

REPUBLIC OF SOUTH AFRICA



IN THE TAX COURT OF SOUTH AFRICA

GAUTENG

Case No: IT 14255

In the matter between:

ABC LIMITED

APPELLANT

and

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

RESPONDENT

J U D G M E N T

VICTOR J

[1] Does section 10(1)(a) and previously section 10(1)(b) of the Income Tax Act exempt ABC (Pty) Ltd from paying tax on its income? ABC (Pty) Ltd contends that it is exempt by virtue of it falling within the definition of Municipality whilst SARS contend it is not a Municipality and is thus not exempt. By agreement this is separated issue from the remaining issues and may be decisive of the income tax claimed by SARS. The appeal relates to the years 2010 to 2012.

[2] The appellant is ABC Ltd (ABC) a wholly owned subsidiary of the City. The City is the municipality. ABC was incorporated in terms of the section 17D of the Promotion of Local Government Affairs Act 91 of 1983 incorporated in terms of the Companies Act 71 of 2008. On 1 October 2012 it gave notice to SARS that it had amended its name from ABC D (Pty) Ltd to ABC Limited as required by section 11(3)(iv) of the Companies Act 71 of 2008.

[3] Since 2001 the City has registered municipal entities in companies to ensure quality top management and create effective services to the communities. State-owned companies (SOCs) exist in South Africa to drive economic development and improve service delivery to the large population and to exercise objective and independent judgement.

[4] The respondent is the Commissioner for the South African Revenue Service (SARS) a public official responsible for the administration and enforcement of the Income Tax Act 58 of 1962 (ITA) and the Tax Administration Act 28 of 2011 (TAA).

[5] Historically and up until 2010 SARS had allowed 100% deduction of ABC's doubtful debts. This resulted in ABC not being in a taxable position on its income. Thereafter SARS reversed this policy and allowed only a 25% deduction for doubtful debts as deductions from income. Clearly the extent of the doubtful debts is considerable, and this reduced deduction means that ABC was indebted to SARS for a considerable amount of tax.

[6] Section 10(1)(a) was promulgated after 1 January 2011 while 10(1)(b) applied prior to that date. In my view a separation of issues was justified as it could be dispositive of the appeal. ABC asserts that upon a proper interpretation of section 10(1) and (b) it is exempt from paying income tax on income as it is a local sphere of government. If this argument is successful it will not have to pay billions of Rand in income tax and penalties.

Statutory exemption from payment of Income Tax by Government Entities

[7] Prior to 1 January 2011 the section 10(1)(b)-exemption related to:

“the receipts and accruals of municipalities”

As from 1 January 2011 the section 10(1)(a)-exemption related to:

“the receipts and accruals of the government of the Republic in the national, provincial or local sphere”.

[8] ABC and SARS have diametrically opposed views on the meaning of the local sphere of government means. I will deal with the two approaches. Prior to doing so it is of cardinal importance to ascertain what the ordinary and grammatical meaning of words local sphere is. In *National Credit Regulator v Opperman & Others* 2013 (2) SA 1 (CC), Cameron J stated at paras 99 and 100 the following in relation to interpreting statutes:

“[99] A longstanding precept of interpretation is that every word must be given a meaning. Words in an enactment should not be treated as tautologous or superfluous. This is for good reason. Interpretation is a cooperative venture between legislature and judge, bounded by mutually understood rules, in which the latter seeks to give meaning to the text enacted by the former ...

[100] The shared enterprise is imperilled if this precept is too readily ignored. It could seem to license judges to pick and choose among words and phrases, and to omit those considered inconvenient. That cannot be. Everything the legislature has enacted must be included in the meaning assigned to the whole. The rule performs a boundary-setting function. Its observance shows that judges are staying within their assigned role of interpretation, and not straying outside it into amendment, enactment or innovation. As this court pointed out in its very first judgment, if the language used by the lawgiver is ignored in favour of other pursuits, 'the result is not interpretation but divination'. Though said in a different context, the point is that constitutionalism has not upended the basic rules of interpretation."

[9] An analysis of the two approaches must commence with the first step and that is to engage the text as it currently stands in section 10(1)(a). The words are the "local sphere of government".¹ The Constitutional purpose is to divide the Government of the Republic of South Africa in three constitutive groups, namely national, provincial and local sphere.

