Interest on loans from foreign persons

By Mike Betts, Tax Partner Grant Thornton Cape

From 1 January 2015, the interest paid or due to non-residents from a source within South Africa (SA) will be subject to a 15% withholding tax, according to sections 50A to 50H of the Income Tax Act ('the Act'). These provisions do not affect interest paid by, amongst others, any sphere of government, or any SA bank and will most likely affect loans from foreign shareholders and from other group companies located beyond the borders of SA.

The effect on non-resident persons
The withholding tax doesn't apply in respect of interest paid to a non-resident natural person who has been physically present in SA for more than 183 days in aggregate during the twelve month period preceding the date of payment. It is also not applicable if the loan in respect of which the interest is paid exists to establish that foreign person in SA permanently and that the person is a registered SA taxpayer. In these instances however, the foreign person will not enjoy the exemption in terms of section 10(1)(h) of the Act and will be subject to normal income tax on the interest.

To benefit from the withholding tax exemption, the non-resident person will need to submit a prescribed declaration confirming that the person qualifies for the exemption before the date of payment or another date that can be determined by the person paying the interest. If the foreign person is entitled to a reduced rate of tax through the application of a double taxation agreement (DTA), then a prescribed declaration, within similar time limits, is required together with a written undertaking to advise the borrower of any subsequent change in status.

If the DTA concerned prohibits the withholding of tax in SA, the provisions of the newly introduced Section 23M will require a specific calculation which is likely to result in the deferral of at least portion of the interest deduction in the hands of the borrower where this person is in a controlling (connected person) relationship with the non-resident lender.

In order to comply with these requirements in full by 1 January 2015, consider the following advice:

- Make the foreign lender aware of these requirements;
- If the foreign lender is a natural person, ensure the time he or she spends in SA is properly monitored and that procedures are put in place to ensure the necessary exemption declaration is received timeously if the 183 day threshold is breached;
- If the loan is effectively connected with the permanent establishment of the foreign lender in SA, ensure the necessary exemption declaration and proof of registration as a taxpayer in SA are in place;
- Examine any DTA between SA and the foreign jurisdiction and if relief from the withholding tax is stipulated or provision is made for a reduce rate of tax, ensure the necessary declaration and written undertaking to advise the borrower of any change in status are in place;
- If full relief from the withholding tax is stipulated in the DTA, determine whether the foreign lender is a connected person and, if so, understand the calculation of the interest deduction that will be required;
- Formalise the loan arrangements if no loan agreement exists and obtain exchange control approval;
- Review any existing loan agreement and consider all amendments that may be appropriate to:
    - Regulate the timing of interest payments. Monthly interest payments may result in excessive administrative work to meet withholding tax

payments that fall due at the end of the next month after the interest is paid. This will also require continuous calculations for determining periods of physical presence in SA, if the foreign lender is a natural person. In the case of annual interest payments with an anniversary arising after 31 December, consider making an early payment on or before 31 December 2014 to minimise exposure to the withholding tax.
    - Comply with the revised transfer pricing and thin capitalisation rules for which purpose an arm's length character needs to be demonstrated for both the level of funding and the interest charged thereon.
    - Comply with all current exchange control regulations. These include a maximum interest rate equivalent to the prime lending rate in the case of shareholder loans. This may not necessarily coincide with an arm's length rate of interest for transfer pricing purposes.
- Seek our expert advice to ensure compliance and minimise administration problems.

Latest Research and Development tax allowance still missing the mark

- **By Barry Visser, Associate Director Grant Thornton Johannesburg**

Recent Research and Development (R&D) legislative amendments

substantially changed the nature of the R&D allowance contained in section 11D of the Income Tax Act. However, despite the significant changes, this allowance still seems to fail to encourage many companies to undertake R&D. We highlight the most significant barriers and provide suggestions to benefit from the allowance.

It was generally welcomed that the initially proposed requirement that the R&D in South Africa should be "world-beating" in order to qualify for the tax allowance, did not find its way into the final legislation. However, there are various other amendments where clarity is still required or amendments are proposed.

R&D Definition

The word "innovative" has been inserted, but without its own definition. This leaves the word open to subjective interpretation. This interpretation was previously left to the discretion of the Minister of Science and Technology; however, a clear definition is required.

The insertion of the term "functional design" is considered to be limiting. Effectively, only designs with a functional purpose will now qualify, thereby excluding designs where it may be difficult to distinguish between aesthetic or functional purposes.

The replacement of the words "developing or significantly improving" with "making a significant and innovative improvement to" implies that only a successful research project will qualify. It disregards that R&D by its very nature involves trial and error, and where there is error a research project may not necessarily result in an innovative or significant improvement. We suggest that the reintroduction of the word "developing" should be considered.

However, what was made clear under the excluded activities section – which was previously separately listed but is now

included as part of the R&D definition – is that internal business processes for sale or granting of right of use to connected parties, is not permissible.

