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ACQUISITION OF TREASURY SHARES

ESTATES AND TRUSTS
TRUSTS, LOANS AND PREFERENCE SHARES

INDIVIDUALS
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UNBUNDLING TRANSACTIONS INVOLVING NON-RESIDENT SHAREHOLDERS

Generally, as a matter of tax parity within South Africa's corporate tax system, the distribution of an asset (including shares) by a company to its shareholders should have the same tax impact as a company sale of the asset followed by a distribution of after-tax cash proceeds. However, section 46 of the Income Tax Act, 1962, makes provision for roll-over relief where shares of a resident company (referred to as an unbundled company) that are held by another resident company (referred to as an unbundling company) are distributed to the shareholders of that unbundling company in accordance with the effective interest of those shareholders.

"National Treasury has identified that the current rule creates a loophole in that the 20% exclusionary rule may not apply where non-resident shareholders are not connected persons in relation to each other."

However, these unbundling transactions are subject to an anti-avoidance rule in section 46(7) aimed at limiting the extent to which taxpayers can distribute shares in resident companies to non-residents on a tax-neutral basis. In simple terms, section 46(7) excludes the shareholders and the unbundling company from benefitting from the roll-over relief if 20% or more of the shares in the unbundled company are, after the transaction, held by "disqualified persons" (including, amongst others, non-residents), either alone or together with persons connected to those non-residents.

National Treasury has identified that the current rule creates a loophole in that the 20% exclusionary rule may not apply where non-resident shareholders are not connected persons in relation to each other. In other words, non-residents may collectively hold 20% or more of the shares in the unbundled company, but to the extent that they are all independent, the anti-avoidance rule in section 46(7) would not be applicable as one would not breach the 20% threshold. To close this loophole, it has been proposed in the 2020 budget that the relevant legislation be amended to ensure that the rule applies irrespective of whether the non-resident shareholders are connected persons in relation to each other.

Editorial comment: It is possible that the changes, when promulgated, will take effect from the date of the announcement.

Cliffe Dekker Hofmeyr

Act sections:

- Income Tax Act 58 of 1962: section 46.

Tags: roll-over relief; unbundled company; unbundling company; non-resident shareholders.

ACQUISITION OF TREASURY SHARES

It is fairly common for a subsidiary company to hold shares in its holding company; such shares are colloquially referred to as treasury shares. Subsidiary companies of an issuer may hold treasury shares for the purposes of facilitating the implementation of employee share schemes. Other reasons why a subsidiary may seek to acquire shares in the holding company include to utilise the shares as payment in a business transaction, to structure a black economic empowerment transaction or to utilise the investment opportunity when the share price is trading below net asset value.

Conversely, a holding company may seek to repurchase or acquire the treasury shares held by the subsidiary where the business purposes identified as motivations to hold the treasury shares in the subsidiary are no longer applicable or where the 10% limit as per the Companies Act, 2008 (on treasury shares held by subsidiaries), has been reached.

Unwinding a treasury shareholding can be achieved by way of a repurchase by the holding company or by way of an *in specie* distribution of the treasury shares by the subsidiary to its holding company. The tax implications of either option are likely to influence the manner of unwinding the treasury shareholding.

In terms of the latter option, a distribution by a subsidiary of an asset to its holding company is a disposal of an asset which is deemed to take place at market value for capital gains tax (CGT) purposes. If the market value of the treasury shares is greater than the base cost, a capital gain will arise for the subsidiary. The holding company will also have acquired an asset, ie the shares in the company itself, at market value and will immediately have disposed of that asset by virtue of its cancellation. A cancellation of shares, however, is deemed not to be a disposal for CGT purposes and thus has no CGT consequences.

Eliminating treasury shares in a tax-efficient manner could previously be achieved by way of a share repurchase, which, if implemented as a dividend, would have had no adverse tax implications for the subsidiary which is disposing of the treasury shares. However, with the introduction and subsequent modification of various anti-avoidance rules dealing with share repurchases and so-called dividend-stripping transactions, such a repurchase could give rise to CGT implications for the subsidiary disposing of the treasury shares.

In the context of the above, it is worth noting the contents of SARS Binding Private Ruling 336 (BPR 336), issued on 6 December 2019, which confirmed the application of the roll-over provisions of the Income Tax Act, 1962 (the Act), where the subsidiary holding the treasury shares is liquidated in terms of section 47 of the Act.

Section 47 forms part of the so-called corporate roll-over provisions. The special rules are meant to facilitate genuine corporate restructuring and mergers and acquisitions and to promote tax efficiency in the implementation of such transactions by permitting tax "roll-overs" to take place where the statutory requirements are satisfied.

"The objective of section 47 is to provide 'roll-over relief' when a liquidation company distributes all its assets to its holding company in terms of a liquidation distribution."

In the ordinary course, the liquidation, winding-up or deregistration of a subsidiary company will involve the transfer of assets to its holding company which invariably results in adverse tax implications as the transfer may give rise to a liability for normal tax, dividends tax and CGT.

The objective of section 47 is to provide 'roll-over relief' when a liquidation company distributes all its assets to its holding company in terms of a liquidation distribution. To the point, where section 47 applies, a capital gain on the transferred capital assets is deferred in that the base cost of a capital asset is "rolled over" to the holding company. This roll-over relief applies where the capital asset distributed by the subsidiary is acquired by the holding company.

In BPR 336, Company A was a listed company that held 100% of Company B. Company B held treasury shares in Company A which were acquired by way of a loan advanced from Company A. Company B was to make a liquidation distribution to Company A by way of Company B passing a resolution to distribute its assets, the treasury shares, as a dividend *in specie* to Company A, in anticipation of the deregistration of Company B.

The ruling given by SARS states that the distribution of shares by Company B to Company A constitutes a "liquidation distribution" as defined in paragraph *(a)* of the definition in section 47(1) with the result that no CGT consequences will result for Company A and Company B from the transfer of the treasury shares.

"Accordingly, where the facts allow, the relief afforded in terms of section 47 could be used to eliminate a treasury shareholding on a tax-efficient basis."

