

SOUTH AFRICA / JUDGMENT

Crookes Brothers Limited v Commissioner of the South African Revenue Services (14179/2017) [2018] ZAGPPHC 311; 80 SATC 439 (8 May 2018) [2018] ZAGPPHC 311

COURT

North Gauteng High Court, Pretoria

BEFORE

Louw

CASE / FILE NUMBER

14179/2017

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IN

THE GAUTENG DIVISION OF THE HIGH COURT, PRETORIA

CASE

NO: 14179/2017

NOT

REPORTABLE

NOT

OF INTEREST TO OTHER JUDGES

REVISED.

8/5/18

In

the matter between:

CROOKES
BROTHERS
LIMITED Applicant
and
THE
COMMISSIONER OF THE SOUTH
AFRICAN
REVENUE
SERVICE Respondent

JUDGMENT

LOUW, J

- [1] This is an application to review and set aside two decisions taken by the respondent ("SARS"), namely not to make a reduced assessment in relation to the payment of normal tax in respect of the applicant's 2015 year of assessment and not to make a reduced assessment in relation to the payment of dividend tax in respect of the 09-2015 period, which SARS was permitted to do in terms of s 93(1)(d)(ii) of the Tax Administration Act 28 of 2011 ("the TAA").
- [2] Section 93(1)(d)(ii) of the TAA provides the following:
- (1) SARS may make a reduced assessment if -
 - (d) SARS is satisfied that there is a readily apparent undisputed error in the assessment by-
 - (i) SARS; or
 - (ii) the taxpayer in a return"
- [3] The applicant is a member of a group of companies which produces a variety of agricultural products in South Africa, Swaziland, Zambia and Mozambique. Murrmo Macadamias Limitada ("MML") is a 99% owned subsidiary of the applicant. It is incorporated in Mozambique and farms macadamia nuts as well as grain and vegetables.
- [4] Upon MML's incorporation in 2012, the applicant approved a loan to MML in the sum of \$1 717 000 to enable it to fund certain costs associated with the establishment of a 700 ha farm from which a macadamia nut crop was expected to be harvested from 2018. Additional loans totaling \$13 750 000 were made by the applicant to MML in terms of two written loan agreements dated 2 October 2015. The terms of all the loan agreements are identical.

The following provisions of the loan agreements are relevant for present purposes:

- Clause 3.5 provides that MML shall not be obliged to repay the loan amount in full within 30 years of the approval date, as stipulated in each agreement, or the date on which the loan amount was advanced by the applicant to MML.
- Clause 3.6 provides that any repayment or redemption of the loan amount in full by MML to the applicant shall not take place if the market value of the assets of MML are less than the market value of its liabilities as of the date of the payment or redemption.
- Clause 3.7 provides that no interest shall accrue or be payable in respect of the loan amount during any year of assessment.

· Clause 7 provides that, in the event of an application being made for the liquidation of MML, or MML going into bankruptcy or business rescue or similar type proceedings, or judgment having been taken against MML and remaining unsatisfied for a period of 14 days, the agreement shall terminate with immediate effect without the necessity of notice and the loan amount, or any balance then outstanding, shall immediately become due and payable to the applicant.

[5] At the end of each year of assessment, after the initial loan was extended by the applicant to MML, the applicant and MML entered into a subordination agreement in relation to the applicant's claim against MML for the repayment of the loan amount outstanding as at the end of the particular financial year. The subordination agreement relevant to the 2015 year of assessment was completed on 30 June

2015. The relevant provisions thereof are the following:

· Clause 1.1 provides that the applicant agrees, subject to the limitation imposed in clause 4 thereof, that the applicant

subordinates for the benefit of the other creditors of MML, both present and future, so much of its claim against MML as will enable

the claims of other creditors to be paid in full.

· Clause 1.2 provides that the claims of the creditors of MML, both present and future, will rank preferentially to the subordinated

claim of the applicant.

