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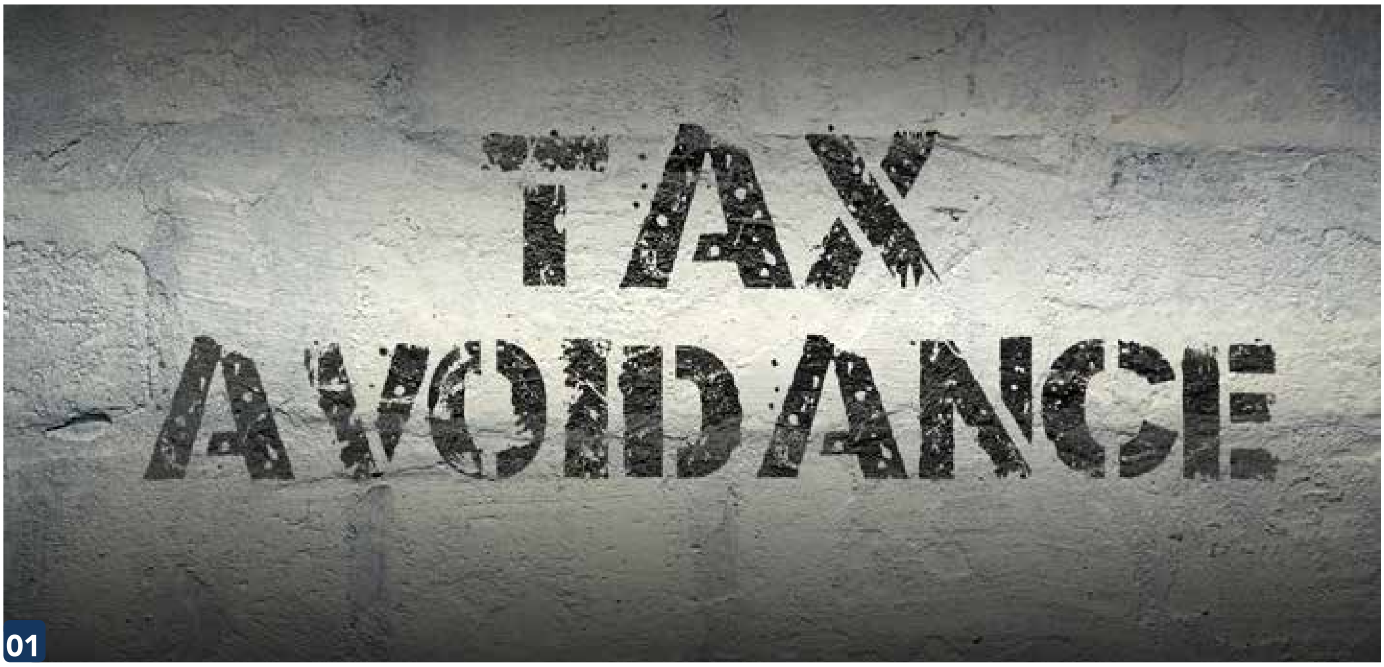
SIMULATION

WHAT IS MEANT BY **'FIT AND PROPER'?**

FUTURE EXPENSES LINKED TO CONTRACT INCOME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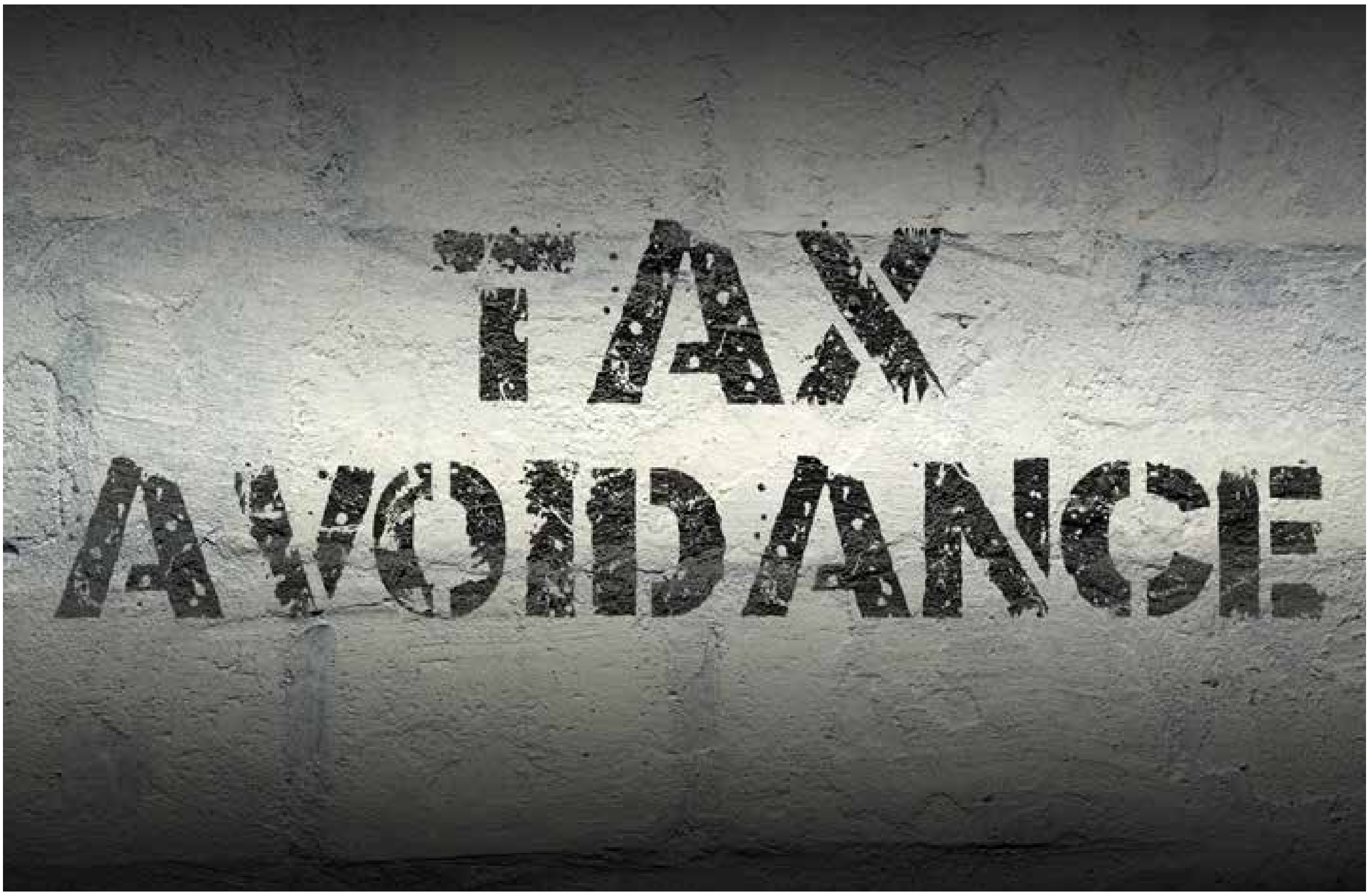
SIMULATION



While it may be reasonable to consider that a split decision is not as strong as a unanimous decision, a majority decision of the Supreme Court of Appeal (the SCA) is of the same value as precedent as a unanimous judgment in that all subordinate courts are bound by it, and only the SCA can overturn it.

