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DEDUCTIBILITY OF INTEREST

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ADVANCE PRICING AGREEMENTS

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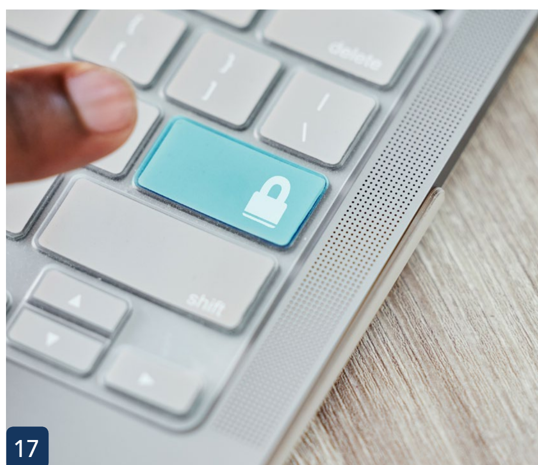
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DEDUCTIONS AND ALLOWANCES

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Editorial panel:
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DEDUCTIBILITY OF INTEREST

In an income tax context, one of the issues that have been considered by our courts on a number of occasions is the issue of deductibility of interest. On 5 November 2021, the South African Revenue Service (SARS) issued Binding Private Ruling 369 (the Ruling), which deals with the deductibility of interest pursuant to the liquidation of a company. We briefly discuss the Ruling below.

FACTS

The applicant in the Ruling is a resident company in liquidation and its liquidators.

- The company ceased trading and the liquidators commenced with its winding-up and the realisation of its assets.
- The resultant proceeds were invested and consequently earned interest.
- The liquidators are legally required to apply the net proceeds against the capital and interest of all proven claims, all of which related to trade debt.
- Only the trade debts carried any provision for interest and hence no interest was incurred by the applicant in relation to the trade debts, with the exception of one creditor.
- The applicant will therefore actually incur interest in relation to the proven claims when the Master of the High Court (Master) confirms the Liquidation and Distribution Account (L&D Account).

SARS RULING

Based on the above facts disclosed in the Ruling, SARS found that:

- The interest payable by the applicant will be "actually incurred" in the year of assessment when the Master confirms the L&D Account.
- The interest payable by the liquidators will not qualify for any deduction under section 24J or section 11*(a)* of the Income Tax Act , 1962 (the Act), on the basis that it will not be incurred in the production of income.

SARS stated that Practice Note 31 does not apply to the proposed transaction.

DISCUSSION AND ANALYSIS

Persons reading the Ruling should not immediately become concerned that the Ruling, in and of itself, reflects a shift in SARS' view regarding the deductibility of interest, as the context in which the interest arose is rather unique.

"Generally speaking, a taxpayer that incurs interest and meets the requirements of sections 24J(2) and 11*(a)* of the Act, will be able to deduct that interest."

Generally speaking, a taxpayer that incurs interest and meets the requirements of sections 24J(2) and 11*(a)* of the Act, will be able to deduct that interest. The key issue in the context of the Ruling is the requirement that for interest to be deductible, it must be incurred in the production of income. Some of our readers will be aware of the judgments that have dealt with the "production of the income" requirement, for example, *Sub-Nigel Ltd v Commissioner for Inland Revenue*, [1948], where the Supreme Court of Appeal (SCA) held that the "in production of the income" requirement is met if the expenditure was incurred for the *purpose* of earning income. Furthermore, in the oft-quoted *Port Elizabeth Electric Tramway Ltd v Commissioner for Inland Revenue*, [1936], the SCA held that for expenses to be incurred in the production of income, one must consider whether the expenses are –

> "...attached to the performance of a business operation *bona fide* performed for the purpose of earning income . . . provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

While SARS' reasoning is not known as it is not included in the Ruling, it appears that, in this case SARS was of the view that the interest incurred on confirmation of the L&D Account by the Master was not sufficiently closely connected to the applicant's trade. Taxpayers must also be mindful that although the introduction of section 24J changed some of the rules regarding interest deductions, it still requires that the "in the production of the income" and "trade" requirements are met for interest deductibility. This was made clear in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004.