· Clause 4 provides that the subordination of the applicant's claim shall remain in force and effect for so long only as the liabilities of MML exceed its assets, fairly valued and shall lapse immediately upon the date that the assets of MML exceeds its liabilities and shall not, except by further agreement in writing, be reinstated, if thereafter the liabilities of MML shall be deemed to continue to exceed its assets unless and until auditors of international standing have certified in writing that they have been furnished with evidence which reasonably satisfies them that the liabilities do not exceed the assets.

· Clause 5 provides that, until such time as the assets of MML, fairly valued, exceeds its liabilities, and the auditor's certificate referred to in clause 4 has been issued, it shall not be entitled to demand or sue for or accept repayment of the whole or any part of the amount subordinated owing to them by MML and set-off shall not operate in relation to the subordinated claim in respect of any debts owing by it then or in the future.

[6] In its income tax return for the 2015 year of assessment which was submitted to SARS on 25 September 2015, the applicant made an adjustment to its taxable income in terms of ss 31(2) and (3) of the Income Tax Act 58 of 1962 ("the ITA"). In broad terms, and insofar as is relevant, s 31(2) provides that where any transaction constitutes an "affected transaction" (which is defined in s 31(1), the relevant part of which refers to any transaction where that transaction has been entered into or for the benefit of either or both a person

that is a resident and a person that is a non-resident) and where any term or condition of that transaction is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length, and results in a tax benefit being derived by a party to that transaction, the taxable income or tax payable by any such person must be calculated as if that transaction had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length. Section 31(3), again in broad terms, stipulates that, to the extent that there is a difference between the amount applied in the calculation of the taxable income of any resident after taking s 31(2) into account and any amount that would, but for s 31(2), have been applied in the calculation of the taxable income of the resident, the amount of that difference, if the resident is a company, shall be deemed to be a dividend consisting of a distribution of an asset in specie declared and paid by the resident to the non-resident on the last day of the period of six months following the end of the year of

assessment in respect of which the adjustment is made.

- [7] The calculation of income tax which the applicant made in the return which it submitted for the 2015 year of assessment, was based on ss 31(2) and 31(3) of the ITA. It also accounted for payment of dividends tax that was deemed to have been declared and paid to- MML in terms of s 31(3).

The applicant was assessed by SARS on 25 September 2015 on the basis of those calculations.

- [8] The applicant states in its founding affidavit that it established during about November 2015 that the adjustment which it had made to its taxable income in terms of s 31(2) had been incorrectly made, having regard to the terms of the loan agreements as read with the subordination agreement. The applicant relies in this regard on the provisions of s 31(7) of the TAA. The relevant part of s 31(7) provides the following:

Where -

- (a) any transactionhas been entered into between a company that is a resident and any foreign company in which that resident company directly or indirectly holds in aggregate at least 10 per cent of the equity shares and voting rights and that transaction comprises the granting of financial assistance that constitutes a debt owed by that foreign company to that resident company ;
- (b) that foreign company is not obliged to redeem that debt in full within 30 years from the date the debt is incurred;
- (c) the redemption of the debt in full by the foreign company is conditional upon the market value of the assets of the foreign company not being less than the market value of the liabilities of the foreign company; and
- (d) No interest accrued in respect of the debt during the year of assessment,

this section must not apply to that debt.

