The Tax Dos and Donts of SBCs

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A Small Business Corporation (or SBC) may qualify for favourable tax treatment if it meets certain requirements in the Income Tax Act (ITA). The benefits, requirements, and common pitfalls are summarised below.

Benefits

Companies (including close corporations) are generally subject to a flat rate income tax of 28%. SBCs are subject to more favourable tax rates on taxable income up to R550 000. The SBC tax rates for financial years ending between 1 April 2018 and 31 March 2019 are:

- 0% of taxable income up to R78 150.
- 7% of taxable income above R78 150.
- R20 080 + 21% of taxable income above R365 000.
- R58 930 + 28% of taxable income above R550 000.

SBCs also qualify for an accelerated depreciation allowance on plant and machinery (or movable assets). Movables owned and acquired by an SBC for a cost qualify for this allowance. The cost is determined as the lesser of the actual cost to the SBC or the amount that would have represented an arms length cost. Assets that were acquired by a SBC for no consideration will not qualify. Such assets may qualify for the general wear and tear allowance, based on the amount by which, in the Commissioners view, the value of the assets has been diminished during the year of assessment.

An SBC may elect to claim the following deductions in respect of movable assets brought into use for the first time by the SBC:

- Assets used directly in a process of manufacture or similar process: 100% of the cost in the year of assessment in which the asset is first brought into use.
- Other qualifying assets: 50% of the cost in the year of assessment in which the asset is first brought into use, 30% in the first succeeding year, and 20% in the second succeeding year.

SBCs can elect to claim the general wear and tear allowance or the special allowance. The latter is usually more favourable from a timing perspective, especially for assets used directly in a process of manufacture.

Requirements

To qualify for the special tax treatment, the SBC must meet six requirements, namely:

1. Corporate entity:Only close corporations, co-operatives, private companies and personal liability companies currently qualify for the SBC regime.
2. Natural shareholders:Shareholders of the SBC must be natural persons throughout the year of assessment.
3. R20 million gross income:The SBCs gross income for the year of assessment may not exceed R20 million.
4. Shareholders not to hold shares in other entities:Shareholders or members of an SBC may not hold a share or interest in the equity of another company, close corporation or co-operative, other than listed companies; collective investment schemes; body corporates, share block companies and certain associations; less than 5% of the interest in certain co-operatives; friendly societies; less than 5% of the interest in certain co-operative banks; venture capital

companies; companies, close corporations or co-operatives which have never carried on any trade and never owned any assets with a total market value exceeding R5 000; and companies, close corporations or co-operatives which have taken certain steps to liquidate, wind up or deregister, which steps have not been withdrawn or invalidated.

5. Investment income and income from rendering of a personal service 20% rule:Not more than 20% of the total receipts and accruals of the SBC may collectively consist of investment income and income from the rendering of a personal service. Investment income includes dividends, foreign dividends, royalties, rental in respect of immovable property, annuities or income of a similar nature, interest and proceeds from investment or trading in financial instruments, marketable securities or immovable property. Personal service includes services performed in a wide array of fields if the service is performed personally by any person who holds an interest in the SBC or by a connected person in relation to a person who holds an interest in the SBC. Services will not be regarded as personal services if the SBC throughout the year of assessment employs three or more full-time employees who are on a full-time basis engaged in the business of the SBC of rendering the service (other than shareholders or members of the SBC, or connected persons in relation to them).
6. Exclusion of personal service providers:The SBC may not be a personal service provider. A company is a personal service provider if a connected person in relation to the company renders services on behalf of the company and the person would otherwise have been regarded as an employee of the companys client; or the client exercises control or supervision over the manner in which the duties are performed in cases where the duties must be performed mainly at the premises of the client; or more than 80% of the companys income from services for the

year of assessment consists of or is likely to consist of amounts received directly or indirectly from any one client or an associated institution in relation to a client. A company will not be regarded as a personal service provider if it (throughout the year of assessment) employs three or more full-time employees who are engaged in the business of the company of rendering the service on a full-time basis (other than shareholders of the company or connected persons in relation to them).

Pitfalls

Companies held by trusts do not qualify as SBCs, even if all the beneficiaries of the trust are natural persons. The natural persons must hold the shares in the SBC directly.

SBCs should inform their shareholders or members of the prohibition on the holding of shares or interests in the equity of other companies, close corporations, or co-operatives, and the exceptions to this rule. A single shareholder holding prohibited shares in another company may result in the SBC as a whole being disqualified from the regime. Shareholders may unknowingly contravene this rule if they hold shares in dormant or semi-dormant companies. Even if an entity never carried on a trade, it will only be an allowable exception if it never owned any assets with a total market value exceeding R5 000. Entities that previously carried on a trade (no matter how long ago) will only qualify as an allowable exception if formal steps have been taken to liquidate, wind up, or deregister.

To ensure compliance with the 20% rule, receipts and accruals should be classified appropriately. Only amounts that properly constitute consulting fees should be labelled as such. Owner operated companies that mainly provide services will usually fall foul of the 20% rule in relation to income from rendering a personal service. These companies may also constitute personal service providers. To overcome both of these difficulties, a company can appoint three or more full-time employees who are not shareholders or connected persons in relation to the shareholders. Companies will also fall foul of the 20% rule if they derive excessive income from the rental of immovable property (or other investment income). One would therefore not expect SBCs to own substantial immovable property other than immovable property occupied by itself.

When a companys gross income exceeds the R20 million threshold it will, from the commencement of that year of assessment, be taxed at the flat corporate income tax rate of 28%. The SBC regime is worthwhile to benefit from until this threshold is reached.

SARS prescription only starts once tax return has been submitted

Author: *Eric Madumo, a Candidate Attorney and Joon Chong, a Partner at Webber Wentzel.*

In the recent case of *CSARS v Char Trade*, the Supreme Court of Appeal (SCA) that prescription begins to run against CSARS when a return for secondary tax on companies (STC) is submitted to SARS by a taxpayer. In the Char Trade case, a return for STC had not been submitted by the taxpayer. Due to this, prescription had not begun to run against CSARS. The result of this is that CSARS was able to make an assessment in 2012 of the taxpayer's liability amounting to ZAR 1,812,609 for the 2007 cycle.

The essence of the taxpayer's argument was that more than 5 years had passed since the 2007 cycle and thus, it was not liable for the assessment in relation to that year. In the court a quo, it was found that the 2007 assessment had prescribed because more than five years had passed since the return and payment were deemed due in terms of s 64B(7) of the Income Tax Act (ITA).

The SCA found that prescription had not begun to run and it reasoned that, in terms of s 102 (1)(a) of the Tax Administration Act (TAA), Char Trade bears the onus of proving that it is not liable for STC in 2007. To do so, Char Trade has to show that in terms of s 99 (1)(b) of the TAA, that five years have expired after the date of the original assessment. The court went on further to reason that Char Trade was obliged in terms of s 64B(7) of the ITA, to submit a return for STC for 2007. This required a self-assessment as defined in the TAA as being a determination of the amount of tax payable under a tax act by a taxpayer and submitting a return which incorporates the determination of the tax or if no return is required, making a payment of tax.