THE FACTS

The matter revolves around additional assessments issued by SARS in relation to the 2005–2007 years of assessment. However, the basis of the dispute lies further back in time. From 1991 onwards, the Sasol group commenced purchasing oil directly from foreign suppliers. It established a South African holding company (SIH) which owned foreign subsidiaries, STI and SISL. Prior to 2001, the Sasol group had for many years purchased crude oil from Middle Eastern suppliers under term contracts. These were negotiated by a company known as STI, which was established in and operated from the Isle of Man. The oil was delivered to the South African group company purchaser at Durban.

In 2001, the structure of procurement was amended. STI purchased oil from the suppliers as before. However, it then sold the oil to SISL on an FOB port-of-loading basis, which in turn onsold the oil to Sasol and arranged shipment of the oil for delivery to the South African group purchaser at Durban. In 2002, SIH underwent a name change and became known as SIC.

In 2004, a new subsidiary company of Sasol Oil (Pty) Ltd (Sasol) was formed in the Isle of Man. This company was referred to as SOIL. Following its incorporation, SOIL acquired the oil procurement business of STI, while the latter company continued to conduct its other activities. STI assigned to SOIL the oil contracts that it had concluded. SOIL thereafter onsold the oil that it had acquired to SISL on an FOB port-of-loading basis. SISL then, as before, sold and delivered the oil to the South African group company purchaser in Durban.

SARS attacked oil sales in the 2005, 2006 and 2007 years of assessment, alleging that the contracts were simulations in that the real intention of the parties was that the sale of oil to Sasol was from SOIL and that SISL was not intended to assume any commercial risk or purpose in the transaction. On this basis, the profit derived by SOIL was imputed to Sasol, and additional assessments were raised. In the alternative SARS asserted that the transactions were tax avoidance transactions for purposes of the general anti-avoidance provisions at that time as set out in section 103(1) of the Income Tax Act, 1962 (the Act).

"The thrust of SARS' argument was that the decision to arrange for the oil procured in the Middle East to be sold to SISL and then onsold to Sasol was motivated by an opinion obtained by Sasol from PwC. This dealt with the impact of the change in the basis of taxation in South Africa from a source basis to a residence basis, and the consequent risk of imputation of income to a resident in respect of profits derived by controlled foreign companies."

Sasol objected to the additional assessments and appealed to the tax court against the disallowance of the objection. The tax court dismissed the appeal, holding that the contracts between SOIL and SISL and between SISL and Sasol were a sham, and that the real contract was for SOIL to sell the oil directly to Sasol.

THE EVIDENCE

Although the facts do not appear to be complicated, the reason for the split decision lies largely in the view taken by the respective justices who delivered written judgments. The thrust of SARS' argument was that the decision to arrange for the oil procured in the Middle East to be sold to SISL and then onsold to Sasol was motivated by an opinion obtained by Sasol from PwC. This dealt with the impact of the change in the basis of taxation in South Africa from a source basis to a residence basis, and the consequent risk of imputation of income to a resident in respect of profits derived by controlled foreign companies. The focus of SARS' argument was largely based on the reasons why the oil procurement structure was changed in 2001.

The judgment of Lewis JA detailed the evidence of the five witnesses called by Sasol. The essence of the history was that the procurement was largely the responsibility of an employee of STI (Bredenkamp), resident in the Isle of Man. The group considered that there would be considerable savings in costs if the procurement function were to be moved to London and STI were to be closed down. The relevant directors (Gird and Loubser) sought advice from a law firm in the United Kingdom (Lovells) regarding whether there would be unacceptable UK tax costs as a result of moving the operation to London. The advice was that there might be a minimal tax impact in the UK. In April 2014, PwC provided advice to Sasol that STI should not make sales directly to Sasol but rather to a UK resident group company, which would sell the oil to Sasol and ship it to South Africa. This proposal took cognisance of the potential imputation of income derived by a controlled foreign company on sales of goods to connected persons who are South African residents and suggested how this may be avoided.

Bredenkamp was pivotal to these activities at the time. When the proposal to move the oil purchasing operation to London was put to Bredenkamp, he stated that he was not prepared to move to London. Instead, he proposed that the oil purchasing operation should remain with STI. He proposed in June 2001 that STI's other operations be moved to London, closer to the shipping and trading markets, and that SISL should purchase the crude oil from STI on an FOB basis and arrange shipping and sale to Sasol. He stated that this would also involve a cancellation of the supply contract between Sasol and STI. The proposal was submitted to the chief financial officer of Sasol, who referred it to the group tax manager. The latter issued an internal opinion on 5 July 2001 to the effect that the proposal was optimal from a tax perspective and commissioned an opinion from PwC confirming his view. The PwC opinion was issued on 16 July 2001.

The PwC opinion of 16 July 2001 cautioned that there should be commercial justification for the disposal of oil to SISL. At the time, this company had access to oil market information and expertise in the shipping of crude oil cargoes in all its multifaceted aspects. SISL was therefore to assume sufficient commercial risk in the product.

SARS' ARGUMENT

The argument advanced on behalf of SARS is summarised in paragraph 31 of the judgment:

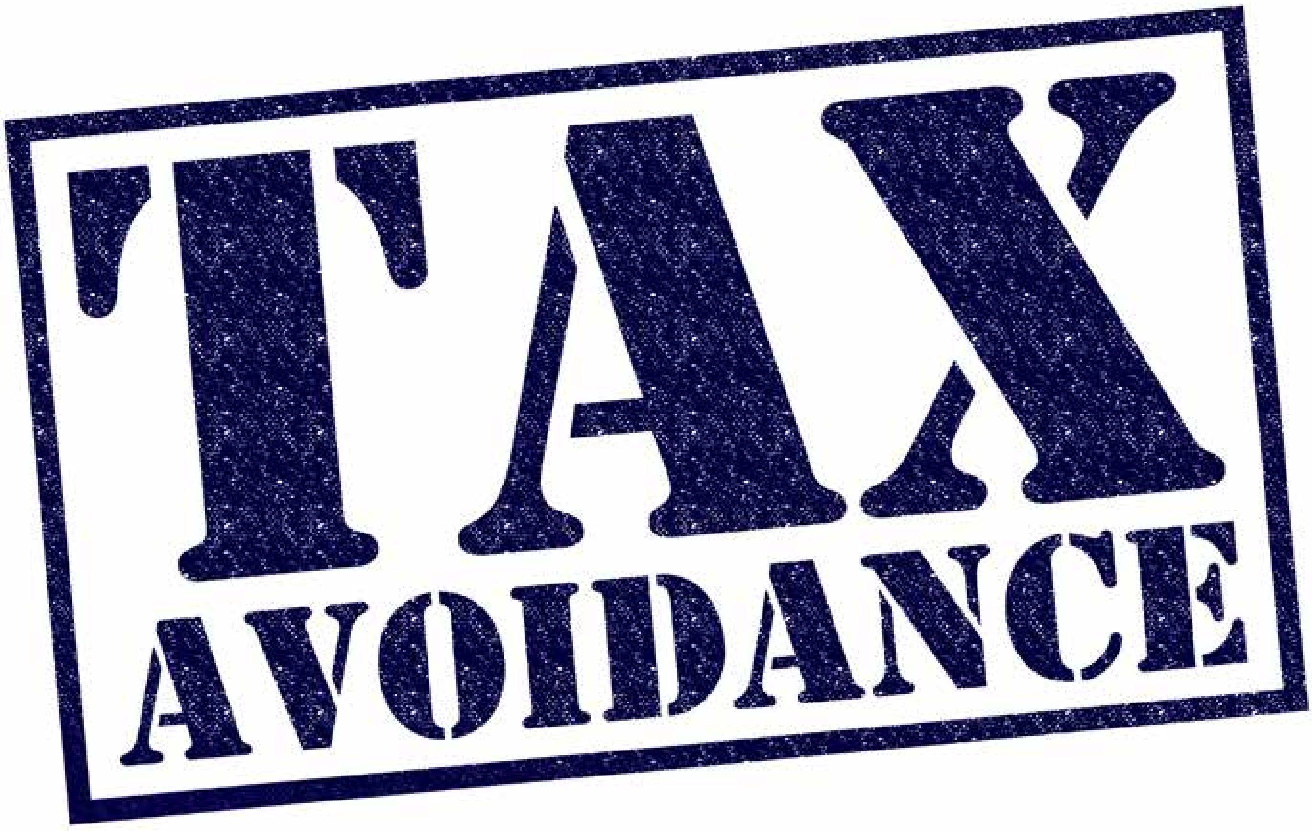
> "The Commissioner's contention is that the structure conceived by Gird and Loubser in 2001, which changed after the Lovells advice, was designed to avoid the implications of the new residence based tax, and was not as a result of the factors that Gird and Loubser adverted to (the importance of maintaining term contracts for the supply of crude oil, and the fact that Bredenkamp was determined to remain on the Isle of Man)."