An important consideration here is that the holding company has to acquire the assets in question (in this case the treasury shares) as a capital asset where the subsidiary company holds them as a capital asset. This is an essential requirement before the relevant CGT relief can apply. The crucial question that arises in this regard is whether there is an acquisition of an asset by the issuer of shares (Company A) when it receives its own shares pursuant to a distribution from its subsidiary company in the same group. Without elaborating on the technical analysis of this issue, there are diverging views as to whether the holding company does acquire the treasury shares, but the ruling seems to confirm the view that it does. The view in favour holds that the shares were acquired, and the fact that the treasury shares are immediately cancelled does not alter the fact that the holding company acquired such capital asset. Put differently, there is no requirement that the holding company must acquire and hold such capital asset for the relief in section 47 to apply. The contrary view is that the acquisition and cancellation were simultaneous, so that no asset was acquired.

Accordingly, where the facts allow, the relief afforded in terms of section 47 could be used to eliminate a treasury shareholding on a tax-efficient basis. However, owing to these divergent views, given that taxpayers other than the applicant cannot rely on the BPR in any dispute with SARS, and given that SARS could change their minds about the interpretation despite what is said in the BPR (as has happened in the past), we would recommend that any company wishing to take this route should obtain its own binding ruling.

Werksmans

Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding private ruling* has a binding effect *between SARS and the applicant only*, and is published for general information. It does not constitute a practice generally prevailing. A third party may not rely upon a binding private ruling under any circumstances. In addition, published binding private rulings may not be cited in any dispute with SARS, other than a dispute involving the applicant or any co-applicant(s) identified therein.

Act sections:

- Companies Act 71 of 2008;
- Income Tax Act 58 of 1962: section 47.

Other documents:

- SARS Binding Private Ruling 336.

Tags: subsidiary company; holding company; employee share schemes; black economic empowerment transaction; market value; base cost; liquidation company; listed company.

TRUSTS, LOANS AND PREFERENCE SHARES

Historically many individuals made use of estate-planning schemes through trusts, whereby taxpayers would transfer assets to a trust and the purchase price owed by the trust to a taxpayer in respect of the assets would be left outstanding as a loan, advance or credit in favour of that taxpayer on which no interest or very low interest would be charged. Alternatively, taxpayers would advance a low-interest or interest-free cash loan, advance or credit to a trust in order for the trust to use the money to acquire assets.

The use of these schemes often resulted in donations tax not being leviable on the basis that such transfers would be treated as sale transactions and not donations. Furthermore, on occasion, the amount that was owed to a taxpayer (ie the loan claim) would remain outstanding indefinitely and the trust would likely have no real intention to pay it off. In some instances, taxpayers would reduce or waive the loan which would then not form part of his/her estate for purposes of estate duty, notwithstanding that taxpayers could make their dependants beneficiaries of the trust.

The use of these estate-planning schemes has been under the microscope in recent times, which culminated in the introduction of anti-avoidance measures in the Income Tax Act, 1962 (the Act). In order to limit taxpayers' ability to transfer wealth to a trust without being subject to tax, section 7C of the Act was introduced with effect from 1 March 2017. In simple terms, interest foregone in respect of low-interest loans or interest-free loans that are made to a trust is now treated as an ongoing and annual donation

made by the natural person to the trust on the last day of the year of assessment of that trust. Effectively, one then has to make a decision as to whether to charge interest on the loan at market-related rates which would be taxable in the hands of the holder of the loan and which may or may not be deductible in the hands of the trust. Alternatively, in the event that one does not charge interest, the donor would be liable for donations tax on the interest foregone.

National Treasury identified further schemes aimed at avoiding the application of section 7C whereby taxpayers advanced interest-free or low-interest loans to companies whose shares are held by trusts. The anti-avoidance rules in section 7C were thus strengthened in 2017 by extending the application of section 7C to the scenario where natural persons or a company (at the instance of a natural person) advances interest-free or low-interest loans to a company that is held by a trust that is a connected person in relation to a natural person or a beneficiary of such trust.

Notwithstanding the strengthening of the rules, National Treasury has identified a further scheme aimed at circumventing the application of the section 7C rules. In this regard, instead of advancing a "loan, advance or credit", taxpayers subscribe for preference shares in a company owned by a trust that is a connected person in relation to the natural person. In this manner, the preference shares would not constitute a "loan, advance or credit" as envisaged in section 7C, thereby circumventing the relevant provisions. As a result, the Minister announced in the 2020 budget that in order to curb this new form of abuse, further rules preventing tax avoidance through the use of trusts would be introduced.

Given the proposal, it is clear that the utilisation of trusts for estate planning and other purposes will remain under the microscope with particular reference to implementing various schemes aimed at utilising such trusts for purposes of shielding growth assets.

"Given the proposal, it is clear that the utilisation of trusts for estate planning and other purposes will remain under the microscope with particular reference to implementing various schemes aimed at utilising such trusts for purposes of shielding growth assets."