Qualifying expenditure

One amendment that came through as a surprise is that previously 100% of qualifying expenditure could have been claimed with no approval and only the 50% uplift allowance required pre-approval by the Department of Science and Technology (DST). Now, the full 150% requires approval and it should be noted that only R&D expenditure incurred after receipt of the approval by the DST may be claimed. This means much more administration, especially where a company was previously satisfied with not claiming the 50% uplift allowance. It will require careful planning not to miss the potential deduction on expenditure incurred prior to application to the DST.

3rd party carrying on R&D on behalf of taxpayer

In the absence of addressing practical problems encountered in this area, we welcomed the announcement in the recent Budget Speech, that the unintended consequences for entities funding research and development activities carried out by another party will be removed retrospectively from 1 January 2014.

Minister to designate deemed R&D activities

The Minister of Finance, in consultation with the Minister of Science and Technology, may prescribe special R&D criteria by regulation.

In this regard there is a special dispensation, for example for the pharmaceutical (generic medicine and clinical trial) industry and in the recent Budget Speech it was further proposed that the barrier to the first three phases of clinical trials being eligible for the R&D allowance will be removed retrospectively from 1 January 2014.

Proposed solution

The aim of the R&D allowance must be to encourage investment in R&D across all industry sectors and not only to promote some. However, further clarity is required regarding the intention of the activities that should be included as well as the industries that are targeted for the R&D incentive. We propose that broad-based consultation, to include all industries, needs to take place.

In the meantime, we recommend that companies investing in R&D activities submit applications to receive the deduction on qualifying expenditure. Contact Grant Thornton for help to complete the application.

Deductions for income tax and VAT

Broadly speaking, in their ordinary business operations, certain entities are entitled to claim certain deductions for income tax and value-added tax (VAT) purposes. In this article we discuss the tests used by South African courts and in practice, for income tax and VAT purposes, in order to determine whether a taxpayer will be entitled to such deductions. Consideration will be given specifically to the deduction of legal expenses incurred by a taxpayer in terms of section 11(*c*) of the Income Tax Act No. 58 of 1962 (the Act) and the deduction of input tax in respect thereof in terms of section 1 read with section 7 of the Value-Added Tax Act No. 89 of 1991 (the VAT Act).

An income tax perspective

Section 11(*c*) of the Act provides, most relevantly, for a deduction from income of –

"any legal expenses … actually incurred by the taxpayer during the year of assessment in respect of any <u>*claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade*</u>*…"*

The phrase "arising in the course of or by reason of the 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 <u>the deductibility of expenditure in terms of section 11(*c*) of the Act does not depend on the purpose of the expenditure, but rather the causal connection of the relevant events with the taxpayer's trade</u>. Accordingly, it would be sufficient if the causal connection between the ordinary trading operations of the taxpayer and a claim, action or dispute is sufficiently close that it can be regarded as having arisen in the course of or by reason of the trading operations. 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 neighbour's farm alight causing severe damage thereto. The High Court, in an action for damages brought against the taxpayer, 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 costs and the issue to be decided by the court was whether such costs were deductible in terms of section 11(*c*). It was found that the costs in issue were connected by chance with work performed by the employee on the farm, as part of the taxpayer's business and that there was a sufficient causal connection with the taxpayer's farming operations. Accordingly, it was held that the legal costs incurred by the taxpayer were deductible in terms of section 11(*c*).)

In light of the above, it appears that the test for

determining whether expenditure will be deductible in terms of section 11(*c*) would be to consider the causal connection with the taxpayer's trade. The purpose for which the expenditure is incurred or the purpose of the events giving rise to the costs is not the deciding factor.

A VAT perspective
Section 7(1)(*a*) of the VAT Act provides, *inter alia*, that:
"there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as value-added tax-
(a) on the *supply by any vendor of goods or services supplied by him* *on or after the commencement date* *in the course or furtherance of any enterprise carried on by him*

Essentially a VAT vendor is entitled to an input tax deduction on the acquisition of goods or services to the extent utilised for making taxable supplies in the course or furtherance of his enterprise. In order for a taxpayer to claim an input tax deduction in terms of section 16 the VAT Act, the taxpayer must be a registered VAT vendor, be carrying on an enterprise and must have paid VAT on goods or services which the vendor acquired wholly for the purpose of consumption, use or supply in the course or furtherance of any enterprise carried on by him, as envisaged in section 7(1)(*a*) of the VAT Act.

In the fairly recent case of the *Commissioner for the South African Revenue Service v De Beers Consolidated Mines Limited* [2012] 74 SATC 127, an aspect that the Supreme Court of Appeal (SCA) had to consider was whether the VAT charged to the vendor on fees for certain local advisory services qualified for deduction as input tax. De Beers Consolidated Mines Limited (DBCM) engaged the services of a range of South African advisors and service providers, including attorneys (local suppliers), to assist in finalizing a proposed transaction. DBCM treated the amounts expended to obtain such services as deductible input tax in its VAT returns. The Commissioner disallowed the input tax claim, against which DBCM lodged an objection. The objection was disallowed by the

Commissioner and DBCM lodged an appeal to the Tax Court held in Cape Town which also found, *inter alia*, that the VAT paid by DBCM in respect of certain local services was not deductible as input tax. The test was whether the services acquired by DBCM were acquired for the purpose of consumption, use or supply of goods or services in the course or furtherance of the enterprise. The SCA had to, *inter alia*, clarify the meaning of and nature of the word "enterprise" since the purpose of acquiring the services and whether they were consumed or utilized in making taxable supplies could only be determined in relation to a particular enterprise. This involved a factual enquiry as to what constituted DBCM's enterprise. The SCA, in adopting a restrictive approach, found that DBCM's enterprise, for the purposes of the VAT Act, consisted of mining, marketing and selling diamonds. It was found that the services provided by such local suppliers were provided for multiple purposes, but ultimately not for the purpose of making taxable supplies by an enterprise which mines, markets and sells diamonds.

