7 May 2021

To: The South African Revenue Service
Lehae La SARS
299 Bronkhorst Street
PRETORIA
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Via email: SARS - policycomments@sars.gov.za

RE: SAIT COMMENTS ON DRAFT INTERPRETATION NOTE 59 (ISSUE 2): TAX TREATMENT OF THE RECEIPT OR ACCRUAL OF GOVERNMENT GRANTS

Dear Colleagues,

We appreciated the invitation to comment on draft interpretation note 59 (Issue 2) (draft IN 59), which deals with the tax treatment of the receipt or accrual of government grants, as outlined in section 12P of the Income Tax Act, No. 58 of 1962 (the Act).

1. Structure and approach of the draft IN 59

The IN 59 deals with:

- The tax consequences of the receipt and accrual of government grants;
- The exemptions from normal tax applicable to government grants; and
- Anti-double dipping rules applicable to expenditure funded by such grants.

At a substantive policy level, we are in general agreement with the interpretation note and we believe that it is a fairly open interpretation note. We also find the plethora of examples immensely helpful. Provided below are our comments highlighting a few key issues.

2. The interaction between specific exemptions and section 12P

In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 (the EM), the National Treasury explained the rationale for the replacement of sections 10(1)(zA), 10(1)(zH) and 10(1)(y) with the insertion of section 12P into the Act. In the EM, the reasons provided for the changes were that the income tax rules pertaining to government grants were scattered amongst various provisions in the Act and *"seemingly lacked overall policy direction*".

Therefore, the proposal was made to devise a unified approach through consistent application of the law (section 12P) and the collation in one place of the grants (the Eleventh Schedule). It was for this reason that section 12P of the Act was inserted and specific exemptions in *inter alia* section 10(1)(zA), (zG), (zH) and (zI) were deleted, while section 12P and the Eleventh Schedule were inserted with effect from years of assessment commencing on or after 1 January 2013.

However, Part 5.3 of the draft IN 59 appears to refer to several miscellaneous exemptions listed in section 10 of the Act. From the wording of the draft IN 59, it appears that the intention is to bring these miscellaneous exemptions within the ambit of section 12P. The draft IN 59 specifically states that:

> *"In determining whether a government grant is subject to normal tax regard must be had to –*
>
> - *…*
> - *any exemption under section 10;*
> - *any exemption under section 12P and the Eleventh Schedule; and*
> - *the facts and circumstances of the particular case."*

The wording of the above conclusion appears to suggest that both section 10 and section 12P of the Act must be considered when determining whether a government grant is subject to normal tax. However, with reference to the exemption under section 10(1)(y) of the Act, the draft IN states the following:

> *"It is irrelevant that amounts received under the Taxi Recapitalisation programme and the Clothing and Textile Competitiveness programme potentially qualify for an exemption under section 10(1)(y) and section 12P(2) because an amount can only be exempt once and no matter which provision is applied section 12P(2) to 12P(6) applies."* (Own emphasis)

The wording from the above extract suggests that irrespective of whether another specific exemption applies, section 12P of the Act will override the application thereof. We are of the view that both provisions operate independently from one another. However, this is not clear in the present reading.

We are therefore of the view that the above interpretation should be reconsidered.

3. Allocation of government grant funding

The draft IN 59 considers the treatment where a government grant is received to fund one asset. However, in the course of ordinary business, a government grant received is usually utilised to fund a number of assets.

Additionally, in many other cases, the taxpayer applies for the government grant before the assets are acquired. Moreover, asset details and costs are often unknown to the taxpayer at the time the grant is applied for.

The draft IN 59 is silent regarding the allocation methodology of allocating the grant to the various assets. This gives rise to a number of queries:

- Will SARS prescribe the allocation of the grant to the assets in this case?
- Will the taxpayer be allowed to allocate the grant as they see fit?
- Will the taxpayer be able to allocate the government grant based on the taxpayers' factual circumstances and needs, and not be required to expend the full government grant on one particular asset?

Essentially, we are interested to know whether SARS will respect the taxpayer's allocation of the government grant and not curtail the taxpayer's spending/ allocation in any particular way.

As this is not clear in the draft IN 59, we recommend that the finalised version of the draft IN 59 clearly outline the way in which SARS intends to deal with the allocation of government grants in practice.