The SCA then posed the question of when did the five year prescription period begin to run? S99(1) of the TAA states that an assessment may not be made in terms of this chapter, in the case of self-assessment for which a return is required, five years after the date of assessment of an original assessment by way of self-assessment by the taxpayer or if no return is received by CSARS.

S1 of the TAA defines date of assessment to mean, in the case of self-assessment by the taxpayer, the date that the return is submitted. The SCA then found that the intended effect of s 99(1)(b) of the TAA, read with the definition of date of assessment as per the TAA, is that prescription cannot begin to run against CSARS until such time as a return that the taxpayer informs CSARS about a dividend, including a deemed dividend, and that STC is payable hereon.

Therefore, prescription in relation to the 2007 cycle could only commence once Char Trade had filed a return for STC. Char Trade had acknowledged that it was liable for STC and was obligated to file returns for all the years of assessment from 2007 to 2012. The return for the year 2007 would have constituted the original assessment. Char Trade failed to submit the STC return and therefore, there was no original assessment from which the five year period could run.

The SCA found that prescription had not begun to run and that the court a quo erred in finding that five years had passed. The appeal was upheld and the assessment for the dividend cycle ending in the 2007 year of assessment was confirmed.

Moving forward, it would appear that the reasoning of the SCA will be applied to other forms of taxes with the underlying principle being that if a return requires a self-assessment as defined in in the TAA, and a taxpayer is required to submit a return to SARS then prescription will only begin to run from the date that the return is submitted to SARS.

The capital v revenue

question in the context of government grants: The SCA decides in favour of the motor manufacturing industry

Author: Louis Botha and Louise Kotze.

In the recent case of *Volkswagen South Africa (Pty) Ltd v Commissioner for South African Revenue Service* 80 SATC 179, the age-old question of whether a receipt is capital or revenue in nature was addressed by the Supreme Court of Appeal (SCA), in the context of government grants paid to motor vehicle manufacturers.

Background and relevant facts

In order to ensure the South African motor manufacturing industry remained internationally competitive, the South African Government initiated a motor industry development program (MIDP) in 1995. One of the objectives of the MIDP was the rationalisation of the motor car models being produced. In other words, the program sought to reduce the number of models being produced to improve performance and save costs. The rationalisation required plant and machinery upgrades and technology enhancements (both of which involved substantial capital outlay) and as such, the Board on Tariffs and Trade recommended the introduction of a Productive Asset Allowance (PAA). The PAA, which was provided in the form of a PAA certificate, was available to those manufacturers that invested a certain minimum value in productive assets for the manufacture and assembly of light motor vehicles. The certificate provided for a rebate on customs duty for certain categories of motor vehicles, which was to be calculated as a percentage of the value of the productive assets approved by the Director-General: Trade and Industry. As such, manufacturers that participated in the PAA scheme were reimbursed for an amount up to 20% of the capital expenditure incurred in the rationalisation process by setting the rebate off against the customs duty the manufacturer was liable to pay on the importation of vehicles to be sold in South Africa.

Volkswagen South Africa (Pty) Ltd (Taxpayer), is a motor manufacturer involved in the manufacture and sale of motor vehicles, including the importation and exportation thereof. The Taxpayer participated in the PAA scheme and received certificates for the 2008 to 2010 years of assessment, which rebate amounts were reflected in its income tax returns as accruals of a capital nature. The South African Revenue Service (SARS) rejected these amounts as being capital in nature and issued assessments on the basis that these amounts were revenue in nature. The Tax Court confirmed SARSs assessments, which decision the Taxpayer appealed against.

Legal principles considered by the SCA

The pivotal question, in this case, was whether the PAA certificates constituted receipts or accruals which were capital or revenue in nature.

Despite the myriad of court decisions regarding the determination of whether an accrual or receipt is capital or revenue in nature (and the numerous guidelines that accompanied them), there are no set rules that can be applied to make this determination. Various cases have reiterated that regard must always be had to whether the accrual arose from the realisation of a capital asset or whether it was received in pursuance of a profit-making scheme. Despite these guidelines, the courts have also stated that commercial and good sense must always be the overarching basis on which such a determination must be made.

Interpretation Note 59 issued by SARS on 10 December 2010 (IN59) also gives an indication of which receipts or accruals of government grants will be considered as capital in nature and which will be revenue in nature. Most relevant to this matter is paragraph 3.2.3, which states the following :

A government grant will be of a revenue nature in the hands of a person carrying on trading operations if it is a trading receipt. A grant is a trading receipt if its receipt is a normal incident of a persons trading operations. The nature of the grant received and the relationship which exists between the grant received and the recipients activities needs to be examined.

A government grant will be a trading receipt when it is paid in order to assist in meeting a persons trading obligations or in order to assist in carrying on trading operations. A grant of this nature results in trading receipts being supplemented and accordingly is itself a trading receipt.

By contrast, any amount received or accrued for the purpose of:
establishing an income-earning structure, or
compensation for the surrender of such a structure, is of a capital nature.

IN59 suggests that SARS regards the purpose of a government grant of utmost importance in determining whether such grant is capital or revenue in nature.

Judgment

The Taxpayer contended that the matter could be decided by answering two questions, these being:

1. What was the real and basic cause of the accrual (i.e. in respect of what activity was the grant made); and
2. Whether the abovementioned cause was more closely associated with the equipment of the taxpayers income-producing machinery (which would make it capital in nature) or with its income-earning operations (which would make it revenue in nature).

The court considered this approach and found it to be appropriate considering the nature of the matter.

SARS contended that the PAA certificates could only be redeemed by the payment of customs duties and therefore only accrued once the motors had been imported. As such, they were so closely connected to the income producing activities of the Taxpayer that they were revenue in nature. The SCA disregarded this contention and held that the PAA certificates did not accrue only once the imports had been made but immediately after they had been issued to the Taxpayer. It found that the PAA certificates were issued to compensate manufacturers for at least a portion of the capital expenditure incurred in pursuance of the rationalisation of motor vehicle models and that this clearly distinguished them as capital in nature. The SCA added that the inability to trade the PAA certificates was a further indication of the capital nature thereof.

It was held that the capital investment made by motor manufacturers was at the centre of the PAA scheme and that without these capital investments, no certificates would have been issued. Furthermore, if the grants had been paid in cash, there would have been no dispute regarding the capital nature thereof. As such, the fact that the grants were paid in the form of rebates does not change the capital nature of the benefit received by the Taxpayer.

The SCA concluded that the PAA certificates were in no way received as part of a scheme of profit making and reimbursed the Taxpayer in respect of a percentage of its capital expenditure. The SCA, therefore, upheld the appeal and declared that the PAA certificates were capital in nature.