In effect, the argument was that SISL was a device placed into the operational structure solely as a conduit, and that the real transaction consisted of Sasol purchasing the oil from STI. The basis of this assertion is found in the following extracts from paragraphs 33 and 34:

> "[33] SOIL received amounts of money (or the rights to it accrued) from the sale of crude oil; these amounts would have fallen within the taxable income of SOIL if it had been a resident and these amounts were attributable to the foreign business establishment. Accordingly, unless such amounts were derived from sales of crude oil to a person connected to SOIL, the connected person being a resident of South Africa, those amounts were not to be taken into account in determining the net income of SOIL for the purposes of s 9D.
> [34] SISL too was not resident in South Africa, but in the UK. Thus, if the crude oil was sold by SOIL to SISL, the foreign business exclusion would apply and these amounts would not be taken into account in determining the net income of SOIL for the purpose of s 9D."

Thus SARS' case was as follows, as stated at paragraph 35:

> "The back to back sale of crude oil by SOIL, which procured it from the Middle Eastern suppliers, to SISL, and the sale and the supply then by SISL to Sasol Oil in South Africa were attacked by the Commissioner as being simulated, designed only to achieve the avoidance of residence based tax in the hands of Sasol Oil."



THE JUDGMENTS

There were three written judgments:

The majority judgment

Lewis JA, who delivered the majority judgment, examined the evidence given by Sasol. This showed that there had been no agreement between STI and Sasol since July 2001. However, the evidence established the following:

- The oil procured by STI was sold to SISL and shipped to South Africa for delivery to Sasol.
- Invoices produced reflected the transactions undertaken and credit notes were issued to Sasol quarterly by SISL to correct any differences between the invoiced quantity and the quantity actually delivered.
- SISL issued instructions to STI with regard to shipment of supplies, and bills of lading were endorsed to SISL from STI.
- A director of STI, who had replaced Bredenkamp, testified that he endorsed the bills of lading which were issued to STI after it had attended to the credit requirements of each supplier.
- There was therefore clear evidence of delivery of oil from the supplier to STI and from STI to SISL.
- SISL's annual financial statements for 2002 reflected its oil trading revenues derived from July 2001 and recorded oil being shipped as trading stock.

SARS argued that the ownership taken while the oil was in transit was 'hollow', as the oil could only be shipped to Sasol in South Africa. Expert evidence was led by Sasol, explaining the nature of the risks assumed by SISL as owner of the oil. Although the evidence was questioned and disputed by SARS, no evidence was led by SARS to contradict it. In 2004, ownership of STI was transferred from SIH to Sasol. SOIL was formed as a subsidiary of Sasol and took over the oil trading business of STI in the Isle of Man. SOIL now invoiced SISL for crude oil purchases and endorsed bills of lading, as had been the previous practice of STI.

The test for simulation was revisited, particularly in light of an earlier judgment (also delivered by Lewis JA) in which it had been suggested that a simulation was identifiable if the purpose was to reduce an exposure to tax. Lewis JA, however, now made it clear that the purpose of reducing a tax exposure is not a test for simulation. The test for identifying whether a simulation has occurred is to examine the arrangements and identify whether they reflect the real intention of the parties. The following passage from *Roshcon (Pty) Ltd v Anchor Auto Bodybuilders*, 2014, paragraph 37, was cited with approval:

> "The position remains that the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated."

SARS' case was based on the fact that the structure followed the advice originally given by PwC. Thus, it was argued, the sole purpose of SISL was to disguise the fact that Sasol purchased the oil from STI. To this the judgment responded, at paragraph 66:

"In examining the circumstances as a whole, critical attention was focused on the PwC advice, the contents of transfer pricing documentation and compulsory reports made to the SEC in the United States. In these, the activities of SISL were not consistently described in the manner adopted in the annual financial statements. "

"In any event, the mere fact that parties have followed professional advice (in this case from PwC) in order to minimize the tax payable by them is not wrong nor does it point to deceit. The real question is whether they actually intended a sale by STI (then later SOIL) to SISL and whether SISL intended to acquire ownership of the crude oil from STI (SOIL). Or did they dishonestly purport to do so solely for the purpose of avoiding the tax that would be payable by Sasol Oil?"

The learned Justice found that the intention to pass ownership from STI to SISL was real and that the arrangements did just that. Regardless of the limitations in its contract with Sasol as to what it could do while it was the owner of the oil, SISL was indeed the owner, as intended. SARS challenged the delivery of the oil from STI to SISL, arguing that the witnesses were unsure about when and how delivery occurred. Furthermore, it was argued, if ownership was intended to be passed over, the contract between STI (later SOIL) and SISL would have provided for the method and time of delivery. The view of Lewis JA, at paragraph 72, was that it was unnecessary to specify the mode of delivery in the contracts between STI (later SOIL) and SISL:

"Whether there is actual or constructive delivery is a matter of law. There was no need to provide for the mode of delivery in the contracts of sale."

The majority conclusion, at paragraph 80, was that there was no difference between the substance and the form of the arrangements:

"I consider that Sasol Oil has discharged the onus of proving that the supply agreements between STI (SOIL), SISL and Sasol Oil were genuine transactions, which they implemented from 1 July 2001 through to the years of assessment being 2005, 2006 and 2007. The transactions had a legitimate purpose. There was nothing impermissible about following the PwC advice, and so reducing Sasol Oil's tax liability. The transactions were not false constructs created solely to avoid residence-based taxation. There was good commercial reason for introducing SISL into the supply chain, as explained by the witnesses for Sasol Oil, and SISL had, from the beginning of 2001, been envisaged as the oil trader and shipper in the supply chain. The PwC advice was not the trigger for the transactions."