Conclusion

In light of the above, it would seem that there are two distinct tests, from an income tax and VAT point of view, in determining whether a taxpayer can claim a deduction. From an income tax perspective, the test is whether there is a causal connection between the relevant events (giving rise to legal expenditure) and the taxpayer's trade whereas from a VAT point of view, the test is whether the expenditure incurred in procuring legal services was acquired for the purpose of consumption, use or supply of goods or services in the course or furtherance of the taxpayer's enterprise. Another (perhaps over simplified way) summary of the position is that for income tax purposes, deductions in respect of overhead and general business expenditure not aimed directly at the taxpayer's income earning activity will be allowed whilst for VAT purposes, our courts tend to require VAT expenditure to be incurred by the taxpayer, significantly more directly in

connection with the earning of (vat-able) income.

ENSAfrica
ITA: Section 11(*c*)
VAT Act: Sections 7 and 16
SARS AND NEWS

Taxation of Income protection policies

Income protection

By Doné Howell, Tax Partner Grant Thornton Johannesburg

The latest in the wave of changes that affect the taxation of insurance policies that exist for the benefit of an employee, but are paid by the employer, is the recent legislation regarding the taxation of income protection policies.

Although the effective date of this legislation is 1 March 2015 (the 2016 tax year), it is important for employers to be aware of the impending changes to the PAYE system and to consider the possible review and renegotiation of your policies in the next year.

Current legislation

- Employer-paid premiums in respect of insurance policies for the benefit, whether directly or indirectly, of an employee or his or her spouse, child, dependant or nominee, is a taxable benefit and is reported on the

IRP5 certificate against code 3801.

- However, to the extent that the premiums are in respect of a policy which (i) *"… covers that person against loss of income as a result of illness, injury, disability or unemployment"* and (ii) *"the amounts payable in terms of the policy… constitute or will constitute income as defined"* and are treated as a taxable benefit in the employee's hands, the employee is deemed to have paid such premiums and will therefore be entitled to a tax deduction of the same amount. This deduction is reported on the IRP5 certificate against code 4018.
- Although there is an initial inclusion as a taxable benefit in the employee's hands, the corresponding deduction in calculating the PAYE results in a nil PAYE liability.
- Taxpayers who pay premiums to such policies are also entitled to a tax deduction. The deduction is allowed in terms of section 11(a) of the Income Tax Act, No.58 of 1962 ('the Act') read with section 23(m)(iii) of the Act.

Reasons for change

- Although the insurance industry may have differing names for disability policies, essentially there are two types of cover; capital protection and income protection.

- Capital protection is essentially cover against a person's loss of income earning capacity, while income protection is cover against a person's loss of future income.
- Currently premiums paid towards capital protection are not deductible but future policy pay-outs will be tax-free. Premiums paid for income protection are tax

deductible however; the income from future policy pay-outs will be taxed.

- The Legislature's motivation to align the tax treatment in respect of these types of policies is that it believes that both types have a similar objective, which is *"to protect the financial future of an individual and his or her family through insurance against an adverse personal event (death or disability)."* This alignment will also ensure a similar tax treatment as applied in respect of life insurance policy premiums.

Consequences of the change

- As from 1 March 2015:
    - Any premiums paid by an employer for the benefit of an employee will be treated as a taxable benefit;
    - The employee will not be entitled to a tax deduction of the corresponding value;
    - An individual will not qualify for a tax deduction in respect of his or her premium paid; and
    - All policy pay-outs will be tax-free, irrespective of whether historical premiums qualified as tax deductions and irrespective of whether the policy pay-out is in the form of a lump sum or an annuity.
    - Notwithstanding the increase in PAYE to be suffered by an employee, employers will also bear an increase to their skills development levies and unemployment insurance fund contributions costs.
- As it will no longer be necessary to provide for tax deductions when calculating the amounts in respect of future pay-outs, employees could be over-insured and employers will need to review and re-negotiate income

protection policies.

- Furthermore, the employee’s net take home pay will be reduced due to the increase in PAYE and therefore the possible re-negotiation for a lower policy pay-out would have a corresponding reduction in the premiums payable.
- It will be necessary to educate employees proactively to ensure they comprehend the future tax implications of these policies.