Comment

The case raises a number of interesting issues. Firstly, it is submitted that the SCA applied the principles regarding the classification of the accruals correctly, by determining that the PAA certificates were capital in nature. The SCAs reliance on the contents of IN59 is interesting. In our Tax and Exchange Control Alert of 4 May 2018, we referred to the Constitutional Courts decision in Marshall NO and Others v Commissioner for SARS (CCT208/17) [2018] ZACC 11 (25 April 2018) where it was held that it would only be justified to rely on an interpretation note, if it reflected a practice of an impartial application of a custom recognised by all concerned. Despite the Constitutional Courts judgment that followed the SCA judgment, It could be argued that the principles in IN59 regarding the classification of government grants could be relied on, as the principles appear to be consistent with the established principles laid down in South African jurisprudence regarding the determination of an amount as capital or revenue in nature.

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SARS issues new guide to understatement penalties – a

march toward further certainty?

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The Tax Administration Act, No 28 of 2011 (TAA) was promulgated with effect from 1 October 2012. The rationale behind the introduction of the TAA was that it would streamline, modernise and align the previous tax administration provisions to ultimately lower the cost and burden of tax administration in South Africa. One of the key changes to the tax administration regime in South Africa pursuant to the promulgation of the TAA was the conversion from the imposition of additional tax by SARS to the understatement penalty regime.

In terms of the now-repealed s76 of the Income Tax Act, No 58 of 1962 (Act), SARS could previously impose additional tax up to 200% in the event of a default or omission by the taxpayer. Several issues were encountered in respect of the erstwhile additional tax regime including the fact that there was a lack of certainty, uniformity and transparency in SARSs application of the relevant provisions. For instance, it was often difficult to ensure that taxpayers in comparable circumstances were treated consistently. Furthermore, the way the provision was constructed had the effect that SARS would often commence imposing the maximum additional tax of 200% and only to the extent that the taxpayer could prove extenuating circumstances, would SARS consider reducing the penalty.

The Memorandum on the Objects of the Tax Administration Bill, 2011 expanded upon the rationale for the relinquishment of the additional tax regime for two further reasons:

- It would remove any uncertainty as to whether additional tax was a tax that may only be imposed under a money bill as contemplated in s77 of the Constitution; and
- South African courts have held on more than one occasion that additional tax was a penalty, and not a tax on, for example, income as the name suggested.

The new understatement penalty regime was thus introduced with effect from 1 October 2012. Without undertaking a detailed analysis of how the provisions work, it is nevertheless worth noting that it is now based on certain objective categories of behaviour. In other words, the understatement penalty percentage imposed is dependent on the behaviour of the taxpayer, which categories include the following:

- substantial understatement;
- reasonable care not taken in completing the return;
- no reasonable grounds for tax position taken;
- impermissible avoidance arrangement;
- gross negligence;
- intentional tax evasion.

Importantly, the onus to prove the grounds for imposition of an understatement penalty and the applicable percentage is on SARS.

While the conversion from the additional tax regime to the understatement penalty regime was welcomed, particularly given the fact that it is now based on certain objective criteria, the challenge is that behaviours listed in the understatement penalty percentage table are not specifically defined in the TAA. One therefore has to rely on other legislative interpretive tools in order to define the specific behaviours. While there have already been some cases dealing with the understatement penalty regime, South African judicial precedent will still take time to fully develop this aspect of tax law.

Nevertheless, one could obtain guidance from other sources such as case law pertaining to the now-repealed additional tax regime, South African criminal case law defining some concepts (which is nevertheless not a perfect substitute) as well as guidance and judicial precedent from other jurisdictions with very similar regimes such as Australia and New Zealand.

While the objective criteria and shift towards greater certainty is welcomed, a key challenge nevertheless remains given that the criteria are open to differing interpretations. At the time the TAA was introduced it was understood that SARS would ultimately provide guidance as to its interpretation of the different behaviours. SARS finally published its Guide to Understatement Penalties (Guide) on 28 March 2018, albeit several years after the promulgation of the TAA.

The Guide is fairly extensive and provides insight and examples regarding several contentious issues underpinning the new understatement penalty regime including, among others, the following key issues:

- what triggers an understatement;
- how to calculate an understatement penalty based on the shortfall of tax; and
- what constitutes a bona fide inadvertent error (the subject of much consternation).

Importantly, the Guide also discusses and provides examples of each of the listed behaviours.

While the Guide will certainly shed some light on SARSs interpretation of the relevant provisions and will no doubt prove useful to taxpayers, it should be appreciated that the Guide is not binding and is merely of persuasive value. Taxpayers would thus be well advised to keep this in mind when faced with this ever-increasing contentious aspect of tax law.

Major new tax burden introduced

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The Taxation Laws Amendment Act of 2017 (Act 17 of 2017) which was promulgated on 18 December 2017 contains provisions, namely section 22B of the principal Income Tax Act and paragraph 43A of the Eighth Schedule to the Income Tax Act, that will result in a significant compliance burden for companies, even in cases in which they do not result in additional taxation. The provisions deal with disposals of shares in a company (say A) that are held by another company (say B) in circumstances in which B held a significant portion of the equity shares (which the Amendment Act defines as a qualifying interest) in A at any time within the 18 months preceding the disposal. Section 22B applies in situations in which the shares that are the subject of the provision are held as trading stock while paragraph 43A of the Eighth Schedule applies in situations in which the shares are held as capital assets.

Essentially, any untaxed dividends (dividends that were exempt from income tax and also not subject to dividends tax) that were received by or that accrued to B during the 18 month period prior to the disposal, or in respect, by reason, or in consequence of the disposal, that are considered extraordinary in amount (which the Amendment Act defines as an extraordinary dividend), must be added to the proceeds on disposal of the shares for capital gains tax purposes. So for example if B held 50% of the equity shares in A and sells any shares held in A, then in calculating Bs capital gain on the disposal it would take into account its actual proceeds plus any extraordinary dividend which it had received or to which it became entitled.

The provision has been backdated to 19 July 2017, which implies that dividends that were received or accrued up to 18 months prior to that date may be subject to taxation if shares are disposed of on or after that date. There is however a carve-out if all the terms to the share disposal agreement were finally agreed to before 19 July 2017 by all parties to that agreement.

A substantial compliance burden is implied in that, in determining whether a dividend is an extraordinary dividend, one has to value the shares that are disposed of in order to determine the market value of the shares on the date 18 months prior to the disposal and then value the shares again at the date of disposal. It is often a difficult, costly and time-consuming exercise to value shares, especially a retrospective valuation such as at a date 18 months prior to the date of disposal of the shares.