THE MINORITY JUDGMENT

The judgment of Mothle AJA, in which Makgoka JA concurred, was that there was a simulation. The crux of the finding is expressed at paragraph 114:

"There is no doubt that the genesis of the structure of the FBE of the Sasol Group of Companies, adopted and implemented from July 2001, is found in the written opinion by PwC dated 3 April 2001, referred to earlier."

As to the commercial substance of SISL, the judgment suggests that there was no evidence to establish that the use of SISL was commercially justified. As to the contracts themselves, Mothle AJA stated at paragraph 119:

"The supply agreements present unusual features of independent trading companies. Firstly, the agreements provide that the crude oil acquired by STI was intended to be sold to SISL and to no other third party. Similarly, the crude oil purchased by SISL from STI, was intended to be sold to Sasol Oil and to no other external party. Secondly, the agreements ensured that the purchase price remained constant in that, from STI to Sasol Oil, there was no room to change the price, by either STI or SISL, with a view to making a profit. In essence therefore, SISL traded by purchasing crude oil only from STI and on-selling it only to Sasol Oil without making any profit. Thirdly, the sale of crude oil by STI to SISL does not result in transfer of ownership in the sale transactions involving SISL. SARS contends that this is a sham. I agree. The absence of transfer of ownership, though not necessarily invalidating the transaction, would within the context of the two supply agreements, be one of the relevant factors indicative of a simulated transaction."

The judgment focused closely on the commercial justification for SISL's activities. In examining the circumstances as a whole, critical attention was focused on the PwC advice, the contents of transfer pricing documentation and compulsory reports made to the SEC in the United States. In these, the activities of SISL were not consistently described in the manner adopted in the annual financial statements. Then, at paragraph 129, it is stated:

"SARS further refers to instances where the description of the role of SISL in the supply chain was sharply contradicted and irreconcilable with the role as described in the supply agreements and the oral evidence presented by Sasol Oil's witnesses in the Tax Court. Sasol Oil made no effort to explain these glaring contradictions and inconsistencies. While these instances, when individually considered, might not say much, their cumulative effect reveals, in the Sasol Group's own words, the true nature and identity of SISL's function as shipping, and never the buying and selling of crude oil."

Finally, the judgment criticised the evidence of the witnesses called by Sasol. Their evidence was said to be unsatisfactory and evasive on the issue of commercial justification. Thus, the minority held at paragraph 136:

"It is trite that an appeal court is bound by the trial court's findings of credibility, unless they were found to be affected by a material misdirection or to be clearly wrong. The appeal court will only reverse these findings where it is convinced that the findings are wrong. I am unable to find any misdirection by the Tax Court in regard to the finding of credibility and contradictions on the part of Sasol's witnesses …"

The minority view was therefore that Sasol had not discharged the onus of establishing that the transactions were not a simulation.

THE JUDGMENT OF PONNAN JA

This judgment was evidently prepared after Ponnan JA had considered the judgments of both Lewis JA and Mothle AJA. The perspective given in this judgment is relevant. Ponnan JA identified that there was no dispute between the parties to the transaction concerning the reality of their dealings. In paragraph 142 he states:

> "We are not concerned here with a dispute between the parties to the agreements. It is a third party – the Commissioner – who contends that the parties did not really intend the agreements to have, *inter partes*, the legal effect which its terms convey to the outside world."

This then leads on to a consideration of whether there was any reason for rejecting Sasol's evidence. The Commissioner introduced no evidence to contradict Sasol's evidence and relied on circumstantial timing of events as recorded in minutes and opinions. The judgment continued:

> "As Lewis JA points out, no evidence was led for the Commissioner. She adds 'but that is hardly surprising as it would not have had access to the internal workings of the Sasol Group.' Whilst that may be so, the fact that no evidence was led for the Commissioner is not without its consequence. It means that there was nothing to gainsay the evidence of Sasol Oil's five factual witnesses and one expert witness. It is unclear to me why the Tax Court took the view that the evidence of Sasol Oil's witnesses fell to be rejected. The criticism of their evidence was not only unduly generalized, but also rather severe. The rejection of the evidence of senior employees, two of whom were retired, absent any countervailing evidence, is disquieting. They had no motive to lie in order to save tax for Sasol Oil. No ready answer presents itself as to why these professional persons would perjure themselves. There thus appears to be no reason to question the reliability of their evidence (either individually or collectively), much less their integrity or to brand them untruthful or evasive witnesses."

The judgment went further and made the point that a finding on reliability of the witnesses is not the end of the matter. The evidence still has to be considered as a whole. Ponnan JA evaluated the evidence that had been placed before the tax court at paragraph 143:

> "For the written agreements to have been a sham would have required the most extensive and elaborate fraud, stretching over a period of many years. It would have required the involvement of the persons participating directly, as well as the boards of directors of not just Sasol Oil, but also their related companies. The conduct of the parties and the documents generated before, at the time of and subsequent to the conclusion of the agreements belies that. There is not the slightest hint or suggestion in the wide array of documents introduced into evidence, such as letters of credit, bills of lading, invoices and certificates of quantity and quality, that the transactions were a sham or disguise. What is more, the financial statements of the relevant companies were entirely consonant with the supply agreements. The conclusion that such a sham was intended

> "The difficulty that the Commissioner faced was that there was no evidence to suggest that the parties had an intention that was any different than the contracts indicated. Unless the surrounding circumstances are overwhelmingly in the Commissioner's favour, it is submitted that the Commissioner's task in pursuing the argument that the substance differs from the form will always be a daunting one. "

> would mean that the production of these documents would have involved an elaborate fraud on the part of the authors of the documents and the members of the boards of directors of the relevant companies, as also their auditors. When one has regard to the history and background, the genesis and conclusion of the agreements in accordance with their terms, makes perfect sense."

The approach of the tax court to the evidence was criticised at paragraph 144:

> "It goes without saying that the evidence must be looked at holistically. The Tax Court approached the evidence piecemeal. It appears to have focused rather too intently upon selected pieces of evidence to support its conclusion that the transactions were simulated… Here, a proper consideration of the entire evidential mosaic, leads me to the conclusion that the alternative hypothesis sought to be advanced by the Commissioner, namely that the agreements are simulated, is without a proper factual foundation and remains but a speculative and conjectural one."

Thus, Ponnan JA concluded at paragraph 145:

> "In my view, it is clear that the relevant agreements were genuine agreements and truly intended by the parties in accordance with their terms. There was no simulation or, more particularly, dishonest intention by the parties to deceive by concealing the real agreements. There is accordingly no basis for finding that the ostensible agreements were a pretense (sic) or that there was any secret or unexpressed agreement, at odds with the apparent agreements."

TAX AVOIDANCE

The issue of tax avoidance assumed relevance once it was found that the transactions were not a simulation. The law relating to tax avoidance generally has been amended since the events in this matter took place, and the issue is thus academic, to an extent. The interesting issue here is that SARS assessed Sasol to tax, asserting that Sasol had entered into the transactions with SISL in 2001 for the purpose of avoiding a liability to tax.