[10] A local sphere of government is defined in section 40 of the Constitution as follows:

"Government of The Republic

Section 40

(1) In the Republic, government is constituted as national, provincial and local spheres of government which are distinctive, interdependent and interrelated."

[11] There is nothing superfluous or tautologous in section 40 of the Constitution. A natural interpretation flowing from the words local sphere of government is that of a unit of government. The definition does not refer to constituent parts in defining the three spheres of government. The textual reading of section 40 does not suggest of any compartmentalising. It is Chapter 7 that provides for the structure of the local sphere of government and its constituent parts. In relevant part these include the status of municipalities, objects of local government, developmental duties of municipalities, their powers and functions.

The Constitutional Scheme in defining Municipalities' duties to provide services

[12] In terms of section 151(1) of the Constitution the local sphere of government consists of municipalities.² The prime purpose of the local sphere of government is to provide services to their communities in a sustainable manner.³ Section 156(1) of the Constitution defines the powers and functions of municipalities. Schedule 4 Part B provides for the reticulation of electricity and gas.⁴

¹ My emphasis.

² Section 151(1) of the Constitution.

³ Section 152(1)(b) of the Constitution.

⁴ Section 156(1) and (2) read with Schedules 4B and 5B of the Constitution

[13] A municipality may provide municipal services through an “internal mechanism”, or through an “external mechanism”,⁵ which is “any other institution, entity or person legally competent to operate a business activity”.

[14] The City is a municipality and is constitutionally obliged to provide electricity services to the people of the City. It elected to supply electricity through an “external mechanism” by concluding a service delivery agreement with an external service provider being ABC.⁶

[15] A central consideration is whether faced with the tight control by the City, does ABC become an organ of state for fiscal determination and find exemption as a local sphere of government in terms of section 10(1)(a) of the ITA? ABC contends that it is to be considered a local sphere of government by virtue of inter alia the tight control exercised by the City. SARS on the other hand essentially disputes that ABC qualifies to be a local sphere of government. It argues that the receipts and accruals of ABC are not those of “the government of the Republic” in any of the three spheres of government.

[16] When ABC was incorporated on 30 November 2000, the Promotion Local Government Affairs Act⁷ was in operation. The Local Government: Municipal Systems Bill and the Local Government Municipal Finance Management Bill was in legislative process.⁸ It was recognised in the sale of business agreement concluded that these pieces of legislation would have drastic effects in relation to the form, structure and the general affairs of ABC when section 17 D would no longer have any effect.

[17] In terms of section 17D a local authority could form, register, promote and hold shares in a company as per the Companies Act. In fact, section 9 of the Companies Act specifically provides for the incorporation of State-Owned Companies, provided the objects are the same as in this case a local authority. Of importance the written business agreement provides that the City should reduce its shareholding in the programme. With effect from 1 March 2001 and in terms of section 8(1) the Local Government: Municipal Systems Act⁹

⁵ Section 76 provides: “A municipality may provide a municipal service in its area or a part of its area through—...an external mechanism by entering into a service delivery agreement with—

- (i) a municipal entity;
- (ii) another municipality;
- (iii) an organ of state, including
- (iv) a community-based organisation or other non-governmental organisation legally competent to enter into such an agreement, or
- (v) any other institution, entity or person legally competent to operate a business activity.”

(Underling for emphasis)

⁶ Section 76(b)(v) of the Local Government Systems Act 32 of 2000.

⁷ 91 of 1983

⁸ ee clause 11 of ABC’s original Memorandum of Association, Trial bundle, page 9

⁹ 32 of 2000.

(“the Municipal Systems Act”), the City took over all the functions and powers as provided for by the Constitution.

[18] Chapter 8 of the Municipal Systems Act deals with municipal services. Section 73(1) and (2) imposes a general duty on municipalities to give effect to the Constitution by effecting service delivery to their communities. It can do so through a “municipal entity” which is defined in section 1 of the Municipal Systems Act and in terms of section 1(a) the municipal entity as a private company referred to in section 86B(1)(a). Chapter 8 provides for the functioning of these private companies. Section 86D(b) provides that such an entity shall have no competence to perform any activity which falls outside the functions and powers of its parent municipality contemplated in Chapter section 8. In terms of section 86E such private company shall be a mechanism to assist in achieving the goals of the municipality.

