 11 June 2015 informing him to do so and to pay R8 million in capital gains tax. The circumstances surrounding this directive were, however, questionable. A witness for SARS in this matter claimed that the document he had sent to the appellant was not a directive and was issued based on the information the appellant had given to SARS. The appellant informed SARS in a letter that the restraint only lasted for a year following the termination of his employment. The witness also confirmed that he did not sign this directive and was not in a position to do so as capital gains was not his area of expertise.

Further, an experienced tax consultant of 27 years who testified for the appellant stated that he advised the appellant to pay over the capital gains tax despite not being able to make the distinction himself on whether the amount was capital or income in nature. He also confirmed that there was no mention of the restraint agreement in the document. With this logic, the court found that the appellant misrepresented the true state of affairs in his letter to SARS in relation to the amount received, which led to SARS' misunderstanding of the amount in question being of a capital nature. As such, the court found that the appellant did not make a bona fide error in his return and was liable for the understatement penalty at the rate of 10% as a substantial understatement.

This case serves as a guide to recipients of amounts in connection with restraint agreements in the completion of their returns. It reminds us of the importance of making a clear and full disclosure of the circumstances surrounding the payment of a restraint of trade consideration as intricate details could be the tipping point in categorising the amount as income or capital.

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
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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