Lewis JA was quick to point out that, in 2001, STI and SISL were controlled foreign companies in relation to SIH (later SIC), and that any income derived by those companies could not have been imputed to Sasol but would have been imputed to SIH. Therefore, the transactions were not entered into for the purpose of avoiding tax by Sasol, as Sasol would not have been liable to any tax in respect of income derived by STI or SISL.

Thus, on the issue of tax avoidance, the majority decision is reflected in paragraph 93:

> "The Commissioner's assessments for the 2005 to 2007 years were based on the incorrect assumption that Sasol Oil had participation rights in STI. It quite simply did not. In 2001 the participation rights in STI were held by SIH. It was only from 2004 and onwards that the participation rights in SOIL were held by Sasol Oil. It is accordingly not necessary to consider the other requirements of s 103(1) in any detail. The application of s 103(1) by the Commissioner in the additional assessments was therefore unfounded."

CONCLUSION

Complex commercial transactions may be viewed with suspicion by SARS. In this instance, SARS attempted to equate a tax planning motive to a deception. There was ample evidence that the contracts were concluded and implemented precisely as intended. The financial results were faithfully recorded and reported, and the parties considered themselves bound by them.

The difficulty that the Commissioner faced was that there was no evidence to suggest that the parties had an intention that was any different than the contracts indicated. Unless the surrounding circumstances are overwhelmingly in the Commissioner's favour, it is submitted that the Commissioner's task in pursuing the argument that the substance differs from the form will always be a daunting one.

A secondary issue in the judgments is the approach to be taken in relation to the evidence of witnesses. While the majority found that the witnesses' evidence was plausible and acceptable, the cautionary remarks of Ponnan JA, that the evidence of a witness is only part of the mosaic and that the evidence must be considered in its entirety, underscore the importance of leading all available corroborative documentary evidence. ■

PWC

Act sections: Income Tax Act 58 of 1962: section 103(1).

Cases: *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC* (49/13) [2014] ZASCA 40 (31 March 2014);

Sasol Oil Proprietary Limited v Commissioner for the South African Revenue Service (923/2017) [2018] ZASCA 153; [2019] 1 All SA 106 (SCA) (9 November 2018).

Tags: Case law, Anti-avoidance, Simulation.

FUTURE EXPENSES LINKED TO CONTRACT INCOME

On 3 December 2018, the Supreme Court of Appeal (SCA) handed down judgment in CSARS v Big G Restaurants (Pty) Ltd, *2018, concerning section 24C of the Income Tax Act, 1962 (the Act).*

FACTS

The matter came before the tax court as a special case in terms of Rule 42 of the tax court's rules read with Rule 33 of the Uniform Rules of Court. The agreed facts of the case were the following:

- The Taxpayer is a franchisee that operates restaurants in terms of various written franchise agreements with the franchisor, Spur Group (Pty) Ltd (Spur).
- The terms of the franchise agreements are virtually identical.
- A copy of one of those agreements was annexed to the special case (the Franchise Agreement) and was considered to reflect the terms of all the agreements.
- In terms of the Franchise Agreement, the Taxpayer undertook that for the duration of the agreement, the main object and sole business carried on by it would be the operation of Spur Steak Ranch Restaurants and restaurants specialising in pizza and pasta, under the style of Panarottis.
- In terms of the Franchise Agreement, the Taxpayer had to pay Spur a monthly service fee, and the Taxpayer was required to upgrade and/or refurbish its restaurants at reasonable intervals, as determined by Spur.
- In respect of the Taxpayer's 2011 to 2014 years of assessment, the Taxpayer claimed certain amounts in terms of section 24C of the Act in relation to future expenditure to be incurred, due to the obligation to upgrade and refurbish restaurants under the Franchise Agreement.

"In *Oosthuizen*, where the words were interpreted in the context of a lease agreement, it was held in the majority judgment that the wide meaning should apply. In that case, the majority judgment held that the meaning of a word depends on the subject matter and context in which it appears. Elaborating on this issue, the judgment explained that the word 'kragtens' (the Afrikaans equivalent of 'in terms of') is clearly capable of having different meanings."

QUESTIONS OF LAW AND TAX COURT DECISION

The tax court had to answer two questions:

- First, whether income received by the Taxpayer from operating the franchise businesses was in the form of amounts received or accrued in terms of the Franchise Agreement as envisaged in section 24C of the Act;
- Second, whether the expenditure required to refurbish, or upgrade restaurants was incurred "in the performance of the taxpayer's obligations under such contract", as contemplated in section 24C.

The main issue in the appeal was whether the income received by the Taxpayer from operating its franchise business included any amount received or accrued in terms of the Franchise Agreement, as envisaged in section 24C of the Act.

The tax court found that the Taxpayer's income was income earned for purposes of section 24C under the same contract as that under which the Taxpayer's future expenditure would be incurred. Consequently, it ordered that the additional assessments raised by SARS for the 2011 to 2014 years of assessment be set aside. The main issue in the appeal was whether the income received by the Taxpayer from operating its franchise business, included any amount received or accrued in terms of the Franchise Agreement, as envisaged in section 24C of the Act.

JUDGMENT

In terms of section 24C(2) of the Act, future expenditure under a contract will be deductible, where:

> "…income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract …."

SARS argued that on any interpretation of section 24C, the Taxpayer did not earn income from the Franchise Agreement and, as such, could not claim the allowance under section 24C. This is because the Taxpayer received income in terms of the ad hoc contracts concluded with patrons when meals were sold to them.

"The SCA rejected the Taxpayer's argument that the Franchise Agreement and the contract(s) with patrons were inextricably linked, and that both contracts required the Taxpayer to service meals to its patrons to earn income, out of which franchise fees were payable to the franchisor. Its reason for rejecting the argument was that even though a contract is useful or even necessary to enable a taxpayer to earn income, it does not mean that its income is earned 'in terms of' such contract."

The Taxpayer conceded that it would not earn any income if it did not provide meals to patrons but contended that it was obliged to do so in terms of the Franchise Agreement, which was its source of income and stated how the Taxpayer had to operate its restaurants. Relying on the judgment in *Oosthuizen & Another v Standard Credit Corporation Ltd*, 1993, the Taxpayer argued that the phrase "in terms of" in section 24C(2) of the Act should be given a wide meaning, namely that the Taxpayer's income was earned "pursuant to" or "in accordance with" the Franchise Agreement.

Relying on the judgment in *Slims (Pty) Ltd & Another v Morris NO*, 1988, the SCA held that the phrase "in terms of", has an ordinary (narrow) or wide meaning.

In *Oosthuizen*, where the words were interpreted in the context of a lease agreement, it was held in the majority judgment that the wide meaning should apply. In that case, the majority judgment held that the meaning of a word depends on the subject matter and context in which it appears. Elaborating on this issue, the judgment explained that the word "kragtens" (the Afrikaans equivalent of "in terms of") is clearly capable of having different meanings. In the narrow sense, it can be used to denote a direct and immediate connection between the two concepts linked by it, and in a wide sense, it may indicate no more than a loose and indirect relationship between the two concepts. In its wide meaning, the word is not confined to the designation of "a direct or exclusive connection between the two matters which it serves to link to each other".