[19] In terms of section 81 the municipality remains responsible to ensure that there is service delivery to the local community and to monitor same. Section 81(2) provides:

- “(a) (i) the collection of service fees for its own account from users of services in accordance with the municipal council's tariff policy in accordance with the credit control measures established in terms of Chapter 9. The municipality also retains the right to set, review and adjust tariffs.”

Statutory Considerations in determining whether ABC is a Local Sphere of Government

[20] It is necessary to consider the jurisprudential basis for determining whether entities are organs of state. ABC argued that the word “municipality” in the erstwhile section 10(1)(b) of the ITA and the term “local sphere of government” in section 10(1)(a) of the ITA, includes a “municipal entity” such as ABC. If so, the section 10(1)(a) exemption applies and even prior to 1 January 2011 the section 10(1)(b) exemption applied.

[21] SARS referred to Income Tax Case no. 327¹⁰ as supporting the meaning of what constitutes “government”. There the court found that an employee of a Board formed by Government was nonetheless the Board's employee and not a government employee notwithstanding that Government had formed the Board. The Board had been established to further the interests of government and had been created by Statute and derived its funds from the Collector of Customs like a great many non-governmental bodies do and it was quite independent. SARS submitted based on the finding set out in ITC 327 the same principal ought to be applied in this matter.

¹⁰ (1935) 8 SATC 254 (U).

[22] ABC relies on *City Power (Pty) Ltd v Grinpal Energy Management Services (Pty) Ltd*¹¹ and submits the contrary. It is to be noted that *Grinpal* was determinative of labour legislation not being subservient to the provisions of the Municipal Systems Act and more particularly:

“The Johannesburg Municipality cannot avoid its constitutional obligations and public accountability for the rendering of public services by forming a municipal entity like City Power. It remains accountable to the people of South Africa for the performance of those functions by City Power. Likewise, City Power cannot avoid its constitutional obligations and public accountability by delegating its functions to Grinpal.”

[23] The principle established applies to a Municipality not being able to avoid its constitutional obligations by establishing a municipal entity such as ABC. *Grinpal* involved the handing over of a business as a going concern where ABC could not avoid its constitutional obligations. In my view ABC cannot avoid its fiscal obligations by virtue of the principle established in *Grinpal*.

[24] The duties and responsibilities of parent municipalities are defined in the Local Government: Municipal Systems Act 32 of 2000 (“Systems Act”). Section 93A(b) provides that the parent municipality of a municipal entity must allow the board of directors and chief executive officer of the municipal entity to fulfil their responsibilities.

[25] Section 93E regulates the appointment of the Directors of the Board and provides that:

“(1) The board of directors of a municipal entity—

- (a) must have the requisite range of expertise to effectively manage and guide the activities of the municipal entity;
- (b) must consist of at least a third non-executive directors; and
- (c) must have a non-executive chairperson.”

[26] Once appointed, it is then the duty of the Board to *inter alia* provide effective, transparent, accountable and coherent corporate governance and conduct effective oversight of the affairs of the municipal entity.¹²

[27] The Chief Executive Officer of the entity is appointed by the Board. Once appointed, the CEO reports to the Board.¹³

¹¹ 2015 JDR 0738 (CC), para [20].

¹² Section 93H.

¹³ Section 93J.

[28] The Local Government: Municipal Finance Management Act 56 of 2003 ("MFMA") is relevant to the interpretation as to whether ABC falls within the sphere of local government. The said Act indicates that a municipal entity is independent and manages its own affairs.

[29] The MFMA also deals with bank accounts at section 85(2) and provides that:

- "(1) A municipal entity must open and maintain at least one bank account in the name of the entity.
- (2) All money received by a municipal entity must be paid into its bank account or accounts, and this must be done promptly and in accordance with any requirements that may be prescribed."