- [9] On 18 December 2015, the applicant submitted a request to SARS for a reduced assessment in terms of s 93(1)(d)(ii) of the TAA. It was stated in the request that the applicant met the criteria referred to in s 31(7) of the ITA by highlighting the relevant provisions of the loan agreements set out above. It indicated that it had made an undisputed error in failing to apply the provisions of s 31(7) in the calculation of its taxable income. The applicant accordingly pointed out that its taxable income for the 2015 year of assessment erroneously reflected normal tax payable in the amount of R6 064 602 52 instead of R4 182 242.12 after reversing the interest adjustment made in terms of s 31(2) of the ITA.
- [10] Also on 18 December 2015, the applicant submitted a request for a reduced dividends tax assessment in respect of the 09-2015 period based on the application of s 31(7) of the ITA to the 2015 loans. It pointed out that it had made an undisputed error in failing to apply the provisions of s 31(7) in the calculation of its taxable - income for the- 2015 year of assessment, which gave rise to a higher deemed dividend resulting in an erroneous amount of dividend tax being paid in the sum of R1 062 109 instead of R63 344.25 ("the first request").
- [11] On 20 January 2016, SARS addressed an email to the applicant in which, inter alia, copies of the loan agreements were requested. The applicant responded on 22 January 2016 and furnished SARS with copies of all signed loan agreements. SARS responded on- 3 March 2016 and rejected the request for a reduced assessment for the following reasons:

- Clause 7 of the loan agreement states that in the event of MML being liquidated or going into bankruptcy the loan is immediately due and payable.
- This is contrary to the requirements of sections 31(7)(b) and (c) of the ITA.
- The loan is therefore more akin to debt rather than equity.

SARS concluded that the error was in fact disputed.

- [12] After having determined that the subordination agreement had inadvertently not been referred to or attached to the first request,

the applicant addressed a further request for a reduced assessment in which it explained that, at the end of each year of assessment, the applicant and MML had signed a subordination agreement for the cumulative loan amount outstanding as at the end of the

particular financial year. Copies of the subordination agreements were attached to the second request. The second request

states that the applicant had overlooked the existence of the subordination agreements and the impact they would have on the loan

agreements. The applicant pointed out that, in terms of the subordination agreements, the applicant waived its preferential ranking to call upon the debt in any and all circumstances where the liabilities of MML, fairly valued, exceeded its assets fairly valued

and that, in these circumstances, the obligation for MML to repay the loans was wholly conditional upon the market value of the assets of MML not being less than the market value of its liabilities. It was therefore contended that the effect of the subordination agreements was that they render clause 7 of the loan agreements inapplicable. This meant, the applicant said, that the requirements of s 31(7)(c) of the Act were applicable to the loan agreements. It was further submitted that the remaining requirements of s 31(7) had been met.

[13] On 7 November 2016, SARS declined the second request. In a letter addressed to the applicant, SARS states that it was not satisfied

that the criteria of s 31(7) of the ITA had been met for the following reasons:

- "Clause 7 of the loan agreement states that in the event of an application being made for the liquidation of MML, MML going into bankruptcy or business rescue or similar type of proceedings, or judgment having been taken against MML, then the loan agreement terminates and the loan is immediately due and payable. This could happen within 30 years.
- In terms of the subordination agreement, Crookes waived its preferential ranking to call upon the debt in any and all circumstances where the liabilities of MML, fairly valued, exceed its assets fairly valued.
- If any of the conditions described in clause 7 occur, the loan agreement terminates and the loan is immediately due and payable. The subordination agreement merely changes Crookes ranking amongst the creditors of MML. However, this doesn't detract from the fact that the loan is immediately due and payable.
- Therefore, I am of the opinion that the subordination agreement does not override clause 7 of the loan agreement.
- The existence of clause 7 of the loan agreement means that the requirements of sections 31(7)(b) and (c) of the IT Act are not met.
- The loan is therefore more akin to debt rather than equity. "

[15] In summary, the view of SARS is that the possibility exist that any one of the eventualities referred to in clause 7 of the loan agreements may occur within the 30 year period of the loan, that the loans may therefore become repayable in less than 30 years and that the loan agreements did accordingly not meet the requirements of ss 31(7)(b) and (c). It disagrees that the subordination agreement renders clause 7 of the loan agreements inapplicable.