Other employer-paid policies

- As a reminder, from 1 March 2012 (the 2013 tax year) a taxable benefit arises in respect of employer paid contributions to an insurer in respect of an insurance policy, whether directly or indirectly for the benefit of an employee, his or her spouse, child, dependent or nominee.
- The policies that will be affected by this taxable benefit provision are ‘unapproved’ policies, i.e. policies that are owned/in the name of an employer.
- Therefore, it is vital that employers ascertain whether their policies qualify as ‘approved’ or ‘unapproved’ policies. Any premiums the employer pays towards an approved policy, i.e. a policy that is part of a pension or provident fund as policyholder, does not qualify as a taxable benefit as the tax treatment is the same as employer contributions to pension or provident funds.

Setting aside business rescue

An interesting judgment was handed down in the North Gauteng High Court on 3 October 2013 in the matter of ***Commissioner for the South African Revenue Service v Miles Plant Hire (Pty) Ltd* (case no 23533/2013).**

Miles Plant Hire (Pty) Ltd (the taxpayer) was involved in a dispute with the South African Revenue Service (SARS) in terms of which an appeal was pending.

The taxpayer adopted a resolution to file for business rescue.

When SARS became aware of the resolution, it brought an application for the setting aside of the resolution, and for the taxpayer to be wound up in terms of section 177(1) of the Tax Administration Act, No. 28 of 2011 (the TAA).

The court was mainly concerned with the application by SARS for the winding up of the taxpayer.

Section 177(3) of the TAA provides that, where a tax debt is subject to objection or appeal, SARS may only apply for the winding up of the taxpayer "*with leave of the court before which the proceedings are brought*".

SARS did not initially request such leave, but subsequently amended its notice of motion to include a prayer for leave to institute the proceedings.

The taxpayer argued that SARS should first, prior to the current proceedings, have applied for leave to bring an application for the winding up of the taxpayer. Because SARS failed to do so, the application had to be dismissed.

SARS argued that two separate applications are not required, but that it may, in the same proceedings, ask for leave to pursue an application for winding up, and ask for the actual winding up order.

In essence, the question for determination was whether section 177(3) requires that, when SARS seeks an order for the winding up of a taxpayer, there must be two separate applications, the one preceding the other. In other words, whether there must first be an application for leave to institute winding up proceedings, and secondly, if leave is granted, whether there must be a further application for the actual winding up of the taxpayer.

The court effectively sided with SARS and held that two separate applications are not required.

In the court's view, the correct interpretation of section 177(3) is that it obliges and empowers a court, before it considers the substantive merits of the application for winding up, but during the same proceedings, to also consider the merits of the pending objection or appeal. Only then may it make an appropriate order.

In other words, the court held that the purpose of section 177(3) is to allow a court before which a winding up application is brought, to also evaluate, without deciding, the grounds of the objection or appeal.

For example, should the court find that there is merit in the objection or appeal, it may postpone the proceedings until such time as the dispute has been finally resolved, and then only make an order in respect of the winding up of the taxpayer.

The court therefore confirmed that the purpose of section 177(3) is to prevent abuse of the 'pay-now-argue-later' principle and to subject applications by SARS for the winding up of taxpayers to judicial scrutiny in circumstances where an objection or appeal is pending.

In the current matter, the court considered the grounds of appeal of the taxpayer, but found that the taxpayer did not seriously contest the capital amount of tax due – the taxpayer

mainly disputed the imposition of a penalty. In respect of the undisputed capital amount alone, the court found that the taxpayer was ‘hopelessly insolvent’ and the court therefore granted the winding up order.

Cliffe Dekker Hofmeyr
TAA: s177 (1), s177 (3)

Malema trying to delay case – Sars lawyer

Pretoria – Julius Malema is seeking to delay a sequestration case brought against him by the SA Revenue Service (Sars), the High Court in Pretoria heard on Monday.

Malema’s legal team brought an application asking for the matter to be postponed because he wanted to reverse an admission of liability, which he signed last year during negotiations with Sars.

Sars was opposing the application for a postponement.

Nick Maritz, for Sars, argued that Malema had had since April last year to file this application but had done nothing.

He gave a timeline of how Malema’s legal team had failed to file court papers on time, delaying matters.

“All this talk… is all a lot of nonsense in obtaining a delay and since April last year no move was made,” Maritz told the court.

“This withdrawal of admission is not a new point.”

He said Malema raised this point in his answering affidavit on April 17 last year.

There was no argument about the prospect of the application to have the admission set aside being successful, Maritz said.

“He shows no prospect of success in that application,” he said.

“He fails to say why since April last year he’s done nothing to settle this issue.”

Earlier, Dolf Masoma, for Malema, said there were two aspects to his argument to have the case postponed. The first was Malema had a corruption case pending against him. The second was Malema intended to apply to have his admission of liability set aside.

He wanted the sequestration case postponed pending finalisation of these two matters.

Maritz said a pending criminal case was not a reason to grant a postponement.

Malema was not in court.

Masoma argued that if the admission of liability was set aside then an order made in the sequestration case would have to be set aside as well.

According to court documents, Malema owed R16 million plus interest after failing to submit tax returns between 2006 and 2010.

In 2010, Sars contacted Malema about his failure to submit tax returns.

It took Malema 18 months, after many attempts by Sars, to file his outstanding returns.