Where there is only a holding of equity shares, the methodology to determine whether a dividend is an extraordinary dividend is as follows: If the market value of the shares 18 months prior to the date of disposal is C and the market value of the shares on the date of disposal is D, then the higher of C and D is chosen. One takes 15% of this figure. An extraordinary dividend is so much of any dividend received or accrued within 18 months prior to the disposal of the shares, or in respect, by reason, or in consequences of the disposal, as exceeds the 15% figure determined above. The provision requires that any untaxed dividend that was received or that accrued within 18 months of the date of disposal, or in respect, by reason, or in consequences of the disposal, must, to the extent that the untaxed dividend is an extraordinary dividend (i.e. the excess of the dividend over the 15% figure determined above) be treated as additional proceeds on the disposal of the shares. The wording of the provision suggests that each individual dividend received or accrued has to be tested against the 15% figure on an individual basis in order to determine whether that dividend is an extraordinary dividend i.e. that one does not aggregate the dividends received or accrued within the 18 month period and test the aggregate of such dividends against the 15% figure. This is likely an oversight.

The initial proposal contained in the Draft Taxation Laws Amendment Bill released in July 2017 was substantially similar, although an important difference was that there was no extraordinary dividend test. The initial proposal was thus that any untaxed dividends that were received or that accrued within the 18 month period were to become additional proceeds. Both the initial proposal and enacted provision are aimed at share buy-backs and the common practice of dividend stripping whereby companies receive untaxed dividends instead of taxable proceeds upon the disposal of shares. However, the provision is not limited to share buy-backs and applies to any disposal of shares. It would therefore apply if the disposal was by way of an outright sale of shares and even if the extraordinary dividend was unrelated to the sale.

The insertion of the extraordinary dividend test represents a better outcome for taxpayers than the more draconian initial proposal. However, it implies a substantial compliance burden even in the case of normal business transactions such as third party sales of shares. In view of the fact that the Tax Administration Act places the burden of proving that an amount should not be subject to tax on the taxpayer rather than on SARS, taxpayers would be ill-advised not to conduct the valuations to which the provision refers.

The definition of qualifying interest is central to the application of the provision in that a qualifying interest must be held at any time within 18 months prior to the disposal of the shares for the provision to apply. In the case of a listed company, the definition of qualifying interest contemplates an equity or voting interest of at least 10 per cent. In the case of an unlisted company, an equity or voting interest of at least 50 per cent (or 20 per cent if no other person holds the majority equity shares or voting rights), whether alone or together with connected persons in relation to the holder, must be held.

It should be noted that the provision could still apply in sell-down situations where a qualifying interest was held at some point during the 18 month period but not on the date of disposal of the shares in question. So for example, even if only a 5 per cent interest is disposed of, the provision could apply if at any point in the 18 month period prior to the disposal a qualifying interest was held.

The provisions have the further undesirable consequence that they have been added to the list of provisions that override the corporate restructuring rules contained in Part III of the Income Tax Act. So for example in an intra-group liquidation transaction under section 47 of the Income Tax Act, one will need to assess whether proceeds will need to be taken into account upon liquidation of the transferring (subsidiary) company. However the override of the corporate rules is not limited to section 47 transactions but potentially may include any corporate rollover transaction in which there is a disposal of shares and the other requirements of the provisions are met. This will add considerable complexity in the application of the corporate restructuring rules and may discourage taxpayers from utilising these rules, the purpose of which was to bring South Africas tax regime into line with international practice. If a disposal of shares would otherwise be capable of occurring on a tax neutral basis in terms of the corporate restructuring rules, it is unclear why a taxpayer should be penalised by having to pay tax on extraordinary dividends declared. Had the extraordinary dividends not been declared, the value of the shares disposed of would presumably have been higher but such disposal is in any event permitted as a tax neutral disposal under the corporate restructuring rules. Put differently, if a disposal of shares will qualify for relief from capital gains tax under the corporate restructuring rules, there is no incentive for taxpayers to attempt to dividend strip a company prior to such disposal in order to reduce the capital gain.

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Deductibility of legal expenses

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For purposes of determining the taxable income derived by any person from carrying on a trade, s11(c) of the Income Tax Act, No. 58 of 1962 (Act) provides for the deduction of legal expenses which arise in the course of or by reason of a taxpayers ordinary trading operations. More specifically, any legal expenses actually incurred by a taxpayer in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by the [taxpayer] in the carrying on of [its] trade will be deductible.

In order for a taxpayer to be able to deduct legal expenses (which include the services of legal practitioners, expenses incurred in procuring evidence or expert advice, court expenses, witness expenses, taxing expenses, expenses of sheriffs or messengers of the court and other expenses of litigation which are of an essentially similar nature to any of the said expenses), such expenses must:

i. be in relation to any claim, dispute or action at law;

ii. arise in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of its trade; and

iii. not be of a capital nature.

These requirements are discussed in more detail below.

Claim, dispute or action at law

The phrase claim, dispute or action at law is not defined in the Act. However, the meaning of this phrase was considered in

ITC 1419 (1986) 49 SATC 45, where the taxpayer incurred expenditure on securing legal representation before a commission of enquiry appointed under s417 of the Companies Act, No. 61 of 1973. The Commissioner for the South African Revenue Service (SARS) argued that the word dispute referred to a defined and readily identifiable dispute between the parties. The court did not find it necessary to decide the issue as commissions appointed under the said s417 are appointed by a court of law. However, the view was expressed that the word dispute covers any disagreement as a result of which parties require legal assistance.

Arise in the course of or by reason of the ordinary operations of a taxpayer in carrying on a trade

For purposes of s11(c), it is not a requirement that the legal expenses should have been incurred in the production of income. It is submitted that all that is required is that the legal expenditure must arise in the course of or by reason of the taxpayers ordinary trading operations.

The term trade is given a very wide meaning in s1 of the Act and includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, or any design as defined in the Designs Act, or any trade mark as defined in the Trade Marks Act, or any copyright as defined in the Copyright Act, or any other property which is of a similar nature.

The phrase arising in the course of or by reason of ordinary operations undertaken by him in the carrying on of his trade has been considered by our courts and has been interpreted to mean that the deductibility of legal expenses in terms of s11(c) does not depend on the purpose of the expenditure, but rather the causal connection of the relevant events with the taxpayers trade.

For example, in the case of *ITC 1710 (1999) 63 SATC 403*, an employee of the taxpayer who was the owner of a farm producing grapes, had, while working in the vineyards, negligently set a neighbours farm alight causing severe damage thereto. In an action for damages brought against the taxpayer, the court had found that the employee in question had acted within the course and scope of his employment and the taxpayer was accordingly liable for the damages caused by the employee as a result of the fire. The taxpayer, in order to defend the legal action, had incurred legal expenses and the issue to be decided by the court was whether such expenses were deductible in terms of s11(c) of the Act. It was found that the expenses in issue were connected with work performed by the employee on the farm, as part of the taxpayers business and that there was a sufficient causal connection with the taxpayers farming operations. Accordingly, it was held that the legal expenses incurred by the taxpayer were deductible in terms of s11(c) of the Act.