In *Slims*, the majority judgment held that in the context of section 37(5) of the Insolvency Act, 1936, the wide meaning of "in terms of" should be preferred. In *Oosthuizen*, where the words were interpreted in the context of a lease agreement, it was held in the majority judgment that the wide meaning should apply.

The SCA then had to consider whether the wide meaning or ordinary meaning of "in terms of" applies in the context of section 24C(2) of the Act. In the SCA's view, there is a direct and immediate connection between the requirements of section 24C and the fact that the Taxpayer must earn income from the same contract in terms of which obligations are incurred, to claim the allowance. The fact that the income and obligations must originate from the same contract points to the conclusion that the allowance in section 24C was intended to apply to cases where income earned in terms of a contract is received before expenditure will be incurred to perform obligations under the same contract.

In the SCA's view, the narrow meaning of "in terms of", is supported by the context and the background to the provision, which constitutes an exception to section 23(e) of the Act. Section 23(e) states that no deduction shall be made in respect of income carried to any reserve fund or capitalised in any way. In terms of the Explanatory Memorandum on the Income Tax Bill, 1990, (the Memorandum), which introduced section 24C, the purpose of section 24C was to address situations where a contract, typically a construction contract, provides for an advance payment to enable the recipient to finance the performance of its obligations under the contract (eg to purchase materials). The scenario in the Memorandum contemplates that the same contract creates the right to income and the obligation that has to be performed. The Taxpayer's income is derived from payments received from patrons as a direct result of food sold to them.

In applying the narrow meaning of "in terms of" to the current facts, the SCA held that the Taxpayer does not receive income under the Franchise Agreement. Instead, the Taxpayer earns income from contracts with patrons. The Taxpayer's income is derived from payments received from patrons as a direct result of food sold to them.

The SCA rejected the Taxpayer's argument that the Franchise Agreement and the contract(s) with patrons were inextricably linked, and that both contracts required the Taxpayer to service meals to its patrons to earn income, out of which franchise fees were payable to the franchisor. Its reason for rejecting the argument was that even though a contract is useful or even necessary to enable a taxpayer to earn income, it does not mean that its income is earned "in terms of" such contract. The court also noted that in ITC 1667 a similar argument to the one made by the Taxpayer was rejected. The SCA upheld the appeal with costs.

COMMENT

The practical importance of this judgment is that in order for a taxpayer to claim the allowance in terms of section 24C, it must ensure that it earns income and incurs obligations under the same contract.

Therefore, where taxpayers anticipate a situation arising whereby they will earn income under a contract prior to incurring obligations or expenses, they must structure their affairs and agree with the counterparty that the obligations must be incurred under the same contract in terms of which income is earned. To ensure that they achieve the desired outcome and can legitimately claim the section 24C allowance, taxpayers should always obtain proper legal advice before entering into the transaction. ■

Cliffe Dekker Hofmeyr

Editorial comment: See also article 0010 in Issue 1 (July 2018).

Act sections: Income Tax Act 58 of 1962: sections 23(e), 24C: Insolvency Act 24 of 1936: section 37(5).

Explanatory Memorandum on the Income Tax Bill, 1990

Cases: *CSARS v Big G Restaurants (Pty) Ltd* (157/2018) [2018] ZASCA 179 (3 December 2018;

Oosthuizen & Another v Standard Credit Corporation Ltd (385/91) [1993] (3) SA 891 914 May 1993);

Slims (Pty) Ltd & Another v Morris NO [1988] (1) SA 715 (A);

ITC 1667 [1999] 61 SATC 439.

Tags: Deductions, accrual, contract income, future expenditure

ACCRUAL IN **PROPERTY DEVELOPMENT**

It is an established tax law principle that an amount will form part of a person's gross income, in the year of assessment in which the amount accrues to that person. However, as illustrated in a 2018 judgment, where property-related transactions are concluded, the parties must consider whether section 24(1) of the Income Tax Act, 1962 (the Act), applies to their agreement.

On 20 November 2018, the Supreme Court of Appeal (SCA) handed down judgment in the matter of *Milnerton Estates Ltd v CSARS*, 2018. The SCA had to consider whether Milnerton Estates Ltd (the Taxpayer) had to include the purchase price of immovable properties sold in its 2013 or 2014 year of assessment. The Taxpayer was appealing against the tax court's judgment, which court found that the purchase price of the properties accrued to the Taxpayer in the Taxpayer's 2013 year of assessment, even though payment was only received in the Taxpayer's 2014 year of assessment.

FACTS

In 2013, the Taxpayer concluded 25 sale agreements of erven in the Parklands Residential Estate. The purchasers were required to pay a nominal deposit of R5 000 and the balance of the purchase price was payable against transfer. Although conditions regarding payment of the purchase price were not the same in all of the sale agreements, the purchase price in all 25 cases was fully secured before the end of the 2013 tax year. This was because the suspensive condition relating to the obtaining of finance was fulfilled in 16 cases.

In terms of each agreement, the Taxpayer could only give possession of the property to the purchaser once it had obtained the approval of the local authority to permit the passage of vehicular traffic on the completed roads in the development. In all 25 cases, the local authority's approval was obtained before the end of the 2013 tax year, although in some cases possession was only given in the subsequent tax year. At the end of the 2013 tax year, the Taxpayer had not yet transferred the 25 stands to the purchasers. Therefore, it omitted the purchase price of each of the stands from its gross income for the 2013 year of assessment. However, SARS contended that in each instance, the purchase price had accrued to the Taxpayer in the 2013 tax year, or alternatively that it was deemed to have accrued to the Taxpayer in terms of section 24(1) of the Act. It therefore issued an assessment in terms of which the Taxpayer was taxed on an amount of R6.8 million.

ISSUE

The SCA stated that two issues were raised in the appeal:

- Firstly, whether the Taxpayer's right to receive the purchase price under the 25 sale agreements accrued to it during the 2013 tax year?
- Secondly, in any event, whether the deeming provision in section 24(1) deemed those amounts to have been received by the Taxpayer during the 2013 tax year?

JUDGMENT

With reference to the issues raised in the appeal, the SCA stated that it was unnecessary to consider the first question, that is, whether there was an accrual in accordance with ordinary principles. It held that the matter should be decided with reference to section 24(1).

"However, SARS contended that in each instance, the purchase price had accrued to the Taxpayer in the 2013 tax year, or alternatively that it was deemed to have accrued to the Taxpayer in terms of section 24(1) of the Act. It therefore issued an assessment in terms of which the Taxpayer was taxed on an amount of R6.8 million."

Section 24(1) states the following:

> "Subject to the provisions of section 24J, if any taxpayer has entered into any agreement with any other person in respect of any property the effect of which is that, in the case of movable property, the ownership shall pass or, in the case of immovable property, transfer shall be passed from the taxpayer to that other person, upon or after the receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement, the whole of that amount shall for the purposes of this Act be deemed to have accrued to the taxpayer on the day on which the agreement was entered into."

SARS contended that the requirements of section 24(1) had been met in that:

- The Taxpayer;
- Had entered into agreements with other persons, being the purchasers of the erven;
- In respect of immovable property, being the erven;

"South Africa does not have any rules protecting its tax base in respect of transactions such as the envisaged loans by the China Development Bank or Industrial and Commercial Bank."