(Underlined for emphasis)

[30] The Bank account is administered by the accounting officer who is accountable to the board of directors for the entity for the entity's bank accounts.¹⁴

[31] SARS argues that ABC agreed, through the Service Level Agreement to grant the City access to its accounts and does not detract from the fact that the decision over the bank account is exercised solely by the accounting officer and the Board. In my view this is a further fact that ABC is not solely controlled by the City.

[32] SARS disputes the contention that ABC is simply an arm of the local authority. This would mean that any private company would qualify as the government in one of its spheres simply because the government holds the shareholding in such company. The government (in one of its spheres) contracts with that entity to render services which the government is under a duty to render. SARS argues that based on the finding set out in ITC 327, the same principal ought to be applied in this matter. It asserts that such a step does not convert a company into "the government" in "its spheres".

[33] A further argument by SARS is that other state-owned entities (SOEs) are not exempt from tax and are regarded as taxpayers. State-owned entities are not the Government nor a municipality.

[34] In my view there is accordingly a marked difference between a municipality as a "sphere" of the government on the one hand and a private company incorporated under the Companies Act albeit wholly owned by a local authority. On a proper interpretation, section 10(a) and (b) cannot be read to exempt municipal entities such as ABC from paying income tax.

¹⁴ Section 85(5).

Framework of the Business Agreement between the City and ABC

[35] The business agreement concluded between the parties is extensive and, in my view, must be considered as to whether its substance is antithetical to the notion of it being a local government in the fiscal sense. Mr. X who was the relevant legal advisor in the year 2000 and has also been the Company Secretary since 2006 confirmed all the business documents put to him. Ms. Y also testified. She was the head of the legal department of the City when ABC was established. She confirmed that the Service Delivery Agreement was implemented, with effect from 1 January 2001, notwithstanding the fact that the second signature to the agreement was only appended on 1 September 2006. She also testified that there was compliance with the terms and conditions of the Service Delivery Agreement. In particular she described that the City oversaw everything done by ABC. The import of their evidence was to demonstrate the complete control of ABC by the City.

[36] Clause 3.1 of the sale of Business Agreement provides that the City sells to ABC the business as a going concern subject to the relevant laws and regulations read with the Service Delivery Agreement. The purchase price was R1 394 280 023 as set out in Clause 4.1. It was obligated to provide electricity distribution services. The purchase price was payable as follows: an amount equal to R700 million would constitute a loan by the seller to the purchaser and be payable as set out in the respective Loan and Shareholder agreements. The balance of the purchase price would be discharged through the allotment and issue by purchaser to the seller of one fully paid up ordinary share. ABC undertook to cooperate and comply with determinations of the Assets and Liabilities Committee of the City. It also undertook to participate in the City's treasury function and to participate in the 24-hourly sweeping of municipal entities' bank accounts. Clause 8 sets out the roles and duties of the City with the establishment of a Contract Management Unit. ABC agreed to all the constitutional obligations of the City in the field of electricity distribution. The agreement also provided that the City would continue to invoice and collect service fees in terms of an agency agreement.

[37] In terms of the Service Delivery Agreement concluded between the appellant and the respondent on 1 September 2006 the services to be provided by ABC *"... shall be their electricity distribution services and shall include the following obligations ..."*. In terms of clause 5.4 it was recorded that *"... the provisions of the electricity distribution services pursuant to this SDA constitutes the core business of ABC"*.

[38] SARS submits the fact that ABC undertook such services does not mean it is a municipality or that it is subject to the same legislation and regulations as the City. The Treasury Department would not control it in the same way as it would a municipality.

[39] In terms of clause 5 a further feature referred to by SARS is in the recordal of powers¹⁵ in the Memorandum of Association. ABC has all the attributes consistent with a commercial company and not only to distribute electricity. SARS listed these powers as –

“powers to lend money to any person or company, to invest money in accordance with the investment policies approved by the directors from time to time, to undertake participation in business and enter into contracts outside the Republic.”

[40] An important submission by SARS in making a distinction states the following:

“The effect of the “*ring fenced*” entity performing the functions of electricity distribution is that the receipts and accruals are those of the company whereas in instances where a City Council itself directly distributes electricity, the receipts and accruals in relation to the supply of electricity would fall into the general funds of the local authority. The evidence of both Mr. X and Ms. Y accepted (as they were bound to do) that the income from the supply of electricity by ABC is income accruing and belonging to ABC, i.e. notwithstanding that the City may have access to such monies. Such income is reflected in the ABC’s financial statements. The funds have thus accrued to ABC. What it decides to do with such funds at a later stage does not change its character.”