The fact that, according to the Ruling, Practice Note 31 (PN 31) does not apply is also of interest. In terms of PN 31, which was issued by SARS in 1994, where a taxpayer incurs interest to earn interest on capital or surplus funds invested, it is SARS' practice to allow expenditure incurred in the production of that interest, even though it is evident that the taxpayer does not trade as a moneylender. The only limitation of PN 31 is that the interest deduction is limited to the interest earned on the surplus funds invested. What the Ruling therefore appears to suggest, is that the interest incurred on approval of the L&D Account by the Master cannot be deducted from the interest earned from the proceeds of the liquidation that were invested, even if the interest income was earned in anticipation of and to pay the interest due to the Master on approval of the L&D Account. It is possible that SARS did not view the investment of the funds as being close enough to the payment of the interest as to have been incurred to earn the interest.

Louis Botha

Cliffe Dekker Hofmeyr

Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding private ruling* has a binding effect on SARS *between SARS and the applicant only* and is published for general information. It does not constitute a practice generally prevailing. A third party may not rely upon a binding private ruling under any circumstances. In addition, published binding private rulings may not be cited in any dispute with SARS, other than a dispute involving the applicant or any co-applicant(s) identified therein.

Acts and Bills

- Income Tax Act 58 of 1962: Sections 11*(a)* & 24J (more specifically subsection (2)).

Other documents

- Binding Private Ruling 369 ("Deductibility of interest incurred pursuant to liquidation of company" (5 November 2021));
- Practice Note 31 ("Income Tax: Interest paid on moneys borrowed" (3 October 1994));
- Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004.

Cases

- *Sub-Nigel Ltd v Commissioner for Inland Revenue* [1948] (4) SA 580 (A);
- *Port Elizabeth Electric Tramway Ltd v Commissioner for Inland Revenue* [1936] CPD 241; 8 SATC 13.

Tags: net proceeds; production of income; interest deduction.

BARTER TRANSACTIONS

Barter transactions are commonplace in today's commercial environment. Parties exchange goods or services without a cash transaction underpinning it. The question is, "What happens when I sell the asset in future? Do I have a tax cost for it?"

Paragraph 20(1)*(a)* of the Eighth Schedule to the Income Tax Act, 1962, refers to "the expenditure actually incurred in respect of the cost of acquisition or creation of that asset". The word "expenditure" includes expenditure in cash or in kind. In ITC 1783 [2004] the court established the following about the meaning of the word "expenditure":

> " 'Expenditure' in its ordinary dictionary meaning is the spending of money or its equivalent e.g. time or labour and a resultant diminution of the assets of the person incurring such expenditure."

The court cited the following extract from the authors of *Silke*:

> "It is submitted that the word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash. For example, if a merchant were required to pay for his goods by tendering land or other goods, the value of the land or goods would constitute expenditure in terms of s 11*(a)* and would be deductible."

This principle confirms that the expenditure in a barter transaction is the amount by which each party's assets are diminished. For example, in *South Atlantic Jazz Festival (Pty) Ltd v Commissioner, South African Revenue Service*, [2015], the taxpayer staged annual international jazz festivals during the period in question. During its enterprise it concluded sponsorship agreements with various suppliers in which the sponsors paid money towards and provided goods and services for the festivals in return for which the taxpayer provided goods and services to the sponsors in the form of branding and marketing. The transactions under the sponsorship agreements were essentially barter transactions despite their part-cash components. The court found that:

> "In consequence, and accepting, as one may, that the transactions were at arm's length, the value of the goods and services provided by the appellant to the sponsors in each case falls to be taken as the same as that of the counter-performance by the relevant sponsor. … In an ordinary arm's-length barter transaction, the value that the parties to it have attributed to the goods or supplies that are exchanged seems to me, in the absence of any contrary indication, to be a reliable indicator of their market value."

In general, therefore, it can be accepted that when assets or services are exchanged for assets or services under a barter transaction, the market value of the assets or services will, absent any contrary indication, be the market value of the assets or services as agreed between the parties and would be of equal value. In most instances the market value of the assets or services to be exchanged between the parties is reflected in the relevant agreement.

