

# **REPORTABLE**

## **IN THE TAX COURT CAPE TOWN**

**Case No. 11986**

**Appellant**

**and**

**THE COMMISSIONER FOR THE SOUTH AFRICAN  
REVENUE SERVICE**

**Respondent**

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**JUDGMENT: 11 DECEMBER 2006**

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**DAVIS P**

### **Introduction:**

This is an appeal against an assessment for income tax raised in respect of a recoupment added back to appellant's income for the year of assessment ending 30 June 2001.

The parties prepared a statement of agreed facts upon which this dispute is to be resolved.

The statement of agreed facts reads thus:

1. For the period ending 30 June 2001, appellant received a distribution in specie, in the form of certain leasehold rights from one of its subsidiaries,

A (Pty) Ltd. The distribution in specie was valued at R82 505 092. In the same period appellant disposed of the leasehold rights for an amount of R99 990 000 to a third party.

2. B (Pty) Ltd had acquired the leasehold rights to a site known as “the Mayor’s garden” under a notarial deed of lease during March 1982, from the C Municipality in terms of the lease. B, or its successors in title, was required to effect certain leasehold improvements to the site.
3. B and the Commissioner had agreed prior to 1989 that B, as holding company of the property sub-group of the group of companies, would include all income and expenditure of its subsidiaries in its income statement. This resulted in B determining taxable income on the consolidated income and expenditure of its subsidiaries in addition to its own income and expenditure. The Commissioner assessed them on this consolidated basis, and no objection was lodged thereto by the company.
4. For the period 1983 to 1991, B (Pty) Limited, claimed an amount of R24 522 112 by way of leasehold improvements incurred in respect of the property known as the “mayor’s garden”, and as per the provisions of section 11(g) of The Income Tax Act, 58 of 1982, “The Act”.
5. On 30 August 1991, X Ltd, appellant’s holding company, applied to the Commissioner for a rationalization exemption, under the provisions of section 48 of the Taxation Laws Amendment Act, 1988, as amended by Section 28 of the Taxation Laws Amendment Act 1989. In terms of this

rationalization application, the intention was to rationalize the X property sub-group, which had consisted of numerous property owning companies. B had been the property owning company in the Group either through direct ownership of property or indirectly through its shareholding in its subsidiaries. Under the rationalization application, X Limited proposed the following;

- (i) Appellant's name changed from X Properties (Pty) Limited to X Property Holdings (Pty) Limited.
  - (ii) The shareholding in appellant was transferred from B to X Limited.
  - (iii) B transferred its shareholding in, inter alia, A (Pty) Limited to appellant.
6. Included in the rationalization application was the transfer of the above mentioned lease from B to A (Pty) Ltd.
7. In the rationalization application letter, inter alia, the following rulings were requested from the Commissioner:
- (i) The controlling company and the controlled companies will be regarded as one and the same company in terms of section 48(5) of the Moratorium and no liability will arise for any taxation in terms of the Income Tax Act in respect of any of the transactions undertaken in terms of the agreements referred to in this document. In particular, all allowances currently being granted to B (Pty) Ltd in respect of the lease of A (Pty) Ltd will

continue to be granted to A (Pty) Ltd as if no transfer of the lease had taken place.

- (ii) The current method of returning income and expenditure of the subsidiary companies of B (Pty) Ltd will continue and all the income and expenditure of the subsidiaries of the Appellant will be accounted for in the tax return of the Appellant.