The effect of the explanatory memorandum by SARS

[41] Lastly in considering the interpretation of section 10(1)(a) and (b), the explanatory memorandum of the Revenue Laws Amendment Bill, 2006 is relevant, SARS relied on the following explanation in referring to the Memorandum:

41.1 In 2006 the Legislature changed the word “local authority” to “municipality”. In terms of section 10(1)(a) and (b) receipts and accruals related to municipalities.

41.2 SARS refers to the reasons for the amendment in the Explanatory Memorandum:

“The Income Tax Act contains various forms of exemption for different spheres of Government. National and Provincial governments are fully exempt under section 10(1)(a)”¹⁶

41.3 The Explanatory Memorandum explains the treatment of entities that are subject to the PFMA and states that:

“Certain institutions, boards and bodies subject to the Public Finance Management Act, 1999 (Act No. 1 of 1999) (‘PFMA’) are exempt from income tax under section 10(1)(cA), along with their wholly owned subsidiaries. Municipalities

¹⁵ Clause 5 p5–7.

¹⁶ Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006.

receive exemption as a “local authority” under section 10(1)(b), but municipal entities that are subject to the Municipal Finance Management Act, 2000 (Act No. 32 of 2000) (‘MFMA’) are fully taxable.”

41.4 The Legislature made a distinction between “municipalities” and other specialised non-privately controlled entities, that might have otherwise fallen under the definition of “local authorities”. Reference is made to its approach as follows:

“The various references to local councils, boards and committees are outdated. The definition of local authority will accordingly be scrapped in line with the new system for local government as prescribed by the Local Government: Municipal Structures Act, 1998 (Act No. 117 of 1998). Henceforth, only “municipalities” (Categories A, B and C) will be exempt as opposed to “local authorities.” Collateral changes in this regard have already been made in the Value-added Tax Act along with corresponding changes to the Transfer Duty Act.”¹⁷

[42] SARS submits that the interpretation of the local sphere of government must be understood within the context of the explanatory memorandum. SARS argued that it is within this context that the definition and scope of the term “Municipality” must be understood.

[43] SARS in describing the statutory structure and the business framework, submits it is clear that ABC was incorporated for business efficacy. SARS also refers to the previous exemption in section 10(f)(viii) which has now been deleted:

“(viii) of any Regional Electricity Distributor that is wholly owned by any person that is exempt from normal tax during any year of assessment commencing before 1 January 2014, or before a later date that may be determined by the Minister by notice in the *Gazette*.”

[44] A “regional electricity distributor” is defined in section 1 of the ITA as:

“**‘regional electricity distributor’** means an electricity distribution services provider established after 30 June 2005 that is—

- (a) a public entity regulated under the Public Finance Management Act;
- (b) a wholly owned subsidiary or entity of a public entity contemplated in paragraph (a) if the operations of the subsidiary or entity are ancillary or complementary to the operations of that public entity; or
- (c) a company as contemplated in paragraph (a) of the definition of ‘company’ which is wholly owned by one or more municipalities.”

¹⁷ Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006.

[45] SARS points out that ABC was established in the year 2000 and is outside of this exemption of the ITA. Section 10(t) was deleted in 2014 by removing the exemption for regional electricity distributors.

[46] The exemption of regional electricity distributors was explained in the Explanatory Memorandum of the Revenue Laws Amendment Bill, 2006, where it was recorded that:

“Government is in the process of restructuring electricity distribution. In the future, this function will be consolidated into entities (known as the REDs) for more efficient coordination. The transfer of electricity distribution operations from municipalities to REDs triggers various tax issues.”¹⁸

[47] The Memorandum distinguishes between a Municipality and electricity distributors and states that:

“... all activities conducted by municipalities are fully exempt from income tax; whereas, the REDs should (in all-likelihood) be subject to income tax because electricity distribution is a commercial business activity (as opposed to a regulatory activity). The shift from exempt to fully taxable status could, however, undo some of the benefits of the desired consolidation, especially if full taxation takes immediate effect. In order to transitionally alleviate this problem, the newly created REDs will be fully exempt from income for all years of assessment commencing before 1 January 2014 (or a later date determined by the Minister if necessary) (section 10(1)(t)(viii)). Correlative adjustments are also made for the Value-Added Tax Act.”