In *ITC 1837 71 SACT 177*, the taxpayer, a premier of a province, had made remarks at a press conference that resulted in him being successfully sued and ordered to pay damages for defamation. It was held that the claim for damages arose in the course and scope of his employment as premier and was sufficiently closely related to his ordinary trading operations to establish the requisite causal connection between such expenditure and those trading operations. The legal expenses incurred in defending the claim were accordingly deductible in terms of s11(c) of the Act.

Not of a capital nature

The question of whether or not expenditure is of a capital nature, depends on the facts of each case. For example, what may be capital expenditure in the case of one taxpayer may be revenue expenditure in the case of another. A useful test, which has been applied and endorsed in a number of South African judgments (such as *New State Areas Ltd v Commissioner* *for Inland Revenue 1946 AD 610* and *Commissioner for Inland Revenue v George Forest Timber Co Ltd 1924 AD 516*) is to ascertain whether the expenditure has been incurred to create, acquire or improve an income-producing asset, in which case the expenditure will be of a capital nature. As with most capital/revenue matters, there is seldom tax certainty and one has to form a view based on a myriad of tax cases with contrasting principles and decisions. Some of these cases are summarised below.

In *ITC 1241 (1975) 37 SATC 300*, a company that was a scrap-metal merchant had erected a crushing machine on hired land zoned by the local municipality for general residential purposes. The municipality then gave notice calling for the removal of the machine but the company took no action. The municipality consequently instituted proceedings in the Supreme Court for an order directing the company to remove the machine. In an attempt to gain time and continue the profitable use of the machine for as long as possible, the company decided to use all legitimate means of resisting the granting of an order for the removal of the machine. At the same time, the company attempted to find a suitable alternative site for the machine.

The court, having regard to the fact that the purpose and effect of the expenditure was to delay as long as possible the granting of an order compelling the removal of the machine, held that (at 306):

The legal expenses incurred did not create or enhance any asset, they did not bring about any advantage for the enduring benefit of trade, and they were more closely related to the appellants income-earning operations than to its income-earning structure. [T]he appellant took a calculated risk, and the expenditure was in truth no more than part of the cost incidental to the performance of the income-producing operations.

The court accordingly concluded that the legal expenses incurred were not of a capital nature and were deductible under s11(c) of the Act.

In *ITC 1677 (1999) 62 SATC 288*, a certain D had applied for an interdict against the taxpayer, a publishing company, on the basis that the taxpayer had published two textbooks which constituted an infringement of Ds copyright. The court had to decide whether legal expenses incurred by the taxpayer were of a capital nature.

The court rejected the taxpayers argument that the expenditure did not give rise to any asset or to any advantage of an enduring nature on the basis of the decision in *Secretary for Inland Revenue v Cadac Engineering Works (Pty) Ltd* 1965 (2) SA 511 (A). In that case, Cadac was manufacturing cookers under licence from the patent holder and asked the patent holder to institute legal proceedings against another firm, Homegas, which had started to market cookers in competition with Cadac. Cadac undertook to indemnify the patent holders for its legal expenses. The court held that the legal expenses were of a capital nature as they were directed at preserving and perhaps expanding the field in which the taxpayers business operated. This was further the case, as the expenditure had been incurred by Cadac to eliminate the competition of Homegas. It was therefore not deductible.

Based on this reasoning in Cadac, the court in *ITC 1677* held that the taxpayers litigation was instituted to preserve an asset and protect the taxpayers market. The legal expenses were therefore capital in nature and not deductible.

Conclusion

In light of the above, to the extent that the requirements of s11(c) are met, legal expenses should be deductible. However, it is important for taxpayers to bear in mind that such deduction is limited to so much thereof as:

a) is not of a capital nature;

b) is not incurred in respect of any claim made against the taxpayer for the payment of damages or compensation if by reason of the nature of the claim or the circumstances any payment which is or might be made in satisfaction or settlement of the claim does not or would not rank for deduction under s11(a) of the Act;

c) is not incurred in respect of any claim made by the taxpayer for the payment to him of any amount which does not or would not constitute income of the taxpayer; and

d) is not incurred in respect of any dispute or action at law relating to any such claim as is referred to in b) or b) above – in other words, where legal expenses are incurred on a claim, the claim must be either for the taxpayer to pay damages or compensation deductible in terms of s11(a) of the Act or for the taxpayer to derive an amount that will be included in its income.

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The shoe is on the other foot: The High Court orders SARS to discover documents in the context of a review

application

Authors: Louis Botha and Nandipha Mzizi(Cliffe Dekker Hofmeyr).

It seldom happens that the South African Revenue Service (SARS) is compelled to provide documents to a taxpayer, while SARS is conducting an audit. In *Carte Blanche Marketing CC and Others v Commissioner for the South African Revenue Service* (26244/2015) [2017] ZAGPPHC 253 (26 May 2017), the Gauteng Division of the High Court, Pretoria had to decide whether SARS should be compelled to produce certain documents requested by the applicants (Taxpayers) in the context of a review application brought by the Taxpayers.

The main proceedings in this matter involve a review application which the Taxpayers brought against SARS seeking to set aside the decision of SARS to audit them in terms of s40 of the Tax Administration Act, No 28 of 2011 (TAA).

Facts

In August 2014, SARS gave the Taxpayers a notice of its intention to audit them, in terms of s40 of the TAA, based on a risk assessment. This is one of the bases on which an audit can be instigated in terms of s40. In the same notice, SARS requested a range of documents in terms of s46 of the TAA. The Taxpayers refused to hand over the said documents but instead sought reasons for the audit. They alleged that the decision to audit was as a result of SARSs improper motives.

In its response, SARS said that it had noted discrepancies between the Taxpayers turnovers as obtained from the bank statements and their declared gross income. SARS had obtained the bank statements in terms of s46(3) of the TAA. The Taxpayers, dissatisfied with the reasons, instituted the main review application in the High Court, to set aside SARSs decision to instigate the audit. SARS accordingly filed a record of proceedings in terms of Rule 53(1) of the Uniform Rules of Court (HC Rules), which it asserted it did for pragmatic reasons. The Taxpayers were again not satisfied that the record contained all documents and sought access to further documents by bringing an interlocutory application to compel SARS to produce additional documents. SARS opposed the application.

The court had to decide whether the Taxpayers interlocutory application to compel discovery should be granted.

Legal Framework

Section 40 of the TAA states that SARS may select a person for inspection, verification or audit on the basis of any considerations relevant for the proper administration of a Tax Act, including on a random or risk assessment basis. Furthermore, s46 of the TAA states that SARS may, for the purposes of the administration of a tax Act in relation to a taxpayerrequire the taxpayer or another person to, within a reasonable period, submit relevant material (whether orally or in writing) that SARS requires.

On the other hand, Rule 53(1) of the HC Rules affords parties the right to review decisions of officers performing administrative functions. Conduct can be reviewed in terms of the Promotion of Administrative Justice Act, No 3 of 2000 (PAJA) or if it was exercised by a public power and had to be rational.