Should you engage in barter transactions on a regular basis, it is advisable to speak to your financial or tax adviser to determine the specific factors relevant to these transactions.

T Roos

Editorial comment: This article deals with the income tax consequences of the barter of goods and services (not the issue of shares which are catered for in section 40CA of the Act). It should be borne in mind that there may also be VAT consequences.

Acts and Bills

- Income Tax Act 58 of 1962: Eighth Schedule: Paragraph 20(1)*(a)*.

Other documents

- *Silke on South African Income Tax* ("Memorial Edition"): Paragraph 7.4.

Cases

- *ITC 1783* [2004], 66 SATC 373 (G);
- *South Atlantic Jazz Festival (Pty) Ltd v Commissioner, South African Revenue Service* [2015] (6) SA 78 (WCC).

Tags: sponsorship agreements; barter transactions.

SOME TAX AMENDMENTS 2021

INTRODUCTION

On 11 November 2021, when the Minister of Finance presented his 2021 Medium-term Budget Policy Statement to Parliament, he also tabled the Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2021, the Tax Administration Laws Amendment Bill, 2021, and the Taxation Laws Amendment Bill, 2021. These Bills were passed by Parliament in December 2021 and promulgated as Acts 19, 21 and 20 of 2021, respectively, on 19 January 2022. Only the last-mentioned Act, the Taxation Laws Amendment Act, is discussed in this article. Furthermore, we limit our discussion to those amendments that are likely to be of interest in the general business environment; more specifically, we are commenting on the Income Tax Act, 1962 (the Act).

CORPORATE RESTRUCTURING RULES

Asset-for-share transactions

Section 42 of the Act allows roll-over relief when a person exchanges an asset for shares in a company and ends up with a "qualifying interest" (as defined in subsection (1) of that section) in that company (usually at least 10%). The section is intended to apply only where the consideration given by the company comprises an issue of its own equity shares. Any other consideration (eg, cash) will trigger CGT to the extent of the amount thereof. An exception to this rule is made where certain qualifying debt is assumed by the company when it acquires the asset.

Because this could result in a loss to the fiscus, section 42(8) provides that the amount of debt assumed will be added to the proceeds when the shares are sold. So, for example, if an asset with a base cost of R100 and a related liability of R80 are transferred to a company in exchange for shares, commercially and for accounting purposes the shares will be issued for R20, which will be the shareholder's cost of those shares. Under section 42, however, the shares issued are deemed to have a base cost in the recipient's hands equal to the base cost of the asset, which is R100 in this case. Assume that at a later stage the shares are sold for R110. Commercially the shareholder makes a profit of R110 – R20 = R90, but for CGT purposes the capital gain is R110 – R100 = R10. For this reason the amount of the debt is added to the proceeds of R110, making it R190, and now the capital gain will be R190 – R100 = R90, which equals the actual commercial profit.

This anti-avoidance provision was, however, defeated where the shares were, in turn, disposed of under one of the other corporate restructuring rules. So, for example, if those shares were distributed by the shareholder to its holding company as a liquidation distribution under section 47 of the Act, the holding company receiving the distribution would have "inherited" the base cost of R100 but would not have been subject to the obligation to add the amount of the debt of R80 when it sells the shares.

To resolve this problem section 42(8) has been amended to state that where the shares are first disposed of, immediately prior thereto there is deemed to be a return of capital equal to the amount of debt assumed. Under the rules, a return of capital is deducted from the base cost by the shareholder, and only if the amount goes negative will a capital gain apply.

So in the example above, the person disposing of the shares with a base cost of R100 would be treated as having received a return of capital of R80 just prior to the disposal, which would reduce the base cost to R20. Now the capital gain, when the shares are sold for R110, equals the commercial profit. But if those shares are not sold but are immediately distributed to a holding company under a liquidation distribution, also as per the example above, the holding company will "inherit" the base cost of R20, so that if it ever on-sells the shares it is the holding company that will make the capital gain based on the base cost of R20, so that the anti-avoidance provision will not have been defeated.

This amendment will apply to disposals of shares on or after 1 January 2022.