[48] It is also noteworthy that the memorandum added a note as follows:

“Note: Eskom will not benefit from any of the proposed changes (i.e. the amendment will apply only to electricity distributors established after 1 January 2005. Eskom has long been fully taxable so continued taxation should not impact electricity restructuring process. However, asset transfers by Eskom to the REDs may require further legislative change at a later date.”

[49] Section 10(1)(t)(viii) was later deleted as the system of regional electricity distributor lapsed on 1 January 2014 as it had not been implemented by the stipulated date.¹⁹

[50] SARS also made reference to the interpretation of section 10(1)(cA) of the ITA which exempts the receipts and accruals of any institution, board or body other than a company as defined in the Companies Act satisfying certain criteria. In terms of section 10(1)(cA)(ii) a company may be exempt where it has been approved by the Commissioner subject to the provisions and conditions of such subsections. SARS concedes there may be situations where a company may indeed qualify for exemption as qua entity but not in the sphere of local government.

¹⁸ Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006 page 41 clause D

¹⁹ Explanatory Memorandum on The Taxation Laws Amendment Bill, 2014

[51] ABC in seeking a purposive interpretation and submitted that it was necessary to move away from a literal interpretation of the statute and relied on the dicta in *Natal Joint Municipal Pension Fund v Endumeni Municipality*²⁰ where Wallis JA stated the following:

“Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence.”

[52] ABC also argued that in preserving constitutional validity its financial situation was relevant. It gave an example of the enormity of their financial situation. If it is not exempt it would struggle to carry out its constitutional role. In the dossier there is a letter from SARS setting out the liability of ABC referring to the partial disallowance. The amounts claimed as deductions by ABC in the relevant years was R6,4 billion and only allowed R1,4 mill deduction equalling the 25% of doubtful debts deduction was allowed. What is more, the deduction of 28% company income tax on the remaining amount of approximately R5 billion not being allowed to be deducted, is approximately R1,4 billion. ABC argues that this would be prohibitive and unsustainable.

[53] ABC submits that when accumulated losses have been depleted it would have to be funded from somewhere. If ABC is not entitled to the exemptions, this would indeed result in oppressive consequences stultifying the broader operation of the relevant legislation, as warned against in the *Endumeni* judgment.²¹ There are no facts justifying the assertion that the payment of income tax in these circumstances will stultify the constitutional obligations of the City to its people.

[54] In conclusion the taxation of state owned enterprises remains a much debated subject internationally. The academic Cui, Wei, “Taxing State-Owned Enterprises: Understanding a Basic Institution of State Capitalism” (2016) ²² describes theories of the income taxation of SOEs. He argues that prior theoretical literature has offered three conflicting views of SOE taxation. The first is that SOE taxation is superfluous, because the government shareholder can simply demand profit distributions from the firms. The second is that SOE taxation is necessary to put state-owned and private firms on an equal competitive footing. The third view postulates a novel theory of taxation and explores its implications for international tax policy. The significance of SOE taxation lies in the fact that SOE managers, like managers of private firms, are dividend averse; in the absence of other effective mechanisms to secure adequate pay out, SOE taxation serves the purpose of forcing

²⁰ 2012(4) SA 593 (SCA) paragraph [18] at 603 F – G.

²¹ [26] at page 610 (c) of the judgment.

²² Osgoode Legal Studies Research Paper Series. 124. Taxing State-Owned Enterprises: Understanding a Basic Institution of State Capitalism Wei Cui Conclusion.

distributions. It follows that that the implementation of SOE taxation should be evaluated not as some unreflective notion of fairness or neutrality, but of some an alternative mechanism for forcing distributions. Clearly in this case the direct taxation of ABC will ensure fiscal fairness for all state owned enterprises.

In the result the appeal is dismissed.



M Victor

President Tax Court