Judgment

As stated above, the issue the High Court had to decide was whether the Taxpayers application to compel discovery should be granted. However, the decision was complicated by the fact that the High Court had to consider whether the issues to be decided in the main review application, should also be taken into account to decide whether to grant the interlocutory application.

In its argument, SARS referred to reported cases where it was decided that a court in an interlocutory application could not avoid deciding a purely legal issue. The court held that such cases can only be decided on a case by case basis. It held that the court hearing the interlocutory application must be reasonably certain that a decision on the legal point will put an end to the case, or will dispose of a substantial part of the case. If there is a risk that the early decision of a legal point could complicate the further and full ventilation of the matter, the court should decline the invitation to decide such a legal issue.

The High Court stated that when one has to decide whether conduct is reviewable in principle, it is advisable to err on the side of caution, especially in the light of Constitutional Court decisions which have held that all public power is reviewable on some or other basis. The court held that the threshold to initiate an audit in terms of s40 of the TAA is extremely low and accepted that the instances where the court will interfere are rare. The High Court did, however, state that it would be unlawful for SARS to use the provisions of the TAA for an ulterior purpose. Any decision to audit must therefore be taken for purposes of administration of a tax Act.

SARS further argued that the Taxpayers litigation was vexatious and constituted an abuse of process and that if litigants were allowed to take decisions made in terms of s40 of the TAA under review, it would bring the entire tax administration system to a halt. The court rejected this argument and held that the issue was whether the parties used the existing court rules sensibly and efficiently. The court also commented that SARS could not select at what stage it wanted to object to litigation.

In the current matter, SARS argued that as the audit did not have any direct external legal effect, which is a requirement for conduct to constitute administrative action in terms of PAJA, the decision to audit was not reviewable. The court took the view that the main application constituted a review in terms of PAJA and also raised general grounds of rationality review, as the powers under s40 and s46 of the TAA constituted exercises of public power. The court accepted that there are strong arguments to be made against an assertion that the audit constituted administrative action, as the audit is merely provisional and only once the additional assessment is raised then it constitutes administrative action. The court, however, noted that the decisions and processes in tax administration are related to a decision that will ultimately constitute administrative action and as such should not be shielded from judicial scrutiny at the earliest stage possible. Court interference at this stage is very rare and occurs in exceptional cases, it said.

On whether the actions had the necessary direct legal effect, the court referred to how the word audit is not defined in the TAA, but that an audit can be unobstructive or invasive, depending on the nature thereof. Therefore, the court suggested that an audit will not always constitute administrative action. The court should also be careful in deciding matters before they are ripe for review especially since the notice sent by SARS is the beginning stage of its statutory powers. On the other hand, malice by SARS must be dealt with. It noted that High Court review proceedings could also seriously affect the efficacy of SARSs work and that some taxpayers have, on occasion, seriously abused court processes.

Interestingly, the court opined that the real complications arising from this matter were due to the issue of jurisdiction of tax courts. The TAA deals with dispute resolution in tax administration extensively and it is therefore unclear why the High Court retains some residual review jurisdiction, but agreed that the legislature appears to have expressly retained High Court jurisdiction over tax cases in limited instances. It considered the provisions of s105 of the TAA and the amendments thereto in 2015, which suggest that the High Court retains residual review jurisdiction. However, it went on to state that in its opinion, there is no reason why an ordinary Tax Court should not be competent to grant urgent interim relief as other courts with similar status to that of a High Court do so, such as labour courts and the land claims courts.

The court concluded that these matters are too complex to be adjudicated in an interlocutory matter and therefore declined to decide the legal issues in the main review application. It ordered SARS to discover the documents requested by the Taxpayers in its discovery notice, in terms of Rule 35(3) of the HC Rules. It also ordered SARS to pay the Taxpayers costs of the application to compel.

Comment

Although the comments by the court regarding the reviewability of SARSs decisions in terms of s40 and s46 of the TAA are not binding and merely constituted *obiter dictum*, its comments do suggest that an audit could constitute administrative action under certain circumstances. It will therefore be interesting to see what the High Court decides in the main application. At the same time, the judgment serves as an indication that where taxpayers feel that SARS is overstepping the bounds of its powers, taxpayers would be well entitled to approach the courts to review such conduct and to enforce their procedural rights, including the right to request discovery.

The High Courts statements regarding the jurisdiction of the High Court and the Tax Court are also interesting to note. It remains to be seen, however, whether its suggestion that the Tax Court can consider review applications regarding tax matters in terms of s105 of the TAA, is correct. In *Wingate-Pearse v Commissioner of the South African Revenue Service* 2017 (1) SA 542 (SCA), the Supreme Court of Appeal (SCA) considered what kind of matters could be heard by the Tax Court. The case concerned a taxpayer wanting to appeal the Tax Courts decision in an interlocutory application. We discussed this case in our Tax and Exchange Control Alert of 7 October 2016.

Section 117 of the TAA defines the jurisdiction of the Tax Court, and s117(3) states that the Tax Courts jurisdiction includes hearing any interlocutory application or any application in a procedural matter relating to a dispute under Chapter 9 of the TAA, which is the chapter dealing with disputes and appeals. Without going into the details of that judgment, the court suggested in *Wingate-Pearse* that as the Tax Court is a creature of statute, its jurisdiction is limited to what is provided by the TAA and the Tax Court Rules. The SCA did not consider whether s105 of the TAA conferred jurisdiction on the Tax Court to consider review applications, as suggested by the High Court in the *Carte Blanche* case discussed in this article. Therefore this issue remains undecided.

Written by Louis Botha and Nandipha Mzizi

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Can SARS limit legal

professional privilege?

Authors: Natalie Napier and Phillip Lourens (Hogan Lovells).

New rules have come into effect for how legal professional privilege is regulated, we look at what effects they may have in practise.

Amendments have been made to the Tax Administration Act (the TAA) by the insertion of a new section 42A with effect from 8 January 2016. Section 42A prescribes the procedures and requirements that must be followed by the taxpayer in order to claim legal professional privilege in respect of relevant material required by SARS, during an inquiry or during the conduct of a search and seizure by SARS.

What is not yet clear, is exactly how the amendments will be interpreted and applied, and ultimately, what effect they will have on taxpayers claiming legal professional privilege.

The resolution of disputes relating to legal privilege between taxpayers and revenue authorities is not unique to South Africa. For example, in the United Kingdom, there are procedures in place to resolve such disputes. Effectively, a tribunal will resolve disputes relating to information or documents requested to be produced by the taxpayer and in respect of which the taxpayer claims legal privilege which Her Majesty's Revenue and Customs does not accept.

In terms of section 42A, a taxpayer who claims legal professional privilege when SARS requests material from them will have to provide the description and purpose of each document where privilege is claimed as well as stating which privilege is claimed. Details include, among others, the author of the document, the person for whom the author was acting, as well as confirmation that privilege is being claimed.details. The information must be submitted to SARS at the place, in the format and within the time specified by SARS.