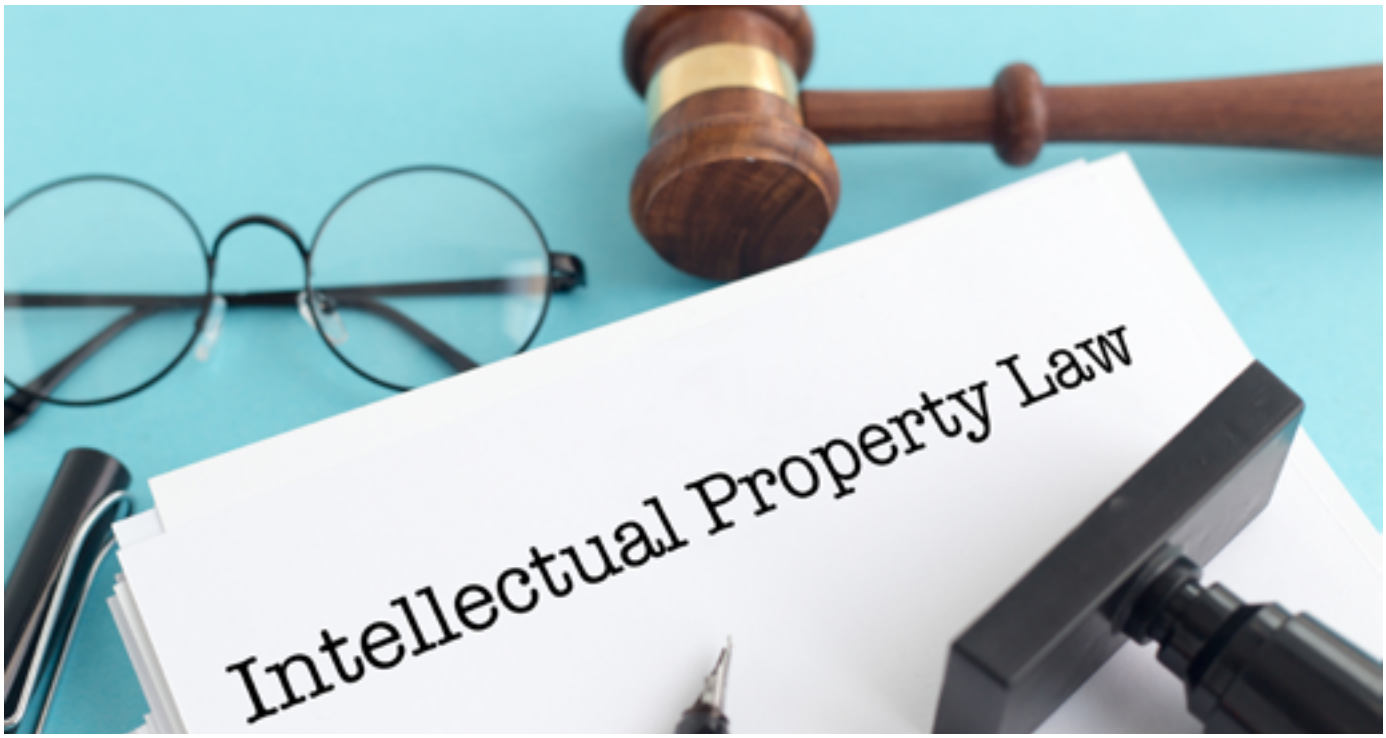
Editorial comment: It is possible that the changes, when promulgated, will take effect from the date of the announcement.

Cliffe Dekker Hofmeyr

Act sections:

- Income Tax Act 58 of 1962: section 7C.

Tags: estate-planning schemes; donations tax; anti-avoidance measures; low-interest loans; interest-free loans; preference shares; connected person.



RELAXATION OF RULES ON EXTERNALISING INTELLECTUAL PROPERTY

Essentially, exchange control is governed by the Exchange Control Regulations, 1961, issued under the Currency and Exchanges Act 9 of 1933.

REGULATION 10(1) STATES THAT:

"No person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose...

(c) enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic".

For many years the term "capital" was interpreted widely to include essentially any form of property also, in particular, intellectual property (IP).

In the case of *Oilwell (Pty) Ltd v Protec International Ltd and Others* [2011], which involved the transfer of IP rights by a resident to a non-resident, the Supreme Court of Appeal held that the term "capital" in this context must be interpreted restrictively to mean cash and money; the term must not be interpreted to include goods, in particular IP. The court also held that IP is not capable of being "exported".

The government was clearly perturbed by the judgment in *Oilwell* as it meant that South Africans were free to transfer IP abroad without exchange control approval being required. On 8 June 2012 the President added regulation 10(4), which reads as follows:

"For the purposes of subregulation [10](1)*(c)*–

(a) 'capital' shall include, without derogating from the generality of that term, any intellectual property right, whether registered or unregistered; and

(b) 'exported from the Republic' shall include, without derogating from the generality of that term, the cession of, the creation of a hypothetic or other form of security over, or the assignment or transfer of any intellectual property right, to or in favour of a person who is not resident in the Republic."

In other words, since the introduction of that provision, owners of IP in South Africa have been prohibited from transferring IP abroad without exchange control approval.

In Annexure E to the 2020 Budget Review issued pursuant to the Budget Speech of the Minister of Finance on 26 February 2020, it is stated that the National Treasury proposes "modernising the foreign-exchange system". Essentially, the exchange control rules will be amended to allow all foreign currency transactions, save for those which are specifically regulated.

In particular, it proposes that no approval will be required for the export of IP for fair value to non-related parties. It is possible that some form of documentation will still be required, for example, a valuation stating what the fair value is and some proof that the party acquiring the IP is not related.

This is great news. It will now likely be much simpler for residents of South Africa who create IP to commercialise their IP.

Approval will presumably still be required for the export of IP to a related party, for example, by a subsidiary of a local company to its holding company abroad.

Cliffe Dekker Hofmeyr

Act sections:

- Currency and Exchanges Act 9 of 1933.

Other documents:

- Exchange Control Regulations, 1961: Regulation 10(1)*(c)* & (4);
- 2020 Budget Review (issued pursuant to the Budget Speech of the Minister of Finance on 26 February 2020): Annexure E.

Cases:

- *Oilwell (Pty) Ltd v Protec International Ltd and Others* [2011] (4) SA 394 (SCA).

Tags: exchange control; foreign currency transactions; holding company.