- The effect of which agreements was that transfer would be passed from the Taxpayer to the purchasers;
- Upon or after the Taxpayer received the whole of the amount payable to it under the agreements.

In response, the Taxpayer raised various arguments. First, it argued that section 24(1) is not concerned with cash sale agreements of this type, but only with agreements for the sale of immovable property on credit. Essentially, the Taxpayer sought to distinguish between cash sales and sales of immovable property, where the purchase price was to be paid in instalments over time, with transfer only being given once the full purchase price had been paid. It argued that this argument was supported by the opening words "subject to the provisions of section 24J" in section 24(1). The SCA rejected this argument.

Second, the Taxpayer referred to section 24(2) of the Act and argued that the effect of section 24(2) is to remove an agreement from the ambit of section 24(1), to which section 24(1) would otherwise apply. Although the SCA rejected this argument, it accepted that this is a factor that together with other factors may suggest that section 24(1) should be interpreted restrictively when considering the range of agreements to which the section may apply.

Third, the Taxpayer argued that as the heading of section 24 refers to credit agreements and debtors allowances, but the agreements concluded by the Taxpayer with the purchasers were not credit agreements, section 24(1) did not apply. The SCA found that there was some merit in this argument, but ultimately rejected it. The SCA reasoned that the heading was amended to read "Credit agreements and debtors allowances" after the judgment in *Secretary for Inland Revenue v Silverglen Investments (Pty) Limited*, 1969 (Silverglen), which is binding authority on section 24(1), without any corresponding amendment to exclude the current case from section 24(1)'s ambit.

Fourth, the Taxpayer argued that in interpreting the Act, the court should adopt a practical approach and that the provisions in the Act should be construed having regard to their situation in the statute so that they "take colour from their surroundings". This argument was also rejected.

The SCA held that even if the four arguments above are taken collectively, it would not justify a restrictive interpretation of section 24(1), so that its application is limited to agreements that are specifically called "credit agreements". The section should be interpreted to apply to all sale agreements where ownership passes to the purchaser "upon or after receipt by the taxpayer of the whole or a certain portion of the purchase price".

Finally, the Taxpayer tried to argue that the requirement in section 24(1) that ownership should only pass "on or after" receipt of the purchase price, had not been met as ownership could only pass after transfer took place in the Deeds Registry, which had not taken place in the 2013 tax year. The SCA rejected this argument in light of the judgment in Silverglen, where this argument was previously rejected. Considering the agreements concluded and that the guarantees provided by the purchasers to the Taxpayer constituted payment, which payment is concurrent with transfer of ownership in the Deeds Registry, the agreements provided for ownership to pass to the purchasers upon or after receipt of the whole of the purchase price in terms of section 24(1). This meant that section 24(1) was applicable and that the entire purchase price in each instance was deemed to be received in the 2013 tax year, when the agreements were concluded and not in the 2014 tax year, when payment was in fact made. This was also the decision in Silverglen, which in the SCA's view was correctly decided.

Accordingly, the SCA dismissed the Taxpayer's appeal with costs.

COMMENT

The judgment confirms that where an agreement for the sale of immovable property contains a suspensive condition whereby transfer of ownership in the Deeds Registry is delayed until payment of any portion of the purchase price, the purchase price is deemed to accrue in the tax year that the agreement was concluded. [Editorial comment: This assumes that there are no unfulfilled suspensive conditions which will suspend the coming into force of the agreement.] Property developers should therefore take note of this judgment and section 24(1) and ensure that where a sale agreement falls within the scope of this provision, they declare the income from the sale in the tax year that the agreement was concluded, even if payment of the purchase price and transfer of ownership only takes place in the following tax year. ■

Cliffe Dekker Hofmeyr

Act sections: Income Tax Act 58 of 1962: sections 24(1), 24(2), 24J.

Cases: *Milnerton Estates Ltd v CSARS* (1159/2017) [2018] ZASCA 155 (20 November 2018);

Secretary for Inland Revenue v Silverglen Investments (Pty) Limited [1969] 30 SATC 199.

Tags: Case Law, Accrual, Purchase price, Sale agreement, Transfer of ownership.

WHAT IS MEANT BY **'FIT AND PROPER'?**

The concept of a 'fit and proper' person is a fundamental one in many professions, jurisdictions and organisations as it is used to determine a person's honesty, integrity and reputation in order to confirm that they are fit and proper for the role they are undertaking. There is, however, no single infallible test regarding what constitutes a 'fit and proper' person and in some instances, this requirement is not defined in legislation.

For example, in the case of *General Council of the Bar of South Africa v Jiba*, 2016, it was stated that in determining whether a person was a 'fit and proper' person for the legal profession, such person should have integrity, dignity, the possession of knowledge and technical skills, a capacity for hard work, respect for legal order and a sense of equality or fairness. Whereas in the older case of *Australian Broadcasting Tribunal v Bond*, 1990, the concept of 'fit and proper' was described more aptly, as follows:

> "The expression 'fit and proper person', standing alone, carries no precise meaning. It takes its meaning from context, from the activities in which the person is or will be engaged and the ends to be served by those activities. The concept of 'fit and proper' cannot be entirely divorced from the conduct of the person who is or will be engaging in those activities. However, depending on the nature of the activities, the question may be whether improper conduct has occurred, whether it is likely to occur, whether it can be assumed that it will not occur, or whether the general community will have confidence that it will not occur. The list is not exhaustive, but it does indicate that, in certain contexts, character (because it provides indication of likely future conduct) or reputation (because it provides indication of public perception as to likely future conduct) may be sufficient to ground a finding that a person is not fit and proper to undertake the activities in question."

"For example, in the case of *General Council of the Bar of South Africa v Jiba*, 2016, it was stated that in determining whether a person was a 'fit and proper' person for the legal profession, such person should have integrity, dignity, the possession of knowledge and technical skills, a capacity for hard work, respect for legal order and a sense of equality or fairness. "

An interesting decision was handed down by the Federal Court of Australia (the Federal Court) on 2 November 2018 in the case of *Ham v Tax Practitioners Board*, 2018, where the Federal Court confirmed the high ethical and professional standards expected of trusted advisers such as tax practitioners. The relevant facts, arguments made by the respective parties, and the decision of the Federal Court are discussed in further detail below.

FACTS

Mr Phillip Ham (the Appellant), an accountant for Mr Trevor Holzapfel (Mr Holzapfel) and his various entities for many years, advised Mr Holzapfel to establish the Holzapfel Property Trust (the HPT) in July 1991. The HPT was a discretionary trust, the beneficiaries of which were Mr Holzapfel, members of his family and companies controlled by them. A shelf company which had the Appellant as its sole director and shareholder, Canehire Proprietary Limited (Canehire), was appointed as the trustee of HPT.

In September 1993, Canehire acquired the lessee's interest over a specific piece of land. Mr Holzapfel was interested in acquiring the freehold title to this land from the Department of Natural Resources (the DNR). However, Canehire (as the trustee of HPT) was unable to settle the purchase price sought by the DNR and instead obtained a renewal of the lease of the land to December 2002.

Mr Holzapfel exercised control over the land until 2002 and negotiated with the DNR for Canehire's acquisition of the freehold title. In November 2002, Canehire accepted an offer by the DNR to acquire the freehold title to the land. The purchase consideration was settled from an advance made by a property development company, South East Property Developments Proprietary Limited (SEPD), controlled by the Appellant and his business partner. A deed of grant of the land was registered in February 2003 in favour of Canehire; however, no reference was made to HPT.