"In 2020 an attempt was made to ameliorate some of the harsh consequences of this debt rule, but the relevant legislation (the Taxation Laws Amendment Act, 2020), which inserted a new subsection (3B), did not go far enough."

Intragroup transactions

Section 45 of the Act allows companies, within the same group for tax purposes, to sell assets among them on a roll-over relief basis. The rules also state that if the transferee disposes of that asset to an acquirer outside of the group within six years, then the transferor would (generally) be subject to the capital gain based on market value at the date of the intragroup transaction as if the roll-over did not apply (but, clearly, after six years this so-called degrouping charge falls away).

Where intragroup debt is utilised for this purpose, eg, where the purchase price is left owing on loan account, that loan is deemed to have a nil base cost in the creditor's hands. The effect of this is that any repayment will trigger a capital gain in the hands of the creditor. However, the rules prevent this from happening by stating that the gain will be disregarded provided that, at the date of repayment, the debtor and creditor still form part of the same tax group. Moreover, unlike in the case of disposals of assets by the transferee company, there was no six-year limitation.

In 2020 an attempt was made to ameliorate some of the harsh consequences of this debt rule, but the relevant legislation (the Taxation Laws Amendment Act, 2020), which inserted a new subsection (3B), did not go far enough. The entire subsection (3B) has thus now been replaced and takes effect in respect of tax years commencing on or after 1 January 2022.

Insofar as is relevant to this discussion, the new subsection (3B) applies in the circumstances where either –

- the transferor and transferee companies cease to form part of the same group of companies; or
- the transferee and transferor companies are still part of the same group on the sixth anniversary of the acquisition.

In such case, in effect, the creditor company will be deemed to have a base cost in respect of the balance of the loan still owing. In other words, the harsh treatment of nil base cost is reversed.

This makes sense because –

- in the case of the situation in the first bullet above, the transferor company will have been subject to the degrouping charge and therefore should not be double taxed, as it were, by being left with a debt owing that has no base cost; and
- in the case of the second bullet above, if the companies have remained as part of the group for the full six years, there seems to be no reason why the creditor should continue to suffer the burden of a nil base cost if the debt is still in existence.

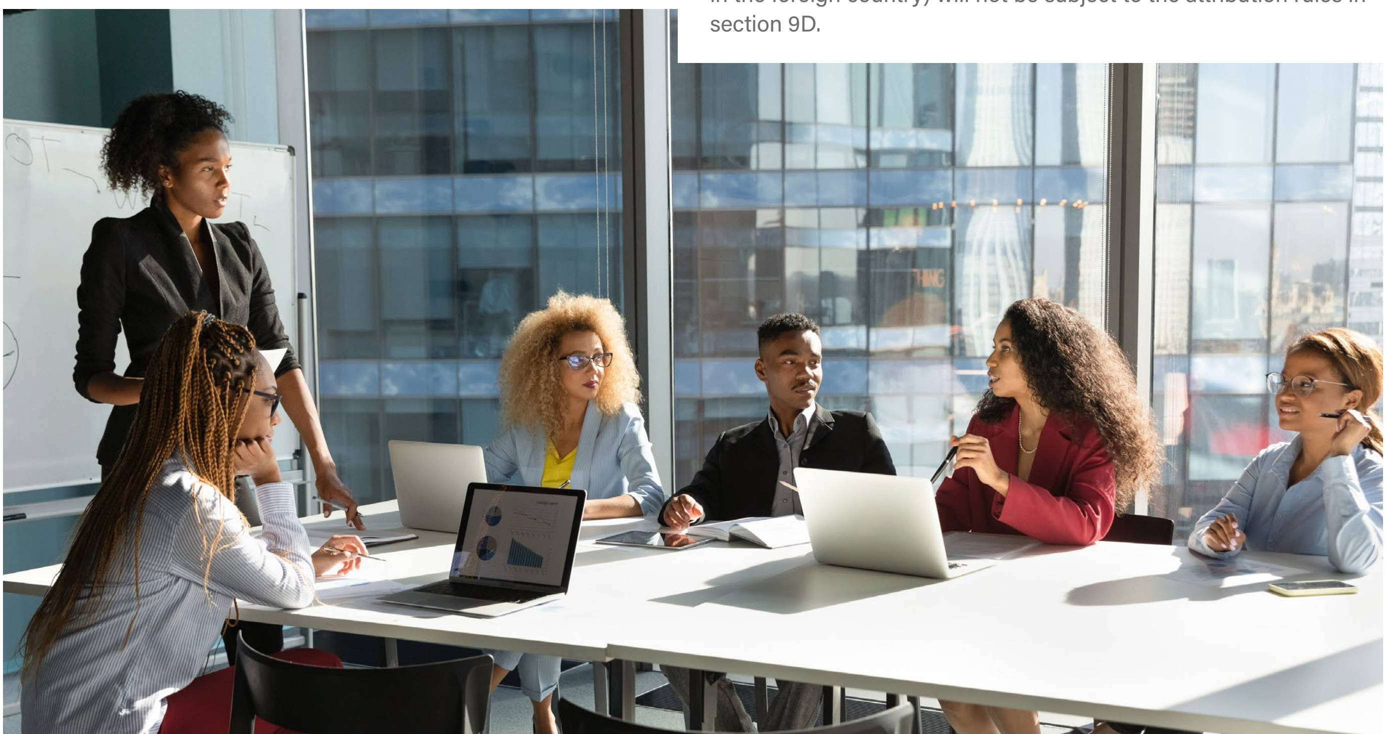
That all said, we cannot see the justification for retaining this nil base cost rule at all. The fact is that it is being imposed, but whether the transferor and transferee companies do degroup within six years or do not, the base cost will always be restored. So the question immediately arises as to when the burden of the nil base cost will ever be felt.