If SARS disputes the validity of the claim, a third party appointed in accordance with the TAA will be given the material and make a determination on whether privilege applies or not.

The taxpayer will not have any input into the appointment of the third party. If no determination is made or a party is not satisfied with the determination made, the matter can be taken to the High Court within a prescribed period of time.

The appointed third party –

- will not act on behalf of SARS or the taxpayer;
- must personally take responsibility for the safekeeping of the material; and
- must give grounds for any determination.

The wording and practical application of section 42A is not clear in a number of instances and may give rise to contradictory interpretations. Whether it will work in practice remains to be seen.

In what circumstances will section 42A apply?

From the introductory words to section 42A(1), it is not certain when exactly section 42A will apply.

If interpreted broadly, it is possible section 42A applies when there is any request (in terms of sections 46 to 49 of the TAA) for relevant material by SARS and in the specific instances of an inquiry (section 53 of the TAA) and a search and seizure conducted by SARS (section 61(3) of the TAA). Taxpayers may wish to argue that the section only applies in the instances of an inquiry or a search and seizure by SARS.

In light of the opening words to the sub-section ("For purposes of Parts B, C and D…"), it is likely that SARS will opt for the wider interpretation although it is by no means clear that the wording of the section contains the enabling wording. Taxpayers should assume that SARS will aim to challenge legal professional privilege claimed by taxpayers in all three instances referred to above and not only in the case of an inquiry or search and seizure.

This being the case, it will be important for taxpayers to be aware of the circumstances when legal professional privilege may be claimed. In summary, legally privileged advice can take the form of:

- written or oral communications between a legal advisor and a client made for the purpose of obtaining or giving legal advice; or
- written or oral communications between legal advisor and a client, or between either of them and a third party, in contemplation of litigation.

Communications are more likely to be regarded as covered by legal professional privilege when received from external advisors. When dealing with internal legal advisors, it is necessary that the legal advisor must have been acting in his or her professional capacity as legal advisor. It is important that the communication is made in confidence and that the appropriate legal professional privilege is claimed by the client. Legal professional privilege can be waived, expressly or by implication, and does not apply when the advice is sought for a criminal or fraudulent purpose.

In the South African context, the Western Cape High Court considered in March 2014 in A Company and Two Others v The

Commissioner for the South African Revenue Service a claim to legal professional privilege relating to a tax invoice rendered by a firm of attorneys to their client in a dispute with SARS. Privilege was claimed on the basis that the nature of the advice sought by the taxpayer was discernible from the detailed narrations of the attorneys' attendances on the invoices.

The court quoted the Constitutional Court decision of Thint (Pty) Ltd v National Director of Public Prosecutions and Others, Zuma and Another v National Director of Public Prosecutions and Others stating that:

> *"[t]he right to legal professional privilege is a general rule of our common law which states that communications between a legal advisor and his or her client are protected from disclosure, provided that certain requirements are met. The requirements are (i) the legal advisor must have been acting in a professional capacity at the time; (ii) the advisor must have been consulted in confidence; (iii) the communication must have been made for the purpose of obtaining legal advice; (iv) the advice must not facilitate the commission of a crime or fraud; and (v) the privilege must be claimed."*

Ultimately, based on the facts of the case, the court held that certain of the invoices did contain privileged information that could be claimed as such by the taxpayer.

What are the time periods within which information must be provided?

Section 42A(2) may cause concern to taxpayers as no fixed time or format is prescribed for the submission of the required information. SARS is given a wide discretion and there do not appear to be any built in safeguards against the possibility of SARS demanding from taxpayers that documents be submitted within limited time periods. Aggrieved taxpayers may be required to rely on their constitutional right to just administrative action in this regard.

Section 42A envisages that a further application can be made to the High Court once the third party has adjudicated the claim for legal professional privilege – or confirmed that he or she is unable to do so.

Where the potential tax liability of the taxpayer justifies approaching the High Court, it is unlikely that a taxpayer with the financial means to do so will relinquish this opportunity to drag out the process.

Some taxpayers may make use of this opportunity to slow down the process, as the welcome date of prescription in terms of section 99 of the TAA may be looming in the background. In this regard, it is worth noting that section 99 has also undergone some changes recently.

With effect from 8 January 2016, the Commissioner may in certain specified circumstances extend prescription by issuing a notice to a taxpayer within no less than 30 days from the date on which the disputed tax liability will prescribe. One of the specified circumstances is where there is an unresolved "information entitlement dispute". The term "information entitlement dispute" is not defined in the TAA, but we believe that the term is wide enough to cover a dispute between SARS and a taxpayer under section 42A of the TAA.

What will occur if there is no determination and the dispute is not referred to the High Court within the set time periods?

Section 42A(3)(e) prescribes a fixed time period within which a dispute regarding legal privilege may be referred to the High Court in the event that either SARS or the taxpayer disputes the third party's determination, or where no determination was made. The question that arises is what would happen if no determination was made within the prescribed 21 business day period and neither party refers the matter to the

High Court within the prescribed 30 days (not business days).

Section 42A(3)(d) specifically states that the third party must retain the relevant material until the parties have resolved the dispute or it is resolved by an order of court. If the dispute cannot be referred to the High Court in terms of section 42A(3)(e), it would be absurd if it means that the third party must retain the relevant material forever – which would effectively mean that the taxpayer has succeeded in not providing the relevant material to SARS. It is possible that the Commissioner may then look to make use of section 99(3) to extend prescription and would need to approach the High Court for condonation of SARS' non-compliance with the time periods for the referral of the dispute to the High Court.

Taxpayers can expect that SARS will be more pro-active in challenging taxpayer claims for legal professional privilege, but it remains to be seen how the new legislative provisions will assist SARS.

This article first appeared on the March/April 2016 edition on Tax Talk.

SARS looks to clear up misconceptions relating to tax exemption for foreign employment income

The South African Revenue Service (SARS) issued Draft Interpretation Note 16 (Issue 2) (Draft IN) for public comment recently. When compared to the current Interpretation Note 16 (IN16), the Draft IN indicates a marked shift, on certain aspects, in SARS's interpretation of the tax exemption that applies to foreign employment income, under s10(1)(o)(ii) of the Income Tax Act, No 58 of 1962 (Act).

Before going into detail on the more important points of the Draft IN, it is useful to deal with the basic principles of s10(1)(o)(ii) of the Act. The exemption has been utilised, quite successfully over the years, by individuals rendering services in a foreign jurisdiction and earning income in respect of those foreign services. The effect of complying with s10(1)(o)(ii) of the Act is that a certain portion of the remuneration earned in respect of those foreign services is exempt from normal tax in South Africa. Certain 'practices' developed over the years in applying the exemption, read with SARS's views as set out in IN16.