8. The Commissioner responded to the rationalization application letter dated 30 August 1991, on the following terms:

- (i) In terms of section 48(5) of The Taxation Laws Amendment Act (Act 87 of 1988), the purchaser and seller of the submitted agreements are regarded as one and the same; more specifically all allowances currently granted to (B) (Pty) Ltd in respect of the lease of A will continue to be granted to A (Pty) Ltd, currently named Y (Pty) Ltd. as if no transfer of the lease had taken place (refer paragraph 2.1 of the letter dated 26 November 1991 issued by the Commissioner).
- (ii) The current method of returning the income and expenditure of the subsidiary owning companies of B (Pty) Limited may continue and all the income and expenditure of the subsidiaries of the Appellant may be accounted for in the tax return of the Appellant, provided that for every year of assessment, a balance sheet is nevertheless submitted for each of the affected

subsidiaries. (refer paragraph 6 of the letter dated 26 November 1991 issued by the Commissioner)

9. The appellant complied with the above arrangement. From the year ending June 1992, appellant accounted for all income and expenditure of all its subsidiaries in both its annual financial statements and tax returns, and continues to return all the income and expenditure of its subsidiaries on this basis.
10. For the period June 1992 to June 1997, an amount of R26 405 966 was claimed by way of leasehold improvements as per the provisions of section 11(g) of The Act, in respect of the property known as "The mayor's garden", in the tax return submitted by the Appellant.
11. For the period ending June 2000, a deferred tax liability in the amount of R15 278 424 was reflected in the Annual Financial Statements of the Appellant. This represented the tax liability on the leasehold improvements which had been claimed in prior years, in respect of "The mayor's garden".

### **Appellant's Case.**

Mr Emslie, who appeared on behalf of appellant, summarized his case thus: when account was taken of the provisions of section 48 of the Taxation Law Amended Act 87 of 1988 ('the Amendment Act') the application of X Ltd in terms thereof and respondent's ruling which was granted in terms of this section, it was clear that, as a matter of law, it never was nor could it have been deemed to be

the same company as either B (Pty) Ltd or A (Pty) Ltd. Further, the correspondence of 26 November 1991 confirmed a pre-existing arrangement in terms of which a consolidated income tax return was submitted and tax paid on behalf of all the property – owning subsidiaries of the X group, which arrangement did not fall within the scope of s 48 of the Amendment Act.

In the context of these submissions, it is now necessary to examine s 48, particularly s 48(5)(b).

Section 48 of the Amendment Act.

Section 48(5)(b) of the Taxation Law Amended Act of 1988 reads thus:

‘For the purposes of the taxation levied under the Income Tax Act and notwithstanding anything to the contrary in that Act – where any property sold or disposed of under an agreement contemplated in subsection (2) includes any building in respect of which any allowance has been granted to the transferor company under the said Act, the transferor company and the transferee company shall for the purposes of calculating any allowance under the said Act granted to the transferee company in respect of that building or for the purpose of determining whether any amount has been recouped in respect of the allowances granted to the two companies in respect of such building, be deemed to be one and the same company and any amount so recouped shall be deemed to be income derived by the company in the course of a trade carried on by it separately from any other trade carried on by it’ (my emphasis).

Mr Emslie submitted that the agreement referred to in this section concerned one between a transferor company and a transferee company within a group of companies whereby shares or property were transferred by the transferor to the transferee in circumstances where there was no necessity to pay stamp duty or transfer duty.

Mr Emslie further submitted that the purpose for which the transferor company and transferee company were deemed to be one and the same was to enable the tax value of what was transferred to be carried over to the transferee company for the purpose of calculating any allowances in the hands of the transferee company and further for the purpose of determining any recoupment in respect of the allowances granted to both companies which would be recouped in the hands of the transferee company when the asset was disposed of for consideration by the transferee company.

In his view, this was the extent to which the transferee company and transferor company were deemed to be one and the same company. Mr Emslie emphasized that the existence of a consolidated income tax return in circumstances where tax was paid on behalf of all the property owning subsidiaries of the X Group was effected in terms of paragraph 6 of a letter from respondent dated 26 November 1991 and was not done in terms of section 48. In other words, appellant followed a practice sanctioned by respondent for the submission of tax returns. In the critical letter of 26 November, respondent

wrote: 'The current method of returning the income and expenditure of the subsidiary property owning companies of (A) (Pty) Ltd may continue.'

Accordingly, Mr Emslie submitted that the income, expenditure and allowances of B (Pty) Ltd and A (Pty) Ltd reflected in the tax returns submitted by appellant on their behalf remained the income, expenditure and allowances of these companies which would be deemed to be one and the same company in terms of respondent's ruling of 26 November 1991 but only for the purpose as set out in section 48(5)(b) of the Amendment Act.