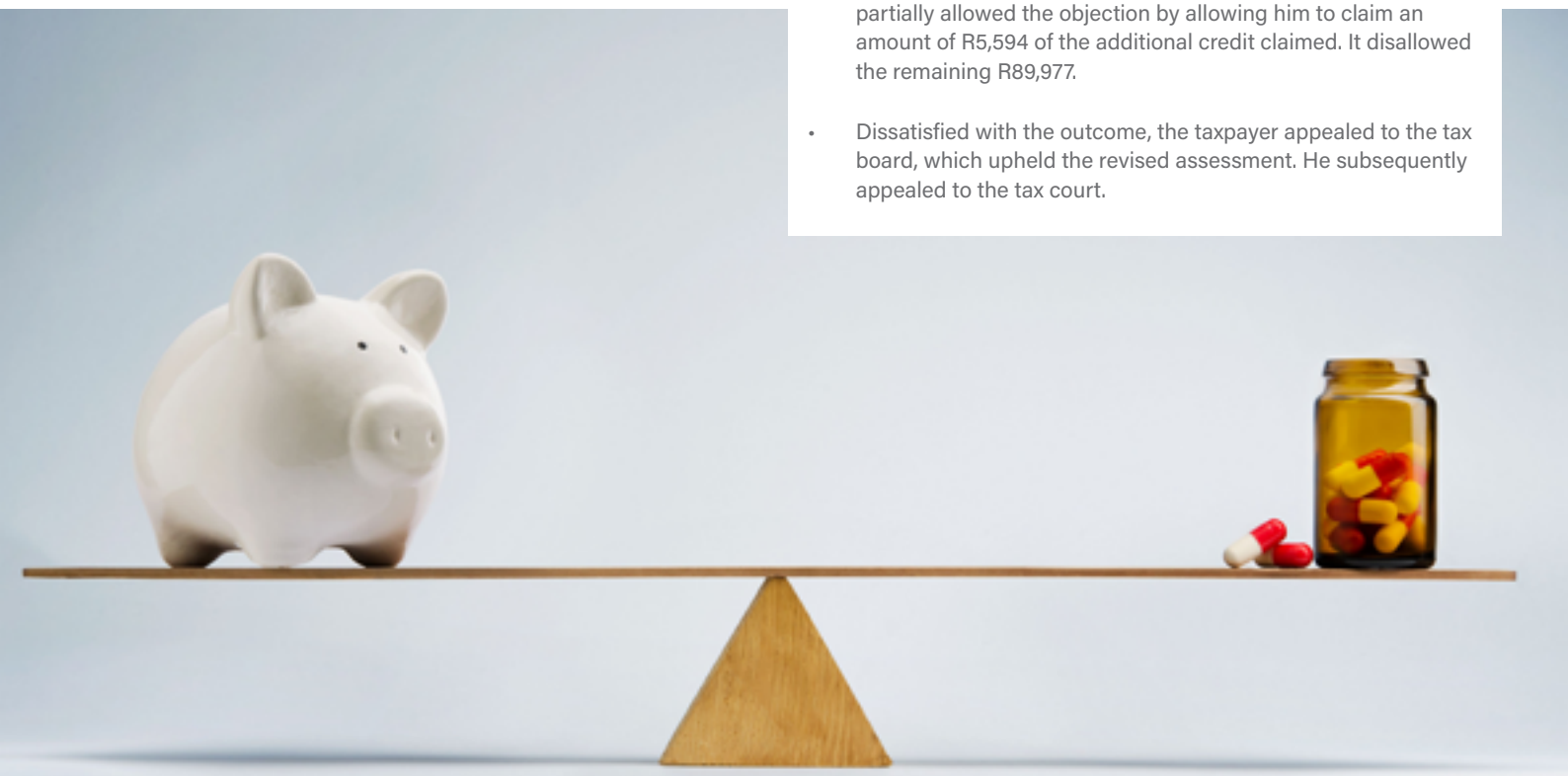
ADDITIONAL MEDICAL EXPENSES TAX CREDIT

The 2020 Budget Review released by National Treasury gave notice of an increase in the value of medical tax credits that can be claimed by individuals. The 2020 Budget Review notes that the increase in the medical scheme fees tax credit by 2.8%, which is below the rate of inflation, is in line with the announcement in the 2018 Budget Review "...to help fund the rollout of national health insurance over the medium term". Aside from the medical scheme fees tax credit that individuals can claim and which is determined by their medical aid contributions, certain taxpayers can also claim the additional medical expenses tax credit (additional credit) available under section 6B of the Income Tax Act, 1962 (the Act), provided that they meet the requirements of the section.

In the recent judgment of *Z v Commissioner for the South African Revenue Service*, [2019] (the *Z* case), the tax court considered the appeal of Mr Z (the taxpayer) against SARS' decision to disallow the additional credit claimed, relating to the alleged treatment for his disability.

FACTS

- In his 2015 income tax return, the taxpayer claimed the additional credit for expenditure allegedly related to his treatment of mercury poisoning, which caused his multiple sclerosis and peripheral polyneuropathy. These conditions resulted in him being wheelchair-bound.
- Based on the information in the taxpayer's return, SARS issued an original assessment indicating that he was due for a tax refund in the amount of R103,358.62.
- The additional medical expenses incurred by the taxpayer included the costs of purchasing "the X machine" in order to self-treat the mercury poisoning and therefore his disability. He also claimed the costs of consultations with a homeopath and a herbalist.
- However, SARS subsequently audited the taxpayer and issued a revised assessment disallowing the additional credit of R95,571, claimed under section 6B.
- The taxpayer objected to the revised assessment and SARS partially allowed the objection by allowing him to claim an amount of R5,594 of the additional credit claimed. It disallowed the remaining R89,977.
- Dissatisfied with the outcome, the taxpayer appealed to the tax board, which upheld the revised assessment. He subsequently appealed to the tax court.



"The taxpayer failed to prove his alleged disability as defined in section 6B(1)*(b)*, in that he failed to present medical reports by a duly registered medical professional that concluded that his disability had been caused by mercury poisoning."

JUDGMENT

Firstly, the tax court held that in terms of section 102(1)*(b)* of the Tax Administration Act, 2011 (the TAA), the onus rests with the taxpayer to prove that he is entitled to claim the full additional credit.

Secondly, where the taxpayer alleges that the expenses were incurred in respect of his/her disability, it must be a "*disability*", as defined in section 6B(1) of the Act. The provision requires the disability to be diagnosed by a duly registered medical professional. Further, the said diagnosis must have lasted or have a prognosis of more than a year.

Thirdly, the tax court posited that, based on the definition of "qualifying medical expenses" in section 6B(1), the following factors ought to be considered when assessing a claim for an additional medical expenses tax credit:

a. the relevant amount must be paid to a duly registered, *inter alia*, medical practitioner, homeopath and/or herbalist for professional services rendered or medicines supplied by a duly registered pharmacist for medication prescribed by any of the above-mentioned persons;

b. relevant professionals must be registered with the Health Professions Council of South Africa (HPCSA) and/or the Allied Health Professions Council of South Africa (AHPCSA);

c. the expenditure must be prescribed by the Commissioner as necessarily incurred and paid by a taxpayer in consequence of any, *inter alia*, physical impairment or disability suffered by the person or any dependant of the person.

Together with meeting the requirements as set out above, a taxpayer must submit a Confirmation of Diagnosis of Disability (ITR - DD) form, which must be completed and signed by a medical practitioner registered with the HPCSA or AHPCSA. In the *Z* case, the taxpayer submitted that the ITR - DD form had been completed and signed by a medical practitioner.

SARS disallowed the taxpayer's objection on the basis that:

- The medical professionals he had consulted, namely the homeopath, herbalist and medical practitioner, were not duly registered with the HPCSA, AHPCSA or any other relevant governing body. In consequence, the taxpayer failed to meet the requirements of section 6B(1)*(a)*, in respect of "qualifying medical expenses" in that the medical expenses had not been incurred with a duly registered medical professional. Additionally, the medical expenses did not relate to medical treatment prescribed by a duly registered medical professional.