Malema also failed to register the Ratanang Trust for tax

purposes, and Sars had to do this on his behalf. – Sapa

Income Tax and VAT consequences of E-Tolls

- Introduction

The levying of tolls for the use of certain highways in Gauteng, the so called e-tolls, took effect on 3 December 2013.

It is therefore appropriate to consider the income tax consequences arising from the payment of e-tolls in those cases where an employee is reimbursed for business travelling or is provided with a vehicle owned by their employer or where an employee receives a travelling allowance to finance the expenditure incurred whilst travelling on the employer's business.

In addition, brief reference will be made to the income tax consequences facing fleet owners and cartage contractors.

Reimbursement at prescribed rate

An employer may decide not to provide an allowance for travelling to their employees nor a company owned vehicle and instead reimburse staff for the actual distance travelled on the business of the employer.

Where an employee travels on the employer's business and does not exceed 8 000 kilometres during a year of assessment and the employee does not receive any other compensation from the employer in the form of a further allowance or reimbursement, the prescribed rate per kilometre, which may be paid without

attracting income tax, is R3.24.

The rate per kilometre was set before e-tolls became effective and future regulations governing the amount payable by an employer to an employee for travelling on the employers business should be clarified to provide that the employer may reimburse the employee in respect of the cost of e-tolls.

Currently, the rate per kilometre fixed for purposes of section 8(1)(b)(iii) of the Income Tax Act, No. 58 of 1962 (‘the Act’) provides that the amount of R3.24 may only be paid without any adverse tax consequence arising when no other compensation in the form of a further allowance or reimbursement is payable by the employer to the recipient of the reimbursement at the specified rate.

The payment of the allowance is also not subject to VAT as a fringe benefit in terms of section 18(3) of the VAT Act.

Company Owned Vehicle

Where the employer owns or leases a motor vehicle and makes that available to an employee the employee will be subject to fringe benefits tax on the value and usage of that vehicle in the manner set out in paragraph 7 of the Seventh Schedule to the Act.

In principle, the employee is subject to fringe benefits tax at a rate of 3.5% of the determined value of the motor vehicle for each month for which the employee is provided with the use of the vehicle by their employer.

The determined value of the vehicle for fringe benefits tax purposes is normally the cash cost thereof, including VAT. In the event that the motor vehicle, at the time of acquisition, is the subject of a maintenance plan, the rate of fringe benefits is reduced to 3.25% of the determined value of the motor vehicle on a monthly basis.

In the case of an employer owned vehicle, the vehicle will be owned by the employer and thus the employer will be liable to pay the e-tolls to the extent that the motor vehicle in question travels on tolled highways.

The employer will be entitled to deduct the cost of e-tolls as an expense incurred in the production of income in that it relates directly to the provision of the motor vehicle by an employer to an employee for purposes of its business.

The employer will, so long as the travelling was for the purpose of making taxable supplies and they receive a valid tax invoice which complies with the provisions of section 20 of the Value-added Tax Act, Act No. 89 of 1991,('VAT Act'), be entitled to recover the VAT paid on the e-tolls as an input credit when submitting its VAT returns to SARS.

Where the employee retains accurate records of business distance travelled it will be possible to reduce the taxability of the fringe benefit by taking account of the ratio of business kilometres to total kilometres travelled by the employee.

Furthermore, where the employee pays for certain expenses relating to the motor vehicle, the value of the taxable fringe benefit may be reduced by taking account of the business kilometres travelled as a proportion of the total kilometres travelled during the tax year.

In accordance with the provisions of the Fourth Schedule to the Act the employer is required to deduct PAYE on 80% of the value of the fringe benefit arising from the use of the employer owned vehicle unless the employer is satisfied that at least 80% of the employee's travel is related to the business of the employer. In these cases the PAYE deduction is based on 20% of the value of fringe benefit in question.

Employee Owned Motor Vehicle

In this case the employee will receive an allowance as part and parcel of their remuneration package with the result that the travelling allowance received will be subject to PAYE such that 80% of the allowance paid per month will attract PAYE.

Where the employer can be satisfied that 80% or more of the travelling undertaken by the employee is for business purposes only 20% of the allowance paid will attract PAYE.

It is essential for the employee to retain a log book recording distance travelled on the business of the employer and the nature thereof so that they may determine the total business kilometres travelled during the tax year and that portion of travelling with constitutes private travel for which no deduction is available.

When the employee completes their annual tax return they will be entitled to claim expenditure regarding the motor vehicle against the allowance received by taking account of actual business kilometres travelled during the tax year.

The taxpayer is entitled to use either actual costs incurred in respect of operating the motor vehicle during the tax year or alternatively may rely on the table of costs prescribed by the Minister of Finance.

Where the employee chooses to claim expenditure based on actual expenditure incurred they will be entitled to take account of the cost of insurance, maintenance and other direct costs relating to the operation of the motor vehicle including fuel, depreciation on the motor vehicle and the cost of e-tolls.

The table of costs prescribed by the Minister takes account of the fixed cost attributable to the motor vehicle which is an attempt to recognise the depreciation in the value of the a motor vehicle depending on the cost thereof as well as the fuel cost and maintenance cost.