Mr Emslie submitted that the fact that the allowances were then claimed by the appellant in a consolidated tax return was irrelevant to this dispute; the allowances had been enjoyed by A (Pty) Ltd. Which, for certain purposes only, was deemed to be one and the same company as C (Pty) Ltd. Hence, the allowances were legally claimed by A (Pty) Ltd and were granted to this entity.

This was then the only taxable entity which could recoup the allowances in terms of section 8(4)(a) of the Income Tax Act 58 of 1962 ('the Act').

This section provides insofar as it is relevant to the present dispute:

'There shall be included in the taxpayers' income all amounts allowed to be deducted....under the provisions of sections 1 to 20 inclusive....which have been recovered or recouped during the current year of assessment.'



The liquidation distribution of the leasehold rights **in specie** was made by A (Pty) Ltd to appellant for no consideration. This did not give rise to a recoupment in the hands of A (Pty) Ltd. The leasehold premium and improvement allowances were never recouped or recovered by A (Pty) Ltd nor did the respondent seek to tax the recoupment in the hands of this entity. As no allowances were ever claimed by appellant on his own behalf or granted on his own behalf it was not open to respondent to tax the recoupment in the hands of appellant. So much for an analysis of appellant's case.

### **Respondent's Case.**

Ms Lalor, who appeared on behalf of respondent, submitted that when the IT 14's of A (Pty) Ltd for the period 1995/1996/1997 were examined, it was revealed that, for each of these years, no amount had been reflected in the returns. In part 5:11 of the return, the question 'Did the company incur any lease premiums for or in respect of improvement to leasehold improvement?' was answered in the negative. The annual financial statements which were attached to these returns did not include an income statement. The explanation given was that all the income and expenses of the company had been borne by appellant. There was also no tax calculation nor any reference to any leasehold improvements claimed.

In addition there was a statement attached to the 1995 return that the income and expenditure had been ceded to appellant in terms of a moratorium

agreement with respondent. For each year of assessment between 1992 and 1997 a nil taxable income was reflected for A (Pty) Ltd.

Ms Lalor referred to a document generated by appellant for the 1995 return which included the following statement:

'We attach annual financial statements in respect of various group companies, the income and expenditure in relation to which had been ceded to (B) (Pty) Ltd. in terms of a moratorium agreement with Inland Revenue'. How and on what basis the cession was effected remains unexplained by appellant or its accountants.

Ms Lalor also submitted that appellant had recognized its liability for the recoupment of the entire amount which it claimed under section 11(g) of the Act as it provided for the tax liability on the full recoupment of R50 928 081, being R15 278 424. This deferred tax liability was created in its balance sheet for the period ending 30 June 2000.

Ms Lalor also referred to appellant's argument that the allowances had been merely accounted for in its tax returns as a matter of administrative convenience. She contended that the allowances had been accounted for and deducted from appellant's income for the period 1992 to 1997 and this calculation resulted in a reduction of appellant's taxable income. Furthermore, while A may have been entitled to claim the allowances, it never did so nor was it granted the allowance. If it had claimed the allowances there would, at least, have been an assessed

loss for each year as it had ceded its income and expenditure to appellant. By contrast, the entitlement to the allowances was effectively removed by the ruling which it granted to appellant.

### **Deferred Tax**

Although the case was argued on the basis of an agreed statement of facts, appellant called Professor Alexandra Watson as an expert witness. Professor Watson, an associate professor in the accounting department at the University of Cape Town has **inter alia** acted as the Chair of the Accounting Practice Committee of the South African Institute of Chartered Accountants since January 2005. She was clearly qualified, both professionally and academically, to deal with the question of the principles of deferred taxation and its application to the accounts of appellant, a point which was of particular relevance to the case of respondent.