- The taxpayer failed to prove his alleged disability as defined in section 6B(1)*(b)*, in that he failed to present medical reports by a duly registered medical professional that concluded that his disability had been caused by mercury poisoning. The taxpayer had personally conducted investigations that led him to conclude that his disability was caused by mercury poisoning.

- The taxpayer did not meet the requirements of section 6B(1) *(c)* in respect of qualifying medical expenses, in that the cost of the X machine had not been incurred in consequence of his disability and had not been prescribed by a duly registered medical professional.

In his defence, the taxpayer contended that he had provided SARS with invoices as evidence that services had been rendered by registered medical professionals. The taxpayer further contended that the invoices submitted to SARS were sufficient to shift the onus to SARS to show that the invoices had been rendered by professionals who fall outside the scope of section 6B(1).

The tax court further stated that the invoices submitted by the taxpayer as proof that services had been rendered by registered medical professionals, did not suffice. The invoices did not constitute sufficient evidence of a medical professional's registration and other corroborating evidence was required. At most, invoices evidenced the amount charged by a specified service provider for a specified service. Therefore, the tax court held that the taxpayer failed to prove that services had been rendered in respect of his alleged disability by a registered medical professional.

In finding in favour of SARS, the tax court found that the taxpayer failed to prove that he had a disability, as diagnosed by a registered medical practitioner and that his claim did not fall within the scope of "qualifying medical expenses".

COMMENT

It is well known that private medical care can be expensive. While one certainly feels sympathy for the taxpayer in the matter under discussion, the judgment illustrates the importance of ensuring compliance with section 6B(1), to avoid that a claim for additional medical expenses incurred in respect of a disability is rejected by SARS.

Cliffe Dekker Hofmeyr

Act sections:

- Income Tax Act 58 of 1962: section 6B;
- Tax Administration Act 28 of 2011: Section 102(1)*(b)*.

Other documents:

- Confirmation of Diagnosis of Disability (ITR - DD) form (of SARS).

Cases:

- *Z v Commissioner for the South African Revenue Service* (IT4412) [2019] ZATC 13 (26 August 2019).

Tags: additional medical expenses tax credit; medical scheme fees tax credit.

THE END OF LIBOR

The London Interbank Offered Rate (LIBOR) is expected to cease after the end of 2021. In particular, LIBOR-linked loans may not be offered after Q3 2020. This will impact the variable rate in LIBOR-linked financial products

Since the 1980s, LIBOR has been used widely as an interest rate benchmark to calculate the interest rate applicable to financial products. These rates are written into loans, derivatives agreements and many other contracts. LIBOR is based on banks' submissions of their interbank borrowing rates. The problem is that since the financial crisis in 2008, banks no longer fund themselves in this way. The absence of an underlying active market has meant that LIBOR is, and has been, sustained by the use of "expert judgement". This cannot continue indefinitely, and 2021 is the last year that UK panel banks have agreed to provide their submissions to LIBOR.

Public authorities, in the UK and internationally, have been clear that LIBOR is expected to cease to exist after 2021. For loans, LIBOR products may not be offered beyond Q3 2020. All counterparties to a financial product or contract that references LIBOR will need to take action to remove any dependence on LIBOR that remains after 2021.

LIBOR is available in five currencies. Each relevant jurisdiction has established an alternative to LIBOR. This includes Sterling Overnight Indexed Average (SONIA) in the UK.

WHAT IS SONIA?

SONIA is an interest rate benchmark administered by the Bank of England. This means that only the Bank of England takes responsibility for its governance and publication every London business day.

SONIA is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions. So, unlike LIBOR, which is fixed in advance for a set period (eg, three months), SONIA is an overnight rate, measured each day over the interest period to produce a final interest rate at the end (ie, SONIA is a backward-looking rate). It is a (nearly) risk-free rate as it does not include any term bank credit risk or liquidity premium. These differences between SONIA and LIBOR impact on how interest is calculated.

In April 2017, the Working Group on Sterling Risk Free Rates in the UK (the Working Group) recommended using the SONIA benchmark as their preferred risk-free rate. Since then, the Working Group has focused on facilitating the transition away from LIBOR across sterling markets.

The overall objective of the Working Group is to enable a broad-based transition of the sterling bond, loan and derivative markets to SONIA by the end of 2021. The objective is to reduce financial stability risks arising from widespread reliance on GBP LIBOR. As part of this work, the Working Group consulted on Term SONIA Reference Rates (TSRR) in 2018. Following this, the Working Group recommended the need for a forward-looking term rate for some participants in the cash markets and to support the transition of certain legacy contracts.

The prevailing view of the Working Group is that overnight SONIA, compounded in arrears, will become the norm in most derivatives, bonds and bilateral and syndicated loan markets given the benefits of the consistent use of benchmarks across markets and the robust nature of overnight SONIA.

In this context, a new Term Rate Use Case Task Force was formed to identify where the usage of SONIA compounded in arrears is appropriate and to provide guidance where the usage of alternative approaches, such as a TSRR, may be necessary. Although a sterling TSRR does not yet formally exist, administrators are working on the development of a TSRR which is compliant with the International Organization of Securities Commissions, and it is expected that TSRRs will be published in Q1 2020 for a period of observation.

WHAT WE NEED TO KNOW ABOUT SONIA'S IMPLEMENTATION

One of the most significant UK financial documents published in recent times was a joint letter sent by the Bank of England and the UK Financial Conduct Authority (the FCA) to senior managers of UK banks and insurers. The letter outlines a series of key targets for 2020 and makes clear that LIBOR transition plans should include these targets. The specified targets are to:

- enable a further shift of volumes from LIBOR to SONIA in derivative markets, supported by a statement from the Bank of England and the FCA encouraging a switch in the convention for sterling interest rate swaps from 2 March 2020;
- cease issuance of cash products linked to sterling LIBOR by the end of Q3; and
- significantly reduce the use of LIBOR-referencing contracts by Q1 2021.

"In sterling, the SONIA overnight rate is an alternative benchmark to LIBOR. SONIA is not a like-for-like replacement for LIBOR and cannot be directly substituted into existing contracts."