The general rule is that income earned by a resident from the rendering of services anywhere in the world will be included in "gross income", as defined in s1 of the Act. Notwithstanding the general residency based rule, certain exemptions apply, in particular, s10(1)(o)(ii) of the Act in respect of remuneration which would ordinarily have been subject to normal tax. The exemption provided under s10(1)(o)(ii) of the Act applies in respect of services rendered outside South Africa for or on behalf of any employer, as long as the individual is outside South Africa for a period or periods exceeding 183 full days (calendar, not working days) in aggregate, during any 12 month period commencing or ending during a tax year.

In addition, the exemption will only apply if, during the 183-day period, there was at least a 60-day continuous period of absence from South Africa. The Draft IN and IN16 confirm that any 12 month period could be taken for the purposes of this provision (ie a backward and forward looking approach). Furthermore, the services referred to in s10(1)(o)(ii) of the Act should in fact be the services performed that led to the generation of income that is now considered for exemption.

Those employers who are brave enough and of the view that the provisions of s10(1)(o)(ii) of the Act apply to a given employee’s scenario, can elect not to deduct employees’ tax (confirmed in the Draft IN and IN16). Given the inherent employees’ tax late payment penalty, understatement penalty and interest risks associated with not complying with the provisions of s10(1)(o)(ii) of the Act, most employers in practice choose the route of least resistance and continue to deduct employees’ tax, thereby passing the baton over to the employee to claim a refund on assessment. The relative size of those refund claims would, in most cases, trigger a SARS review in the hands of the affected employee.

In respect of calculating the 183/60 day periods, as required under s10(1)(o)(ii) of the Act, the Draft IN essentially continues SARS’s previous practice (under IN16) whereby weekends, public holidays, annual leave days, sick leave days and rest periods spent outside South Africa are taken into account in determining any potential exemption. IN16 contains examples indicating the practical application of the ‘183/60 day approach’ and it could reasonably be accepted, based on that practice, that the determination of an amount qualifying for exemption is relatively straightforward. That straightforward approach is set for a rethink under the Draft IN and employers need to carefully evaluate the impact on its employees that render services offshore.

The Draft IN states that a “common misconception is that all remuneration received or accrued during the qualifying 12 month period of 12 months is exempt". The Draft IN goes further to state that only "the remuneration received or accrued in respect of services rendered outside the Republic during the qualifying period of 12 months is exempt". SARS is correct in its approach, in my view, however, the practical application of the aforementioned statement may be based on an approach not considered by many employers (at least not in practice). Essentially, the Draft IN brings in an apportionment calculation, which seems to act as a 'second step' in determining the actual remuneration exempt from normal tax, once the 183/60 day tests have been complied with.

Stated differently, in any given situation, the first test would be to apply the normal 183/60 day rules, which take into account weekends, public holidays, annual leave days, sick leave days and rest periods, and, as a second test, apply SARS's apportionment methodology which excludes any day not regarded as a 'work day'. A 'work day', as contemplated in the Draft IN does not include "weekends, public holidays or leave days. Only days of actual services rendered are taken into account". The effect is that remuneration received for 'work days' in South Africa, would be subject to normal tax, whereas jetting in and out of South Africa could have slipped into the exemption potentially under IN16 (where no apportionment is contemplated).

In determining the tax exempt portion under s10(1)(o)(ii) of the Act, the following apportionment formula is contemplated under the Draft IN:

Exempt portion = (Work days outside South Africa for the period/Total work days for the period) x Remuneration received during the period.

The Draft IN provides various examples of the practical application of the apportionment approach and it would be in a taxpayer's best interest to fully understand how it applies to a given set of facts.

The Draft IN also deals with a common scenario where employees are required to take mandatory rest periods that are enforced by their home or host country's health and safety regulations and states that no "actual services are rendered during the rest periods, even though the employees remain in continuous employment during these periods. The services that are rendered to earn the remuneration are the services that are rendered during the work shifts". SARS concludes their view on the aforementioned scenario by stating that if "those services are rendered offshore and during a qualifying period, all remuneration attributable to those offshore services will qualify for exemption and no apportionment must be done". This approach is uncertain as it may be that the 183/60 day rules are complied with, but it is not clear whether compulsory health and safety rest periods (which are not annual leave) are then regarded as 'work days' outside South Africa. What if those compulsory rest periods are spent in South Africa – does it affect the 'work day' driver in the apportionment approach? Clarity by way of a practical example is probably required in the final version of the Draft IN.

Although not covered in this article, the Draft IN also expands on the approach to take in respect of share incentive scheme gains made under s8C of the Act. The apportionment approach contemplated for purposes of s8C of the Act follows on similar approaches already dealt with under Binding Private Rulings issued previously.

Employers and individuals rendering services offshore need to take account of SARS's contemplated approach under the Draft IN and ensure compliance with s10(1)(o)(ii) of the Act. SARS is going to tighten the requirements for being able to access the foreign employment tax exemption without necessarily changing the wording of the Act itself.

Author: Ruaan van Eeden
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Interpretation of the term ‘substantially the whole’

Authors: Nicole Paulsen and Gigi Nyanin.

The South African Revenue Service (SARS) released Binding General Ruling No. 20 (issue 2) (BGR 20) on 20 January 2016, which provides clarity on the interpretation of the term ‘substantially the whole’ as referred to in specific sections of the Income Tax Act, No 58 of 1962 (Act).

By way of background, the term ‘substantially the whole’ was introduced in the revised tax system for public benefit organisations (PBOs) in 2000, to achieve a more supportive fiscal environment and to give effect to the proposals and recommendations made by the Katz Commission, as set out in the Ninth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa.

In general, the term ‘substantially the whole’ allows approved associations, PBOs, recreational clubs and small business funding entities (SBFE) to carry on limited business undertakings or trading activities, provided that the sole or principal object of:

- an approved association, remains the promoting of the common interests of persons (being members of a company, society, or association of persons) carrying on any particular kind of business, profession or occupation approved by the Commissioner for SARS;
- a PBO, remains the carrying on of a public benefit activity as listed in Part I of the Ninth Schedule to the Act;
- a recreational club, remains the provision of social and recreational facilities for its members; and
- a SBFE, remains the provision of funding for small, medium and micro-sized enterprises.

Accordingly, to the extent that 'substantially the whole' of such undertaking or activity is directed towards the recovery of costs, the receipts and accruals derived by any of the aforementioned entities from any business undertaking or trading activity will be exempt from normal tax.

In BGR 20, SARS ruled that the receipts and accruals from business undertakings and trading activities of the aforementioned entities will be exempt from normal tax, if at least 90% or more of the undertaking or activity is directed toward the recovery of costs. SARS has however made provision for leniency where 85% or more of the business undertakings or trading activities of the aforementioned entities, are directed at the recovery of costs.

BGR 20 applies from the date of issue until it is withdrawn, amended or the relevant provisions of the Act are amended.