The table of costs currently in existence does not take account of the cost of e-tolls.

The table of costs is unlikely to be amended because e-tolls are only applicable on certain highways in Gauteng and not in South Africa generally.

The alternative for the employee is to seek the reimbursement of the actual e-toll costs incurred from the employer in respect of business travelling.

This will be neutral for tax purposes from the employee's point of view.

The employer should be entitled to claim the reimbursement of e-toll costs as a deduction for income tax purposes under section 11(a) of the Act.

Where an employer reimburses an employee who travelled for taxable business purposes for e-toll costs that employer will be entitled to recover the VAT relating thereto even though the tax invoice will be issued in the name of the employee and not in the name of the employer.

This is based on the provisions of sections 16(2)(a) and 54 of the VAT Act which regulates the position of input tax borne by an agent on behalf of their principal.

Also, section 20(5) of the VAT Act does not require that the name, address and VAT registration number of the employer be reflected on a tax invoice where the consideration for the supply does not exceed R5 000.

Fleet owners and cartage contractors

Those businesses which own a large number of vehicles, such as the car rental companies will face an increase in their operating costs as a result of the introduction of e-tolls.

Similarly, the transport contractors will experience an

increase in their costs of moving goods around the country as a result of the imposition of e-tolls.

The cost of e-tolls are directly related to the business conducted by such taxpayers and will be deductible under section 11(a) of the Act.

Where the affected businesses are registered for VAT, they will be entitled to recover the VAT incurred on the e-tolls if the vehicles were used in the course of making taxable supplies and so long as they are in possession of a valid tax invoice which meets the requirements of section 20 of the VAT Act.

The introduction of e-tolls will no doubt result in an increase in the cost of goods transported by road which will ultimately be carried by the consumer in South Africa.

Conclusion

Where an employee receives a reimbursement of travelling at a rate not exceeding the amount specified by the Minister of Finance it may be possible to seek the reimbursement of e-toll costs without adverse tax consequences.

However, it would be preferable if the rules regulating such reimbursement are clarified in this regard.

In the case of a company or employer owned vehicle, the employer will be liable to pay the e-tolls and should be entitled to deduct that cost as a deduction for tax purposes.

No adverse tax consequences should arise in so far as the employee is concerned who is subject to fringe benefits tax on the usage of the motor vehicle in any event.

In those cases where an employee receives a travelling allowance to finance the cost of travelling on the employer’s business a decision will need to be made whether to claim the

actual expenditure incurred regarding the motor vehicle, including the cost of e-tolls or to rely on the table of prescribed costs as set out by the Minister of Finance from time to time.

Those businesses which own a fleet of vehicles for renting out to clients or which own trucks to transport goods around the country will face an increase in costs which will, no doubt, be recovered from their clients.

The cost of e-tolls will be deductible for tax purposes in terms of section 11(a) and the VAT element should be recoverable where the business is registered for VAT purposes and the vehicle is used for taxable business purposes.

Author: Beric Croome (ENSafrica)

Firms seeking tax benefits face legal repercussions

THE tax consequences of decisions made in the boardroom have been highlighted in some recent court cases, where judgments were made against parties who had entered into transactions that were motivated by the potential tax benefits it would bring rather than the profits they would generate.

A judgment laid down in the case of ABC vs the South African Revenue Service (SARS) heard in the Western Cape Tax Court last year reiterated the importance of paying attention to the details of a transaction as reflected in the financial statements, including related taxes.

ABC acquired land with a forest on it and carried on forestry activities on the land. It then sold the land together with the forest for a specific amount, of which R144.7m related to the forest. The question before the court was whether the R144.7m should be included in ABC's gross income.

SARS contended that it should on the basis of the first schedule to the Income Tax Act which states: "Any amount received by or accrued to a farmer in respect of the disposal of any plantation shall, whether such plantation is disposed of separately or with the land on which it is growing, be deemed not to be a receipt or accrual of a capital nature and shall form part of such farmer's gross income."

The appellant said it was a passive investor in land and acquired the land together with the forest as an investment. It also argued that the company it sold the land to was then given the right to use the property and the forest; and was therefore carrying on the forestry (farming) operations and was using it without paying, the benefit for ABC being that its asset (forest) was maintained, and thus the profit being capital in nature, was subject to capital gains tax and not company tax.

But SARS said ABC was conducting farming operations and appointed the acquiring company (E) to do so on its behalf based on the following:

- The purchase agreement indicated that ABC acquired a business from D in 2001;

- The sale agreement indicated that ABC sold a business to E in 2003;

- A board resolution indicated that ABC transferred a going concern and income earning activity to E; and

- An invoice, which was explained as a bonus for good stewardship, indicated that ABC paid E a management fee.

The judge referred to a case in the Natal Special Court in 1972, where the following was held: “The court’s function is to determine, on an objective overview of all the relevant facts and circumstances, what the motive, purpose and intention of the taxpayer were. In other words, whatever a taxpayer may tell the court has to be analysed through the prism of the objective facts presented”.

SizweNtsalubaGobodo head of taxation services Zweli Mabhoza says: “The test to be applied when it is necessary to determine whether profit made on the sale of property by a taxpayer represents revenue or a receipt of a capital nature has been formulated in many ways, but so far the general approach to the problem has been maintained.