INTERNATIONAL TAX

Controlled foreign company rules

Section 9D of the Act contains the rules relating to a controlled foreign company (CFC). In short, an amount, the "net income", which is determined under the rules in the Act based on the CFC's income and expenses in the same way that one would determine a South African taxpayer's taxable income, is included in the South African-resident shareholders' (taxable) incomes, pro rata to their shareholding and is taxed at their normal tax rates.

There are certain exclusions to the CFC "net income" calculation and one of them is where the CFC has a qualifying foreign business establishment (FBE), namely, adequate premises, equipment, management and staff outside South Africa, through which the CFC's business is carried on. Provided there is such an FBE the amounts, which would otherwise have been included in the "net income" calculation, attributable to that FBE (even if not taxed at all in the foreign country) will not be subject to the attribution rules in section 9D.



But it is not all types of income attributable to the FBE that fall within the exclusion. Certain amounts that must nevertheless be included in the "net income" calculation are contained in the rules that effectively render those amounts still taxable in the shareholders' hands. Some of these rules are known as "diversionary rules" in that they relate to transactions that have the effect of denuding the South African tax base.

These diversionary rules are contained in section 9D(9A) and one of them is to be found in subparagraph *(a)*(i) of section 9D(9A). This applies where income is derived by the CFC from the sale of goods directly or indirectly to any connected person in relation to the CFC that is a resident (eg, a South African group company). Without the diversionary rule there would be the potential for shifting profit from South Africa to a lower tax jurisdiction, where the CFC operates, by the CFC charging the highest possible price for the goods (within the confines of the transfer pricing rules). This diversionary rule was, however, made inapplicable (and thus the FBE exclusion would still apply) if *inter alia* –

- the CFC purchased the goods (later sold to the SA connected resident) within its country of residence from a supplier who is not a connected person in relation to the CFC (item *(aa)* of paragraph *(a)*(i)); or

- the CFC purchased the same or similar goods mainly within its country of residence from persons who are not connected persons to it (item *(dd)* of paragraph *(a)*(i)).

With effect from tax years commencing on or after 1 January 2022, the diversionary rule has been amended and will be rendered inapplicable only if the CFC purchases the goods (which are later sold to the South African connected resident), or the same or similar goods, and their purchase has been mainly "for delivery" in the country of residence of the CFC.

