KWJ Investments: A cautionary tale on tax "friendly" structures

June 2018
Tax Newsletter

A key consideration in the structuring of any business or transaction is that of tax. As stated by Lord Tomlin in the *Duke of Westminster* case, a taxpayer is "entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be" and accordingly, in so structuring his affairs, a taxpayer must undertake a balancing exercise to ensure that he has properly considered the relevant tax acts to ensure that there are no unintended consequences resulting from the implementation of a structure or transaction.

In the recently decided case of C*ommissioner of the South African Revenue Service v KWJ Investments (142/2017) [2018] ZASCA 81 (31 May 2018)*, the Supreme Court of Appeal (the SCA) heard an appeal that involved a set of transactions designed to "exploit the tax code in ways that would enhance the profitability of the participants, whilst avoiding any liability for tax". The court in this instance had to determine two issues, namely whether:

- The value of rights to dividends declared but not accrued to the respondent (KWJ) by way of a cession constituted "gross income" as contemplated by the Income Tax Act 58 of 1962 (the ITA).
- Whether the appellant (SARS) was precluded from raising an additional assessment against KWJ on the basis that the original assessments were issued in accordance with a "practice generally prevailing".

The facts of this case are briefly as follows. KWJ conducted a business in redeemable preferences shares. Investors who sought a return in the form a dividend subscribed for and were issued preference shares by KWJ. KWJ then invested the proceeds from the issue of preference shares with Investec Bank Ltd (Investec).

Investec, as a *quid pro quo* for KWJ's investment with it, issued KWJ with a Composite Note, the terms of which being that:

- Investec would, as a return on the KWJ's investment, cede rights to KWJ in respect of dividends declared but not yet paid by certain entities listed on the Johannesburg Stock Exchange (the JSE Companies) before Investec was actually entitled to these dividends themselves (the Ceded Dividends).

- The cession took place prior to the last date for registration of the shareholder, on which date the right to the Ceded Dividends would have accrued to the registered shareholder.

SARS contended that an accrual took place on the date of the cession of the dividend right to KWJ from Investec and that a second accrual took place on the date the JSE Companies declared the Ceded Dividends and paid to KWJ the dividend amounts to which it was entitled.

KWJ contended that the Ceded Dividends income was exempt from income tax in terms of section 10(1)(k) of the ITA at the time. SARS subsequently raised assessments against KWJ on this basis for the 2008 and 2009 years of assessment (the Original Assessments). The amount included in the Original Assessment was the profit made by KWJ on the investments made on behalf of its investors which profits comprised the Ceded Dividend amount less the dividends to which the investors were entitled to by virtue of their preference shares.

SARS argued that the receipt by KWJ of the Ceded Dividends constituted an unconditional receipt or accrual, taxable as gross income (or interest under section 24J of the ITA). SARS thereafter raised additional assessments in respect of the KWJ's 2008 and 2009 years of assessment including the whole Ceded Dividend amount in the assessment (the Additional Assessments).

The SCA held, in relation to the first issue under consideration relating to the Ceded Dividends, that:

- An amount accrues to a taxpayer once a taxpayer becomes unconditionally entitled to such an amount.
- The Ceded Dividends constituted incorporeal property, possessed value and as such, constituted "an amount" for the purposes of gross income.
- Accordingly, an amount accrued to KWJ unconditionally and therefore the Ceded Dividends constituted "gross income".
- As the Ceded Dividends fell within the scope of "gross income" there was accordingly no need to consider the provisions of section 24J of the ITA.

In dealing with the second issue in contention, the court had to consider whether SARS issued the Additional Assessments contrary to its generally prevailing practice at the time of the issue of the Original Assessments. The Additional Assessments included the entire amount of the Ceded Dividend, rendering KWJ liable for tax on this amount.

Section 79 of the ITA (now repealed) states that where an assessment is raised, and an amount therein assessed in accordance with a "practice generally prevailing", then SARS would be precluded from raising an additional assessment, notwithstanding that it may be justified in terms of the ITA. A practice generally prevailing is simply a practice "which is applied generally in the different offices of the Department in the assessment of taxpayers". The court found that, by producing the following evidence, KWJ had discharged its onus to show that the Original Assessments were issued in accordance with a practice generally prevailing:

- That SARS had assessed five previous transactions identical to the KWJ transaction, which resulted in the Additional Assessments on the basis that exempt dividends were received.
- A ruling was obtained by Investec in relation to another fund in 2003 wherein the same structure was utilised, which stated that the dividends received would be exempt from income tax.
- KWJ sought a formal admission from SARS as to whether any other South African taxpayer had been assessed based on the Additional Assessments. SARS could not identify any such taxpayers.
- SARS had sufficient information in relation to the transaction at the time that it issued the Original Assessments.

SARS accordingly issued the Original Assessments in accordance with a practice generally prevailing as contemplated in the ITA at the time and as a result was precluded in law from issuing such Additional Assessments.

In dealing with costs, the court overturned the decision of the court *a quo* in awarding costs against SARS and stated that "were it not for the existence of a practice generally prevailing, the transaction into which the respondent (KWJ) had entered would have been subject to tax".

In light of this judgment, taxpayers should take cognisance of potential pitfalls when entering into tax "friendly" structures or transactions.

Article co-authored by Mateen Memon, candidate attorney

> Read the full article online