“The fundamental inquiry is whether, in buying and selling the property and thus earning the profit which is the subject of the inquiry, the taxpayer was engaged in carrying on a trade or business or a profit-making scheme. If that is what he was doing, the profits are income and taxable in his hands.”

Based on the signed documentation, which differed from the evidence of the witnesses, the judge concluded that ABC was in fact carrying on farming operations and the proceeds fell within the ambit of the Income Tax Act.

“This judgment is a useful reminder of the importance of considering the detail of any agreement or other document relating to a transaction from a tax perspective,” Mr Mabhoza says.

“Not even an opinion obtained from a tax adviser would be enough to protect the taxpayer from legal recourse, if the discussions are in the boardroom. A related aspect is to ensure that agreements and related documents reflect any tax advice obtained accurately.

“Not doing so is likely to lead to a tax predicament.”

In December last year another tax case involved a taxpayer's sponsor who did not provide an invoice for a noncash transaction. Tax authorities argued that the taxpayer was liable for value added tax on the noncash element of the sponsorship received.

Attempts by the taxpayer to argue that it did not receive invoices for sponsorship were in vain.

"The wording in the annual financial statements and lack of invoice by sponsors of another taxpayer resulted in unintended negative tax consequences," Mr Mabhoza says.

"For this reason, companies in South Africa should consider the need for tax directors on their board to ensure this will not happen."

Shauwn Mpisane: More than 100 tax fraud charges withdrawn

Shauwn Mpisane. Picture: Khaya Ngwenya/City Press

Durban tender queen Shauwn Mpisane has walked out of the Durban Regional Court a free woman after the state withdrew more than 100 tax fraud charges against her.

Mpisane, the owner of Zikhulise Cleaning, Maintenance and Transport, was charged with defrauding the SA Revenue Service of R4.7 million by submitting false VAT invoices, but applied to National Director of Public Prosecutions Advocate Mxolisi Nxasana to have the case withdrawn over prosecutorial

misconduct.

This morning Nxasana was at court for the hearing, at which prosecutor Arno Rossouw told Magistrate Blessing Msane that he had been instructed to withdraw the case in terms of Section 6 (b) of the Criminal Procedure Act.

Msane, who described the case as “the most gruelling I have been involved in’’, said he was acquitting Mpisane, who was accompanied to court by her husband S’bu and a large group of family and friends, in line with a request from her lawyer, Rafik Bhana, SC.

A secondary case of attempting to bribe a witness in the tax matter will be withdrawn in the Pinetown Magistrate’s Court later today.

Two weeks ago, a separate case of fraud and forgery was withdrawn against Mpisane after the prosecution failed to meet a court deadline for presenting a forensic report to back up the charges.

She said she had kept quiet for three years but that she and her husband were “delighted’’ the ordeal was over.

“We’ve been here for three years. We saw justice was being delayed and denied,’’ she said.

Mpisane thanked S’bu for “always being here beside me’’ and “being that big shoulder to cry on”.

She said all she wanted now was to have a chance to be a mother, a wife and a businesswoman.

“We just want to take this chapter and close it and carry on with what I do best, being a businesswoman,’’ she said.

She will go to court next week to secure the return of some R70 million in assets held by the Asset Forfeiture Unit in connection with the forgery case.

National Prosecuting Authority spokesperson Nathi Ncube said the alleged misconduct had been so serious that to continue with the prosecution would have been a miscarriage of justice.

The misconduct, he said, had been so bad that “we could not undo the damage’’.

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The limitation of deductions for untaxed interest

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The Taxation Laws Amendment Bill 39 of 2013 proposes the introduction of a new section (section 23M) to the Income Tax Act (ITA) to limit the deduction of interest incurred by a debtor in respect of a debt owed to a creditor that is in a ‘controlling relationship’ with the debtor and the interest in question is not subject to South African tax. The restriction will apply to interest incurred on or after 1 January 2015. In essence, the section limits the deduction for interest paid between connected persons where the interest is not taxed in the hands of the recipient to an amount determined with reference to 40% of taxable income before interest and capital allowances.

This new provision is, however, not as simple as it appears at first blush. Before the provision applies, the following requirements must all be present:

- the debtor must be a South African resident for tax purposes;
- the debtor and the creditor must be in a controlling relationship;
- the interest incurred must not be subject to tax during that year of assessment.

Each of these requirements deserves further consideration and analysis.

The debtor must be resident

The implications of this requirement seem obvious at first. Clearly, any debtor that is resident in South Africa will meet the requirement. The bigger issue is with respect to debtors not covered by the provision. Notably, a South African branch of a non-resident would not be a debtor as defined and any interest incurred by such a branch would not be subject to the interest limitation. This may raise some interesting constitutional issues. Section 9(3) of the Constitution of the Republic of South Africa, 1996 (the Constitution) provides that "The state may not unfairly discriminate directly or indirectly against anyone on one or more grounds". Section 9(5) goes on to provide that "Discrimination on one or more of the grounds listed in subsection (3) is unfair unless it is established that the discrimination is fair."
There is little doubt that section 23M discriminates against South African tax residents in favour of non residents. The question then is whether this discrimination is fair. It is difficult to see how such discrimination could be fair, particularly given the objective of protecting the South African tax base against excessive interest deductions; after all, South African branches of non-residents are as much part of the tax net as South African resident companies. The arguable result is that the provisions of section 23M are unconstitutional and invalid and may therefore not be enforced.