So, whereas it was previously possible for a CFC to purchase goods from a third party in its country of residence and on-sell these to a South African group company, without endangering the FBE exclusion for the CFC, now the FBE exclusion can only continue to apply if the CFC purchases those goods "for delivery" to it in its country of residence.

"There is, of course, a difference between the concept of delivery from a commercial perspective and from a legal perspective."

There is, of course, a difference between the concept of delivery from a commercial perspective and from a legal perspective. Commercially one would see delivery as meaning the actual passing of possession of the goods, eg, the goods are delivered to the purchaser's warehouse and handed over. Legally, delivery occurs when ownership passes in the goods. Because the amendment makes no reference to "physical delivery" it would therefore be possible to arrange that the CFC purchases the goods such that there is legal delivery taking place within the CFC's country of residence, which means that the FBE exclusion will continue to apply.

SARS takes the view that delivery here means physical delivery, ie, in the commercial sense, though, as mentioned, the legislation does not state this. It is possible that a court would agree with SARS having regard to the purpose of the provision, and the relative ease whereby legal delivery can be ensured.

Withholding tax on interest

One of the amendments made to the Act was to clarify the tax treatment in the case of hybrid debt instruments and hybrid interest, dealt with in sections 8F and 8FA respectively. Under these sections the interest paid is deemed to be a dividend *in specie* rather than interest so that the company gets no deduction. The amendment now clarifies that the amount will also be treated as a dividend in the recipient's hands, and thus will not be taxed.

As a consequential amendment, section 50A – which forms part of the rules relating to withholding tax on interest – is being amended to make it clear that "interest" as defined does not include a deemed dividend received under sections 8F or 8FA.

There is a difficulty that arises in this regard that has not been addressed:

- First, it must be understood that, unlike in the case of a cash dividend where the dividends tax is imposed on the shareholder (even though withheld by the company and paid over to SARS), in the case of a dividend *in specie* it is the *company* that is liable for the tax because the tax is imposed on the company itself and not on the shareholder. Technically, this means that a non-resident shareholder, which is entitled to a lower rate of dividends tax under a DTA, will lose its entitlement thereto. This problem is addressed by the Act itself providing that the company will be liable for the same amount of tax on a dividend *in specie* that would have been payable by the non-resident shareholder under the DTA.

- Even though the Act will treat the amount paid as a dividend, it remains interest for the purposes of a DTA, where the withholding rate could be less than 15% – even zero. It can be argued that this is neutral to the recipient or even advantageous, because it will receive the deemed dividend free of tax, which is the same as where the DTA provides for a zero withholding, or even be better off if the DTA provides for a rate of, say, 10% withholding on the interest – now nothing will be withheld.

- But this assumes that the company paying the interest is content to pay the interest *plus* the dividends tax that, at best under the DTA, might be reduced to 5%, or maybe only to 15%. If the hybrid interest paid is, say, R100 with zero withholding under the DTA but the company might have to pay dividends tax of, say, R15, depending upon the terms of the loan agreement, then the company might not be able to only pay the recipient a net R85, which means that it becomes a larger burden to the local company, ie the cost of finance is R115 instead of R100. And the company cannot seek any relief because it has already been held by our courts (in relation to STC (secondary tax on companies) before it was abolished) that a tax on dividends imposed on the company paying it cannot be reduced under a DTA as it is not a tax on the shareholder, but on the company itself.

SECTION 57B INSERTED INTO THE ACT

The major change has been the introduction of a new section 57B into the Act. This is supposed to counter a scheme that has been identified by SARS in which the donations tax and trust attribution rules have been avoided.

Under existing law, it is possible to divest oneself of the right to an amount prior to accrual, by antecedently divesting it in favour of the new recipient. This could be the case, for example, where one cedes one's right to a dividend before it accrues. The law recognises that it is the person to whom it is ceded who is taxable on that dividend (leaving aside any other anti-avoidance provisions). When it comes to remuneration for services rendered, the law already states that if A renders services and B receives the compensation therefor, A will nevertheless be taxed on the amount received by B.