WHAT DO YOU NEED TO DO NOW?

Establish where your LIBOR exposures are

Loans, deposit facilities, derivatives and floating rate notes may reference LIBOR. It is important to identify your exposure to LIBOR and to understand what will happen to these contracts if LIBOR is no longer available.

Check your contract terms

Your contracts may include "fall-back" terms setting out what will happen when LIBOR is not available. However, these terms often do not envisage that LIBOR could be permanently unavailable. Check the fall-back terms, what they mean for your financial product and whether they need to be amended.

Familiarise yourself with SONIA, and what it means for you or your business

In sterling, the SONIA overnight rate is an alternative benchmark to LIBOR. SONIA is not a like-for-like replacement for LIBOR and cannot be directly substituted into existing contracts. Given the differences between the two rates, you or your business may need to make changes to systems in order to use SONIA.

ENSafrica

Editorial comment: The LIBOR interest rate is often referred to in determining cross-border interest rates for Income Tax Act purposes, including the official rate of interest and the section 31 arm's length interest rate. SARS and taxpayers will need to develop new measures for these purposes.

Editorial comment: LIBOR is available in five currencies. Each relevant jurisdiction has established an alternative to LIBOR:

- EUROPE: Euro short-term rate (ESTR);
- JAPAN: Tokyo overnight average rate (TONAR);
- SWITZERLAND: Swiss average rate overnight (SARON);
- UNITED KINGDOM: Sterling overnight index average (SONIA);
- UNITED STATES: Secured Overnight Financing Rate (SOFR).

Act sections:

- Income Tax Act 58 of 1962: section 31.

Tags: LIBOR-linked financial products; derivative markets.

STATEMENT OF GROUNDS OF ASSESSMENT AND UNDERSTATEMENT PENALTIES

In the context of a tax dispute between the South African Revenue Service (SARS) and a taxpayer, once the dispute reaches the appeal stage, the taxpayer can elect for the appeal to be heard by the tax court, without the parties first trying to resolve the dispute in terms of the alternative dispute resolution (ADR) process. Once the taxpayer elects for the appeal to be heard by the tax court, SARS must file its statement of grounds of assessment in terms of rule 31 (rule 31 statement) of the rules promulgated in terms of section 103 of the Tax Administration Act, 2011 (the TAA) (the Tax Court Rules).

In terms of rule 31(2) of the Tax Court Rules, the rule 31 statement must set out a clear and concise statement of –

- The consolidated grounds of the disputed assessment;
- Which of the facts or the legal grounds in the notice of appeal under rule 10 are admitted and which of those facts or legal grounds are opposed; and
- The material facts and legal grounds upon which SARS relies in opposing the appeal.

In *A v the Commissioner for the South African Revenue Service* (Case No 24643) (as yet unreported) heard by the tax court sitting in Johannesburg, the applicant (the Taxpayer) took exception to SARS' rule 31 statement.

FACTS

In summary, the facts were as follows:

- The Taxpayer's exception was framed in the alternative in that it firstly stated that SARS' rule 31 statement lacked averments necessary to sustain a finding of gross negligence and the imposition of an understatement penalty at the rate of 100%. In the alternative, the exception complained that the rule 31 statement was vague and embarrassing as it failed to explain the basis upon which SARS opposed the Taxpayer's appeal against the imposition of the understatement penalty (USP) at the rate of 100%;
- In the further alternative, the Taxpayer argued that the rule 31 statement failed to set out a clear and concise statement of material facts upon which SARS relied in opposing the appellant's appeal against the USP at the rate of 100%;
- The relevant passage in the rule 31 statement in respect of which the Taxpayer took exception appeared in paragraph 22 and stated the following:

"22.1 The appellant neglected to provide complete and accurate information together with the submission of his annual income tax returns for the tax year in dispute;

22.2 The facts uncovered during the audit fell in the sole knowledge of the appellant, these facts the appellant failed to disclose to SARS;

22.3 It is SARS' contention that there was no *bona fide* inadvertent error on the part of the appellant when he completed and submitted his tax returns;

22.4 SARS deems the conduct of the appellant as stipulated above to fall under the category of gross negligence in completing a return as listed in the understatement penalty percentage table of section 223(1) of the Tax Administration Act."

JUDGMENT

Firstly, the tax court stated that it was common cause between the parties that the onus rests upon SARS in respect of the imposition of a USP. This is clear from section 102(2) of the TAA, which states that –

"[T]the burden of proving whether an estimate under section 95 is reasonable or the facts on which SARS based the imposition of an understatement penalty under Chapter 16, is upon SARS."

The tax court then proceeded to state that the real question it needed to answer in considering the exception, was whether the averments contained in paragraph 22 of the rule 31 statement sufficed for the purposes of rule 31 of the Tax Court Rules. With reference to rule 31(1)*(c)* and rule 32(2)*(c)* of the Tax Court Rules, the latter of which deals with what must be set out in the Taxpayer's statement of grounds of appeal (rule 32 statement), the tax court noted that the rule 31 statement and rule 32 statement must state "... facts and legal grounds that are sufficiently clearly and concisely specified so as to know what issues proceed to an appeal."

The question is then whether the matters that were raised in paragraph 22 of the rule 31 statement, sufficed to meet the requirement that the facts are set out in compliance with rule 31, in a manner sufficient to define the issues that are to proceed on appeal.

The tax court considered the USP percentage table in section 223 of the TAA, which distinguishes between different kinds of behaviour and the penalty percentages that flow from the different behaviours. The penalty percentages increase with the differentiation in the behaviour, with "gross negligence" in a standard case resulting in a penalty percentage of 100%, which is the percentage that SARS alleged in the rule 31 statement should apply.