Following improvements to the land, the land was sold by Canehire in October 2008 for A$4,892,030. A portion of the proceeds was used to discharge the debt owing by Canehire to SEPD and other lenders. No part of the proceeds was paid to HPT or any of its beneficiaries.

After Mr Holzapfel became aware of the sale of the land, legal proceedings were instituted against Canehire and the Appellant in the Queensland Supreme Court (Supreme Court). Mr Holzapfel contended that there was an agreement between him and the Appellant for Canehire to acquire the freehold title on behalf of HPT. However, the Appellant contended that the agreement was such that Canehire purchased the freehold title in its own right.

FINDINGS OF THE SUPREME COURT

In finding for Mr Holzapfel, the Supreme Court stated that Canehire acted in breach of its fiduciary duty and breach of trust by paying away the profits derived from the sale of the land. Furthermore, it was held that the Appellant, as the controlling mind of Canehire, had acted dishonestly in paying away the proceeds of the sale. The Appellant was aware of the fact that the proceeds lawfully belonged to the beneficiaries of the HPT and that Mr Holzapfel had not consented to Canehire distributing the proceeds to any other party.

IMPACT OF THE SUPREME COURT FINDINGS

The Appellant was registered with the Chartered Accountants Australia and New Zealand body (the CAANZ) and as a tax agent in terms of the Tax Agent Services Act, 2009 (the TAS Act). Based on the findings of the Supreme Court, the CAANZ revoked the Appellant's membership following a hearing by the CAANZ Professional Conduct Tribunal (the PCT), on the basis that the Appellant's conduct breached certain CAANZ by-laws. In addition, the CAANZ sent a copy of the PCT's findings to the Tax Practitioners Board (the Board), which administers the system set out in the TAS Act for the registration of tax agents.

In May 2016, the Board sought a written explanation from the Appellant in respect of the PCT's findings. This process was overtaken by the need for the Appellant to renew his registration as a tax agent. The Appellant's application for renewal of registration as a tax agent (the Application) was considered by a committee of the Board. The committee rejected the Appellant's Application on the basis that he was not a 'fit and proper person' as required by the provisions of the TAS Act. The Appellant approached the Administrative Appeals Tribunal (the Tribunal) to review the decision of the Board, which decision was ultimately upheld by the Tribunal. The Appellant then appealed to the Federal Court.

It is important to note that the Board's case before the Tribunal was not based on the findings of the Supreme Court, but rather on the Appellant's failure to disclose the decision of the Supreme Court and the PCT findings to the Board, prior to the disclosure being made by the CAANZ. The Tribunal also accepted that the conduct of the Appellant (ie breach of fiduciary duties) (the Relevant Conduct) that led to the findings was not related to his conduct as a tax agent.

APPEAL TO THE FEDERAL COURT

The relevant provisions of the TAS Act that govern the criteria and procedure for registration as a tax agent are as follows:

- An individual, who is 18 years or older, is eligible for registration as a tax agent if the Board is satisfied that, inter alia, the individual is a fit and proper person;
- In deciding whether it is satisfied that an individual is a fit and proper person, the Board must have regard to, *inter alia:*
  - Whether the individual is of "good fame, integrity and character";
  - Whether the individual has been convicted of a serious taxation offence, an offence involving fraud or dishonesty or sentenced to a term of imprisonment; or
  - Whether the individual has been penalised for being a promoter of a tax exploitation scheme.

The Appellant contended that the Relevant Conduct was neither in respect of the provision of tax services to the public, nor did it relate to any breach of standard of professional or ethical conduct as a registered agent. In other words, unless the Relevant Conduct fell within one of the categories as set out in the TAS Act, it was not relevant for the Tribunal to consider when deciding whether the Appellant was a 'fit and proper' person. Further, other than

"The Appellant contended that the Relevant Conduct was neither in respect of the provision of tax services to the public, nor did it relate to any breach of standard of professional or ethical conduct as a registered agent. In other words, unless the Relevant Conduct fell within one of the categories as set out in the TAS Act, it was not relevant for the Tribunal to consider when deciding whether the Appellant was a 'fit and proper' person. "

the allegations arising from the Relevant Conduct, the Appellant reiterated that there was no evidence of any other lack of "good fame, integrity and character" on his part.

Contrary to the above, the Board's position was that the construction of the TAS Act was such that it was necessary for the Board to consider the Relevant Conduct in deciding whether the Appellant was a 'fit and proper' person. The Tribunal stated that:

> "...the Relevant Conduct need not occur directly in the course of professional practice as a tax agent to impact adversely on the agent's fitness...Acts may be 'sufficiently closely connected' with the actual practice that they demonstrate the presence of qualities (such as dishonesty or deception) that are inconsistent with fitness and propriety to practice as a registered tax agent".

FINDINGS OF THE FEDERAL COURT

The Federal Court found that:

- Having regard to the provisions of the TAS Act, the eligibility for registration as a tax agent is not dependent upon the existence of particular criteria, but rather upon the Board's satisfaction as to the existence of those criteria. It does not mean that, to the extent that a specific criterion which affects registration is not present, the Board must be satisfied that an applicant is a person of good fame, integrity and character and thus a 'fit and proper' person; and
- It was not irrelevant for the Tribunal to have taken the Relevant Conduct into account, even though none of that conduct constituted an event in terms of the TAS Act.

The Appellant was found not to be a 'fit and proper' person as

> "his conduct was inconsistent with the qualities of moral soundness, uprightness and honesty that one would expect of a tax agent. Such conduct was, and is, incompatible with the 'atmosphere of mutual trust' which underpins the relationships which tax agents have with their clients...While the conduct was concerned with dealings with the same property over an extended period of time, it is an oversimplification to describe the offending conduct as an isolated instance of lapse or error of judgment".

CONCLUSION

It is interesting to note that, from a South African perspective, the 2018 Tax Administration Laws Amendment Act provides an amendment to section 240 of the Tax Administration Act, 2011, (the Act) (which deals with the registration of tax practitioners) to include an additional requirement.

The amendment provides that where a registered tax practitioner has not been tax compliant for an aggregate period of at least six months during the preceding twelve months and has failed to (i) demonstrate that he or she has been compliant for that period, or (ii) remedy the non-compliance, within the period specified in a notice delivered by the South African Revenue Service, the practitioner will be deregistered as a tax practitioner.

The above discussion, this judgment and the amendments to the Act confirm the universal notion that tax services are to be provided to the public in accordance with the appropriate standards of professional and ethical conduct. It is therefore imperative for a tax practitioner to be a person with competence and integrity, such that the public may entrust their tax affairs to him or her. ■

Cliffe Dekker Hofmeyr

Act sections: Tax Administration Act, No 28 of 2011: section 240.

Cases: *General Council of the Bar of South Africa v Jiba and others* [2016] 4 All SA 443 (GP);
Australian Broadcasting Tribunal v Bond (1990) 170 CLR 321;
Ham v Tax Practitioners Board [2018] FCA 1652.

Tags: International, Australian Federal Court, Case law, 'Fit and proper'.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