4. Limitation rule applicable to future allowances

When applying section 12P(4) of the Act, in practice certain taxpayers simply reduce the cost of the asset by the grant in year one and calculate the annual allowances on the reduced cost. However, example 5 in the draft IN 59, illustrates SARS' interpretation (which is in line with the EM and differs from the above approach that is presently being undertaken in practice). Essentially, SARS' approach calculates the allowance on the cost and tracks what the cumulative allowances are relative to the cost, less any exempt grants relating to the asset.

The taxpayers' approach appears to have the effect of "burning up" or fast tracking the utlisation of the allowances in the earlier years. The SARS approach does seem more in line with the wording of the Act as the allowances are based on actual cost.

Example for illustrative purposes:

- **Facts**: The taxpayer acquires an asset amounting to R200 000. The taxpayer is allocated a government grant amounting to R50 000. In the first year of acquisition, the taxpayer allocates the cumulative amount of the government grant to the acquisition cost, thus reducing the acquisition cost significantly in year one (i.e., R200 000 less R50 000). Thereafter, the taxpayer applies the section 12C allowance to the reduced acquisition cost (i.e., R150 000).
- **Result**: By applying the section 12C allowance on the reduced acquisition cost, the taxpayer effectively fast tracks the utlisation of its allowances in the earlier years

Although example 5 of the draft IN 59 outlines SARS' interpretation of the way limitations of allowances should be undertaken, we note from the wording of section 12P of the Act that an express methodology is not outlined in this regard. The question of which provision precedes the other could, upon a strict reading section 12P of the Act, be open to interpretation. On the basis that the interpretation is vague one could argue that the *contra fiscum* rule of interpretation applies.

We request that SARS address the above discrepancy in the finalised IN 59.

5. Government grants in kind

Although the term 'grant in kind' is not defined in the Act, we welcome the detailed explanation of what a 'grant in kind' entails as set out in the draft IN 59. However, both section 12P of the Act and the draft IN 59 are silent on the tax treatment of expenditure funded by government grants 'in kind'.

Upon consultation with a practitioner on this contentious matter, we wish to present the following practical example:

- **Facts**: Taxpayer A receives a government grant in kind in terms of the Automotive Production and Development Programme (APDP). The grant is payable in the form of production rebate credit certificates (PRCC), which are rebatable. For accounting purposes, the gross amount of the PRCC rebates is recorded as income in the financial statements, and the gross amount of expenditure incurred is recorded as expenses in the financial statements.
- For tax purposes, the PRCC rebates are exempt from tax in terms of section 12P of the Act and would be subtracted in the tax computation. The expenditure should not be deductible, as the PRCC's would have been utilised to reduce the expenditure payable.

From the above scenario it appears that there is a possibility of a double deduction in this regard.

Although this is not articulated in the draft IN 59, essentially our understanding is that government grants 'in kind' typically assume a tax cost of zero. However, some government grants (such as the APDP) are not routine in nature. For brevity's sake the APDP is a production incentive scheme for the motor industry aimed at promoting production volumes in the specified motor vehicle industry, promoting added value in the automotive component industry thus creating employment across the automotive value chain.

Under the APDP, a taxpayer may acquire a number of rebates, one being the PRCC. The PRCC is designed to offset a taxpayer's customs obligations. However, the PRCC itself is the grant 'in kind', which we assume has a tax cost of zero. In this vein we would be interested to know what would the tax treatment be if the taxpayer did not utilise the PRCC rebates but rather on-sells its PRCC rebates to another taxpayer? We would assume that on the basis that the PRCC is acquired at zero tax cost, at the point that the taxpayers on-sells the PRCC, the taxpayer would derive 100% gain upon disposal.

We recommend that SARS addresses this scenario in the draft IN 59.

The current APDP that was launched in 2021 will be operational until 2035. As the APDP will be operational for several years, the above practical example may be more apparent in the future. We note that the APDP is likely the biggest programme for Department of Trade Industry and Competition (DTIC), and for that reason believe that it is important that the matter be addressed. We recommend that SARS should cover the above practical scenario and comments in the draft IN 59.

6. Miscellaneous

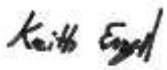
In example 3, the (**) explanation states *"The full government grant of R500 00 is deducted because all the related trading stock is still on hand."*

For the purposes of finalisation: There appears to be an error, as a zero has been omitted from the R500 00**0**.

7. Conclusion

In conclusion, SAIT welcomes the opportunity to comment on this draft IN 59 prior to the finalisation thereof. We would welcome further engagement.

Yours faithfully,



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