[16] It was submitted on behalf of the applicant that SARS committed an error of law in that the assessment of tax payable is an annual event and that, therefore, it must be determined from year to year whether or not the requirements of s 31 (7) have been met. If in a

particular year the facts show that they have not, then the provisions of s 31(2) kick in. I respectfully disagree with the submission. The requirements of s 31(7) are clearly aimed at the nature of the transaction and not at the prevailing facts in a particular year. If, in a particular year, the market value of the assets of the foreign company exceeded the market value of its liabilities, such fact would not trigger the obligation of the foreign company to repay the loan as the foreign company is not obliged to redeem the loan in full within 30 years from the date on which the debt is incurred. It is only after expiry of the 30 year period that the obligation of the foreign company to redeem the loan will depend on whether or not the market value of its assets exceeds the market value of its liabilities.

- [17] In terms of clause 7 of the loan agreements, the agreements terminate with immediate effect and the loan amount, or any balance then outstanding, becomes immediately due and payable to the applicant in the event of an application being made for the liquidation of MML, or MML going into bankruptcy or business rescue or similar type proceedings, or judgment having been taken against MML and remaining unsatisfied for a period of 14 days. A situation may therefore arise which obliges the foreign company to repay the loan before the expiry of 30 years. It follows that the loan agreements therefore do not comply with the requirement of s 31(7)(b). The decision of SARS that the criteria of s 31(7)(b) had not been met, was therefore in my view correct.
- [18] The applicant obviously realised what the problem was after its first request for a reduced assessment was rejected, whereafter it submitted its second request which was founded on the contention that the subordination agreement made clause 7 of the loan agreements inapplicable. In terms of clauses 1.1 and 1.2 of the subordination agreement, the applicant agreed with MML to subordinate, for the benefit of the other creditors of MML, both present and future, so much of its claim against MML as would enable the claims of other creditors to be paid in full and that such claims of other creditors would rank preferentially to the subordinated claim of the applicant. Clause 4 of the subordination agreement provides the following:

"The subordination referred to in clauses 2[1] shall remain in force and effect for so long only as the liabilities of MML exceed its assets; fairly valued and shall lapse immediately upon the date that the assets of MML exceed its liabilities and shall not, except by further agreement in writing, be reinstated, if thereafter the liabilities of MML shall be deemed to continue unless and until auditors of international standing have certified in writing that they have been furnished with evidence which reasonably satisfies them that the liabilities do not exceed the assets."

The relevant part of clause 5 of the subordination agreement provides the following:

"CBL[2] hereby agrees that, until such time as the assets of MML, fairly valued, exceed its liabilities, and the auditor's certificate referred to in clause 4 above has been issued, it shall not be entitled to demand or sue for or accept the payment of the whole or any part of the amount subordinated owing to them by MML and set-off shall not operate in relation to the subordinated claim in respect of any debts owing by it now or in the future."

[19] It is apparent from the above quoted passages of the subordination agreement that they do not override clause 7 of the loan agreements or make it inapplicable. They simply regulate the subordination of the applicant's claim against MML to the claims of other creditors for such time as the liabilities of MML exceed its assets, during which time the applicant will not be entitled to the amount or sue for or accept payment of any part of the amount subordinated owing to the applicant by MML. The clauses cannot be interpreted to mean that the applicant shall not be entitled to claim immediate payment from MML in the event of an application being made for the liquidation of MML or any of the other eventualities provided for in clause 7 of the loan agreements occurring. Its claim will just be subordinated to the claims of other creditors of MML in circumstances where the liabilities of MML exceed its assets, fairly valued. The finding of SARS that the subordination agreement merely changes the applicant's ranking amongst the creditors of MML, and does not detract from the fact that the loans will become immediately due and payable under the circumstances provided for in clause 7 of the loan agreements circumstances, was therefore correct.

[20] In result, the application is dismissed with costs.

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Instructed by: Livingston Leandy Inc, Durban.

Counsel for respondent: Adv. A M Annandal SC.

Instructed by: Lomas-Walker Attorneys, Westville.

[1] This is an obvious error. The reference should have been to clauses 1.1 and 1.2

[2] The applicant.

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