Professor Watson referred to the accounts of appellant as at June 30 2000 in which the amount for deferred taxation included a leasehold recoupment for R15 278 4214. She testified that this amount should not have been included in the balance sheet because of the absence of the underlying assets from which the recoupment would be sourced. She testified that from an examination of the balance sheet, it was impossible to determine who bore the liability for the recoupment nor could one identify the owner of the underlying assets. In her view, appellant's balance sheet could not be classified as a group balance

sheet nor was it an adequate company balance sheet because assets which underpinned the provision for deferred taxation had not been included in the balance sheet. Prof Watson also referred to appellant's accounts as at June 30 2001 and noted that there was an amount of R15 278 424 described as 'deferred tax on recoupment reversed.' She noted that it was not clear to which asset this reversal had referred, save that in the figure for current assets, the amount owing by the group company had been reduced from R19 073 277 to R1 980 617.

Professor Watson also testified generally about deferred tax which she described as an accounting concept which has no cash flow implications. A deferred tax balance reflected on a balance sheet illustrates the future tax consequences of the amounts already recognised for accounting purposes. An analysis of the deferred tax balance highlighted the extent to which there are differences between the basis used for the calculation of accounting and taxable income, but was not a liability in the usual sense of being an amount owed to some other party. In this case the difficulty in reading the accounts was to determine on whose behalf the liability for the deferred tax had been raised. A deferred tax credit balance does not imply that there is an obligation to pay tax; it does imply that if an asset were to be sold for its carrying value, tax would be payable. In the present case the question arose: on whom lay this tax obligation? Beyond this question and the expert view that the balance sheet was unsatisfactory as an explanatory tool, there was little of importance in this evidence.

## Evaluation

The dispute regarding deferred taxation reflected in the appellant's applicable balance sheets can only be analysed within the context of the broader dispute between the parties: Was appellant correct to maintain that both the income and the expenditure received and incurred by subsidiaries was reflected in appellant's accounts as income and expenditure received and accrued on behalf of the subsidiaries? If so, it followed that there was no tax implication for appellant.

From the evidence, particularly the oral evidence of Prof Watson, it is clear that the accounts of appellant fell between a proper group balance sheet and an adequate balance sheet of appellant as a company **per se**. This hybrid form of balance sheet can, for example, be seen in the accounts of appellant ending 30 June 2001. In dealing with the revenue figure of R84 616 526 there was included R71 110 480 reflected as profit operations. In this amount, there is included R12 680 886 reflected as "X rent received". While this figure might have created the impression that this income had accrued not on behalf of the subsidiaries, but for the account of appellant, it is significant that this income is described in a note to the balance sheet as "income from group companies".

The accounts reflect further problems. It appears that appellant accrues the income (and expenditure) of its subsidiaries but it is difficult to trace the legal right thereto (or obligation in respect of expenditure). Further, because the

income and expenditure are not allocated or broken down per property it is not possible to determine the net income (or taxable income after allowances and other timing differences) per property and thus for each of the property owning subsidiaries. For example, it is difficult to analyse expenses that require allocation being interest cost, building repairs, rents paid, rates and taxes, insurance and collection fees.

There is the added problem that the dividend distributed by appellant was sourced in profits belonging to the subsidiaries of appellant.

These conceptual difficulties, including the nature of the balance sheet and income statement of appellant as described by Prof Watson are, in my view, to be traced to respondent's letter of 26 November 2006. The complete paragraph reads:

'Returning Income.

The current method of returning the income and expenditure of the subsidiary property owning companies of (B) (Pty) Limited may continue and all the income and expenditure of the subsidiaries of (B) may be accounted for in the tax return of (B) (Pty) Ltd provided that for every year of assessment, a balance sheet is nevertheless submitted for each of the affected subsidiaries.'

The wording employed in this paragraph appears to reveal that respondent was prepared to accept a method of returning income and expenditure of subsidiary property companies through appellant's balance sheet, save that each of the

subsidiaries was required to submit a balance sheet. Thus no income statement was prepared in respect of the subsidiary companies because all that was required of them was the submission of a balance sheet. So much is made clear in paragraph 6 of respondent's letter of 26 November 1991.