The debtor and creditor must be in a controlling relationship

A ‘controlling relationship’ is defined in section 23M as a relationship between a company and any connected person in relation to that company. The implication is that at least either the debtor or the creditor must be a company. The provisions will therefore not apply, for example, to debts between a beneficiary and a trust or a partner and a partnership. The provision also contains an anti-avoidance rule to prevent an unconnected person being interposed. This rule will apply where an unconnected creditor obtained the funds advanced to the debtor from a person that is in a controlling relationship with the debtor or the creditor where the debt is guaranteed by a person that is in a controlling relationship with the debtor.

The interest incurred must not be subject to tax during that year of assessment

The first issue which requires consideration is what is meant by ‘tax’ in the context of section 23M. This is a defined term in section 1 of the ITA and means any tax imposed by the Act. In effect, what it means is that if the interest is subject to either the normal tax (income tax) or the withholding tax on interest, the interest deduction will not be limited in the hands of the debtor. It also does not matter whether the interest is taxable in the hands of the recipient or in the hands of a shareholder of a controlled foreign company.

The second issue that needs to be considered is what is meant by ‘subject to tax’. Does this include all amounts that fall within the scope of the taxing legislation, whether exempted or not, or does include only amounts that are actually taxed? The answer is the latter. Notwithstanding that an amount of interest may, for example, constitute gross income, it will not be regarded as being subject to tax if it is exempted. Similarly, an amount of interest will not be regarded as being subject to the withholding tax on interest if it is exempted from that tax, either in terms of the legislation or in terms of a double tax treaty. However, an amount of interest that is fully offset by deductible amounts such that not actual tax liability arises is still regarded as being subject to tax.

The third aspect that should be considered is the time at which the interest is subject to tax. It is clear from the

section that the interest must be subject to tax in the year of assessment of the debtor. Ordinarily, this would present no problem with regard to income tax as the interest income will accrue at the same time that the interest expense is incurred. However, insofar as the withholding tax on interest is concerned, some risks do arise with regard to potential timing mismatches. This is because the liability for withholding tax on interest arises only when the interest is paid or is due and payable. Where the terms of the debt are such that interest is payable only periodically, a debtor could find itself in the position where the interest falls foul of section 23M, notwithstanding that the interest may be subject to tax in the future. For example, assume a company has a June year end. It incurs interest in relation to that year; however, the interest is only payable annually in arrears on 31 December each year. The result is that the interest from January to June of each year is not subject to withholding tax on interest during the year of assessment of the debtor, but only in the subsequent year.

Interaction with other provisions

Another issue that is not clear is the interaction between section 23M, section 23N and section 31. Although section 23N is made subject to section 23M, all 3 sections could potentially apply to the same debt. Assume Company A borrows an amount of R1000 at 10% from Company B, a connected non resident in a treaty country where the treaty provides for a nil withholding tax on interest, in order to fund a reorgan-isation transaction as contemplated in section 23N. Company A has adjusted taxable income of R200 and no interest received. Applying section 23M, Company A’s interest deduction will be limited to R80 and the balance of R20 will be carried forward to the next year. An identical result arises in terms of section 23N, with the exception that the excess is entirely disallowed for the first 6 tax years. The question then arises as to whether the interest is permanently disallowed under section 23N or rolled

forward to the next year under section 23M. Section 31 could also apply if Company A is considered to be thinly capitalised.

The implication of this section being applied is also a permanent disallowance of the deduction. However, it also gives rise to a secondary adjustment in the form of a deemed loan. Arguably, section 31 cannot be applied to the extent that section 23M has been applied as there would be no tax benefit as contemplated in section 31.
Treaty non-discrimination

Arguably, section 23M could fall foul of the non-discrimination provisions of double tax treaties. Paragraph 4 of Article 24 of the OECD Model Tax Treaty (MTC) provides as follows: "Except where the provisions of paragraph 6 of Article 11 apply, interest paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first mentioned State."

The reference to paragraph 6 of Article 11 is a reference to excessive interest in accordance with the arm's length principle. The commentary on the MTC states that this non-discrimination provision does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with paragraph 6 of Article 11 and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.
The provisions of section 23M seemingly do not comply with the arm's length principle as the limitation is purely arbitrary. While the rules do not strictly speaking discriminate on the basis of residence, but rather on the basis of whether the recipient is subject to tax, this issue would only arise in a situation where South Africa has surrendered its right to tax

interest arising from a South African source in terms of a negotiated treaty. It seems at odds with this position that South Africa should then unilaterally be able to introduce legislation that penalises the debtor as a result of the application of such a treaty. It would be interesting to see if any taxpayer is prepared to challenge the section on the basis of treaty non-discrimination.