The tax court considered the contents of paragraph 22 of the rule 31 statement and held that it did not go far enough to meet the requirements of rule 31 and in particular the facts that were relied upon and needed to be pleaded, as stipulated in rule 31(2)*(b)* and 31(2)*(c)*. The tax court's reasons for this finding can be summarised as follows:

- In paragraph 22.2 of the rule 31 statement it was pleaded that facts were uncovered in the course of the audit, but paragraph 22.2 does not state what these facts are and why the failure to disclose them to SARS gave rise to gross negligence. At the very least, this should be explained in a summary and concise fashion.
- This explanation is necessary because without some averments as to why failure on the part of the Taxpayer was grossly negligent, there is no basis on which the Taxpayer can know why SARS considers his conduct to be grossly negligent, rather than merely negligent or whether it constitutes a "substantial understatement", as contemplated in section 223.
- The behaviours tabulated in section 223 point towards differentiated forms of culpability. In order to differentiate the behaviour, it is necessary to understand by reference to some facts SARS has uncovered, why the deviation from the standard of reasonable care is so great that it amounts to gross negligence, rather than ordinary negligence or simply a substantial understatement.
- The determination of the relevant behaviour is not purely a matter of evidence, but is something where certain facts would have to be proved to show that gross negligence is present, and that gross negligence must have something to do with which facts were not disclosed, and why SARS believes that the failure to disclose those facts constitutes gross negligence, as opposed to mere negligence or innocent understatement.
- Something more is required in order to place the Taxpayer in a position to know the case that it must meet and then to meaningfully plead in its rule 32 statement as to which facts it admits and which facts it denies for the purposes of determining those matters that will proceed as the issues on appeal.
- Absent the essential facts that SARS relies upon as to why there is gross negligence, the pleadings will simply be a bare denial of gross negligence and that will not be helpful for the purposes of explaining the true dispute that must be resolved on appeal.

Pursuant to finding in favour of the Taxpayer and that the rule 31 statement lacked averments necessary to sustain a finding of gross negligence and the imposition of a USP at the rate of 100%, the tax court further granted SARS 15 days in order to remedy the defect in the rule 31 statement.

OBSERVATIONS

In recent times, a number of tax disputes heard by the tax court and the Supreme Court of Appeal (SCA) have dealt with the issue of USPs, such as the SCA judgment in *Purlish Holdings v The Commissioner for the South African Revenue Service*, [2019].

The key principle derived from this judgment is that once a taxpayer has received SARS' rule 31 statement in a particular matter, it can consider taking an exception if the taxpayer believes that the rule 31 statement lacks averments necessary to sustain a particular finding, including a finding regarding the USP to be imposed. It is important to note that if the exception is allowed, the tax court would likely give SARS an opportunity to remedy the defect. The taxpayer would then have to file a rule 32 statement in response to the amended rule 31 statement.

Therefore, where an exception is allowed, such as in the case discussed in this article, it simply compels SARS to state the facts on which it relies at an earlier stage, following which the taxpayer would likely be better placed to respond to SARS' allegations in its rule 32 statement.

Cliffe Dekker Hofmeyr

Act sections:

- Tax Administration Act 28 of 2011: sections 95, 102, 103 & 223.

Other documents:

- Tax Court Rules (rules promulgated in terms of section 103 of the Tax Administration Act): rules 31 & 32.

Cases:

- *A v the Commissioner for the South African Revenue Service* (Case No 24643) (as yet unreported);
- *Purlish Holdings v The Commissioner for the South African Revenue Service* (76/2018) [2019] ZASCA 4 (26 February 2019).

Tags: statement of grounds of assessment; statement of grounds of appeal; culpability; gross negligence; substantial understatement.

WAIVER OF LEGAL PROFESSIONAL PRIVILEGE

The communications between attorneys and their clients during litigious proceedings are protected from disclosure in terms of the doctrine of legal professional privilege. However, when a litigant expressly or implicitly waives such privilege, the protection afforded to the litigant will be lost and they may be compelled to disclose the relevant communication.

While disputes generally do not arise in the case of express waiver of privilege, difficulties arise when it is contended that a litigant has, by means of their actions, implicitly waived privilege.

In the recent Supreme Court of Appeal (SCA) case of *Contango Trading SA & Others v Central Energy Fund SOC Limited & Others*, [2019], in which judgment was handed down on 13 December 2019, the SCA revisited and discussed the requirements for the implicit waiver of legal professional privilege.

FACTS

In the course of review proceedings, the appellants applied to the Western Cape High Court for an order to compel two of the respondents, being state-owned entities (SOE), to comply with a notice, served in terms of rule 35(12) of the Uniform Rules of Court, for the production of various documents. Specifically, the appellants sought the disclosure of three categories of documents:

1. the "Legal Review";
2. the documents prepared by the SOE's auditors, PWC and KPMG (auditors' reports); and
3. two opinions furnished to the respondents by senior counsel.

After the High Court dismissed the appellants' application to compel delivery, an appeal was brought to the SCA.

In respect of the opinions drafted by senior counsel, the respondents asserted that the opinions were protected by legal professional privilege and therefore were not capable of disclosure to the appellants. It was the appellants' case that the respondents had made reference to the documents in their founding affidavit to the main review proceedings and that the documents, in terms of rule 35(12), stood to be produced by the respondents as the reference thereto in the founding affidavit meant that legal professional privilege had been waived.

Although the respondents only made brief mention of the opinions in their founding affidavit, and further asserted that the opinions were subject to legal professional privilege, the appellants argued that the respondents had implicitly waived privilege by disclosing that the opinions supported what had been set out earlier in the affidavit, thereby disclosing the content of the opinions.

The proceedings in the SCA dealt with each of the categories of documents sought by the appellants separately and ultimately it was the wording used in the respondents' founding affidavit that was determinative of the SCA's findings.

JUDGMENT

At the outset, the SCA acknowledged that the process of determining whether any right, privilege or similar interest has been waived is founded primarily on the intention of the party to whom such right or privilege attaches. The test to be applied is an objective test comprising of three principles:

1. The intention to waive is judged by its outward manifestations;

2. Mental reservations that are not communicated to the other party are of no legal consequence; and

3. The outward manifestations of intention must be judged from the perspective of a reasonable person standing in the shoes of the party to whom the right or interest does not attach.

An intention to waive is self-evident when a party expressly waives privilege, as would be the case when a privileged document is voluntarily disclosed to a litigious opponent. However, when there has been no express waiver, but the conduct of the relevant litigant is such that waiver of privilege can be inferred, it is possible that privilege has indeed been waived.

South African case law predominantly classifies this type of waiver as an "implied" waiver. However, it has been suggested that reference to an "imputed" waiver would be a more suitable term for waiver in the absence of an express manifestation of the intention to waive. In *Peacock v SA Eagle Insurance Co Ltd*, [1991], the court reasoned that privilege cannot be implicitly lost when the party losing the privilege did not intend to waive the privilege; therefore, when no actual intention to waive can be inferred from the facts, privilege can only be waived by imputation of law in the specific circumstances.