An examination of appellant's 2001 financial statement reveals that income accounted for in the income statement of appellant included the income of the subsidiaries pursuant to paragraph 6 of the letter of 26 November 1991. For example, the amount of R12 680, 886 reflected as '(X) Rent Received' in appellant's 2001 financial statements, was received from an asset of (A) (Pty) Ltd and not of the appellant. Notwithstanding the impurity of the accounting treatment, it is clear that appellant followed an understanding of the basis of the ruling which had been provided to it by respondent. For this reason, the accounting treatment did not affect the fact that the relevant income was that of the subsidiaries.

Significantly the letter of 26 November 1991 provides 'in terms of section 48(5)(b) of the Taxation Laws Amendment Act...the purchaser and seller of the submitted agreements are regarded as one and the same'. This letter incorrectly refers to section 48(5)(e), clearly an error as there was no such section. The further suggestion that the reference was to section 48(5)(3) cannot be correct because there was no sale of a business undertaking which is the subject matter of section 48(5)(c). The letter of 26 November 1991 provides further: 'All allowances currently granted to (B) (Pty) Ltd in respect of the lease of (A) will

continue to be granted to (A) (Pty) Limited currently known as (C) Pty Limited as if no transfer of the lease had taken place.’

The accounts of appellant may not have passed accounting muster. The reason for this conclusion is that the accounts sought to comply with a ruling which inevitably led to a hybrid form of accounts that vexed not only Prof Watson but this Court. The drafters of the ruling may well not have thought through the accounting difficulties as set out in this judgment. But the ruling was given on the basis that it was intended that the parties act thereon.

The only plausible basis in terms of which the ruling and appellant’s consequent action can be analysed appears to be that the allowances in question were granted by the respondent to A (Pty) Ltd, notwithstanding that the assessment was undertaken pursuant to a ‘consolidated’ tax return submitted by appellant; being the only logical execution of the arrangement which had been prefigured in respondent’s letter of 26 November 1991. Only if the effect of the ruling is ignored, does the submission that the income and expenditure of the subsidiaries were reflected in appellant’s accounts as its own income and expenditure hold true. How, however, one might ask rhetorically, was appellant to reflect these amounts pursuant to the ruling other than in the manner in which it so did?

In appellant’s letter of objection it was asserted that the ruling represented a concession, made extra statutorily and not in terms of any specific provision of



the Income Tax Act. Appellant further claims that the ruling did not purport to do anything other than authorise the reporting of the income of the relevant companies in a single tax return and that the income and expenditure concerned remained that of the relevant subsidiary companies. A plausible counter-explanation of the ruling was never offered.

It therefore follows that the only taxpayer which could claim the allowances was A (Pty) Ltd and hence no recoupment could lie to be taxed in the hands of the appellant.

Ms Lalor submitted that there was one further obstacle in the way of a successful appeal, namely the approach adopted in **CIR v Turnbull** 1953(2) SA 573 (A) that where an allowance has been claimed, this gave rise to recoupment, even where the allowance was incorrectly granted or claimed. In that case Centlivres CJ framed the question as to whether a recoupment applies 'both where the Commissioner has correctly allowed a deduction under s. 11(2) and where he has incorrectly allowed it'. at 582H. In the view of the learned Chief Justice, it would be anomalous not to allow Revenue a recoupment where the taxpayer had already benefited, albeit incorrectly, from a deduction.

In the present case, the key question is to whom was the allowance granted? Following the analysis which I have undertaken, the allowances were granted not to the appellant but to its subsidiary. Accordingly, **Turnbull** supra is of no application to the present case in that the allowance were properly granted and

the recoupment attached to the taxpayer who, in terms of the ruling, was granted the allowance.

**Conclusion.**

For the reasons set out, the appeal succeeds and the assessment is referred back to the respondent for reassessment on the basis that the allowances in question were not recouped by appellant.

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**DAVIS P**

On behalf of the Appellant: TS Emlie

On behalf of the Commissioner for the South African Revenue Service: Diane Lalor