The SCA performed a thorough exposition of both foreign and South African case law in order to ascertain whether the difference in terminology is purely semantic or whether there are substantive grounds for the differentiation. The SCA took the view that the terms "waiver by imputation" and "waiver by implication" are synonymous and that the distinction is purely terminological. In this regard, the SCA agreed that "disputes pertaining to implied waiver usually arise from the need to decide whether particular conduct is inconsistent with the maintenance of the confidentiality which the privilege is intended to protect." As such, even if a litigant did not intend to waive privilege, if such litigant's conduct is inconsistent with the maintenance of confidentiality, that conduct may result in a waiver of privilege.

"Taxpayers must be aware that legal professional privilege does not extend to communications between a taxpayer and its auditors, accountants or tax advisors, who do not qualify as legal advisors."

The exposition done by the SCA also highlighted the various requirements and considerations to which regard must be had when determining whether privilege has been waived implicitly. In coming to its final conclusions, the SCA held that there are four factors that, in the present case, had to be considered cumulatively to determine whether the respondents had waived privilege in respect of the opinions, specifically:

a) That there is no difference between implied waiver and a waiver imputed by law;

b) That an implied waiver may be inferred from the objective conduct of the party claiming the privilege in disclosing part of the content or the gist of the material;

c) Whether the disclosure impacts upon the fairness of the legal process and whether the issues between the parties can be fairly determined without reference to the material; and

d) That there is no general over-arching principle that privilege can be overridden on grounds of fairness alone.

Ultimately, the SCA held that the respondents had not waived privilege in respect of the opinions furnished by senior counsel.

It was found that the reference to the opinions in the respondents' founding papers was included solely to supplement the respondents' application for condonation for the late filing of the review application and was not included in connection with the substantive issues in dispute between the parties. As such, it was unnecessary for the appellants to respond to the contents of the opinions and the non-disclosure thereof did not impact on the fairness of the legal proceedings.

Furthermore, even though the preceding paragraphs of the founding affidavit had hinted at the content of the opinions, the SCA reiterated that there is no presumption that the disclosure of the gist of legal advice will inevitably amount to conduct incompatible with asserting privilege in relation to the advice itself and, as the respondents had clearly asserted privilege over the opinions when reference thereto was made, it was held that privilege had not been waived. In the result, the SCA dismissed the appellants' appeal in respect of the opinions furnished to the respondents by senior counsel.

COMMENT

Litigation proceedings between SARS and taxpayers in the tax court are regulated by the Tax Court Rules, promulgated in terms of section 103 of the Tax Administration Act, 2011. Rule 36 of the Tax Court Rules operates in a similar fashion to rule 35 of the Uniform Rules of Court and makes provision for either party to request the disclosure of documents that are relevant to the dispute, and subsequently to request that such documents are made available to the extent necessary.

Importantly, rule 36(4) of the Tax Court Rules makes provision for either SARS or a taxpayer to object to the disclosure of a document if a valid reason for such objection exists, including where the document in question is covered by legal professional privilege.

There are several aspects pertaining to legal professional privilege, and specifically also to the implied waiver thereof, that must be borne in mind by litigants in the tax court.

Firstly, taxpayers must be aware that legal professional privilege does not extend to communications between a taxpayer and its auditors, accountants or tax advisors, who do not qualify as legal advisors. Any such communications will not be protected by legal professional privilege and will have to be disclosed to SARS should such disclosure be required.

The communication between a taxpayer and their legal advisor will be covered by legal professional privilege where the communication pertains to legal advice that has been sought and given in a professional capacity, and where the communication between the taxpayer and the legal advisor has been made in confidence. It is also necessary that legal professional privilege be asserted by a taxpayer in respect of a communication.

It is trite that once a communication is covered by legal professional privilege, that communication will enjoy an enduring protection benefit until such time as the legal professional privilege is waived by the holder thereof. As legal professional privilege is the right of the taxpayer, it cannot be waived by a legal advisor or a third party. Furthermore, it is noteworthy that once privilege in respect of a communication has been waived, it is not possible for that document to regain its previously privileged status. Consequently, it is very important that taxpayers are aware of what conduct may constitute an implicit waiver of legal professional privilege.

Generally, in order for waiver to be implied, it is necessary for the privilege holder to:

1. have full knowledge of the rights so held; and

2. have conducted himself in such a manner that, objectively speaking, an inference can be drawn that he intended to abandon those rights.

A party to a dispute in the tax court will be regarded as having implicitly waived legal professional privilege if that party's conduct is objectively inconsistent with an intention to maintain confidentiality and if such conduct will unfairly fetter the opposing party's ability to adequately respond to the case advanced in reliance on the privileged communication. Therefore, if a litigant places reliance on a privileged document and incorporates the contents of that document into its case such that the document forms part of the cause of action in respect of which the opposing party is required to respond, the privilege attaching to that document may be implicitly waived and disclosure thereof will then have to be made. This may be the case notwithstanding any express reservation by the litigant of the right to invoke privilege.

Furthermore, taxpayers should be aware that the partial disclosure of a document that is privileged may constitute implied waiver of the privilege that attaches to the whole document.

In the interests of safeguarding confidential information shared between taxpayers and their legal advisors, it is imperative that taxpayers take cognisance of the limitations of the doctrine of legal professional privilege and the forms of conduct that may lead to an inference of implied waiver.

"In the interests of safeguarding confidential information shared between taxpayers and their legal advisors, it is imperative that taxpayers take cognisance of the limitations of the doctrine of legal professional privilege and the forms of conduct that may lead to an inference of implied waiver."

Cliffe Dekker Hofmeyr

Act sections:

- Tax Administration Act 28 of 2011: section 103.

Other documents:

- Tax Court Rules, promulgated in terms of section 103 of the Tax Administration Act 28 of 2011: rule 36;
- Uniform Rules of Court: rule 35.

Cases:

- *Contango Trading SA & Others v Central Energy Fund SOC Limited & Others* (533/2019) [2019] ZASCA 191;
- *Peacock v SA Eagle Insurance Co Ltd* 1991 (1) SA 589 (C).

Tags: legal professional privilege; express waiver of privilege; implicit waiver of legal professional privilege; "implied" waiver; "imputed" waiver; founding affidavit; privileged document.