But where that remuneration is in the form of a right to receive an asset and, before it accrues, the employee cedes his or her right to receive the asset to, for example, a family trust, then the employee will still be taxable on the amount but will have been able to ensure that the asset is held by a trust and is therefore outside of the employee's estate for estate duty purposes. The employee will also not be subject to donations tax because the value of that right is argued to be nil. Moreover, any income of the trust derived from that asset will not be attributed to, and taxed in the hands of, the employee as donor, under the trust attribution rules.

To counter this, section 57B states that the disposal of the right is disregarded, and the employee is treated as having acquired the asset for an amount equal to the amount included in his or her gross income, and then he or she is treated as having disposed of the asset to, say, the trust by way of a donation for an amount equal to that deemed cost. This applies for all purposes of the Act, so that it will now apply both for donations tax and attribution purposes.

This provision applies in respect of the disposal of the right to receive an asset on or after 1 March 2022.

EXTENSION OF INCENTIVES

Two important incentives to certain taxpayers, both of which have so-called sunset clauses (ie, they automatically cease to be available from a specific date), have had their termination dates extended.

Thus –

- whereas the learnership allowance under section 12H of the Act only applied to a registered learnership agreement entered into between a learner and an employer before 1 April 2022, that date has been extended to 1 April 2024; and

- in the case of the Urban Development Zone (UDZ) incentive, whereby allowances are given to a taxpayer who redevelops urban areas in terms of section 13*quat* of the Act, the date by which the building must be brought into use to qualify for the incentive has been extended from 31 March 2021 to 31 March 2023 (this amendment is deemed to have come into operation on 1 April 2021 and to apply in respect of any building, part thereof or improvement that is brought into use on or after that date).

Ernest Mazansky

Werksmans Attorneys

Acts and Bills

- Income Tax Act 58 of 1962: Sections 8F, 8FA, 9D(9A) (specifically paragraph *(a)*(i)*(aa)* & *(dd)*), 12H, 13*quat*, 42 (more specifically subsections (1) (definition of "qualifying interest") & (8)), 45 (specifically subsection (3B)), 47, 50A & 57B;
- Taxation Laws Amendment Act 23 of 2020;
- Rates and Monetary Amounts and Amendment of Revenue Laws Bill 21 of 2021;
- Taxation Laws Amendment Bill 22B of 2021;
- Tax Administration Laws Amendment Bill 23 of 2021;
- Rates and Monetary Amounts and Amendment of Revenue Laws Act 19 of 2021;
- Taxation Laws Amendment Act 20 of 2021;
- Tax Administration Laws Amendment Act 21 of 2021.

Other documents

- 2021 Medium-term Budget Policy Statement.

Tags: qualifying interest; roll-over relief basis; intragroup debt; controlled foreign company (CFC); foreign business establishment (FBE); learnership allowance.

ADVANCE PRICING AGREEMENTS

Following the issue of the discussion paper on the subject in late 2020, the December 2021 issue of a "Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation" (the Paper) has interested both taxpayers and potential investors. It's been a long time coming as businesses operating in South Africa have been calling for Advance Pricing Agreements (APAs) for a long time and the DTC recommended the consideration of an APA programme in its BEPS Report of 2016. So, the issue of the proposed model and draft legislation is great news for the progression of the implementation of the APA programme so that businesses can get certainty on cross-border pricing; of course, implementing a new programme like this will take time and lots of SARS resources.

OECD recommended administrative mechanisms against BEPS

In what is frequently referred to as the "post-BEPS world", ie, today's environment of cracking down on any shifting of profits to low-tax jurisdictions, transfer pricing (TP) is a hot topic, even gaining momentum in the political world. This has brought significant scrutiny into the tax affairs of multinational enterprises the world over and has resulted in unprecedented levels of cooperation amongst tax authorities to share information and better coordinate their audits.

What is an APA?

The Organisation for Economic Co-operation and Development (OECD) defines an APA as

> "an arrangement that determines, in advance of a controlled transaction, an appropriate set of criteria for determination of the transfer price for those transactions over a fixed period of time."

Thus, it is basically prior approval from the relevant tax authority that a business' transfer pricing methodology, ie, the method by which it determines the pricing for the relevant goods and services between it and its cross-border connected parties, is accepted by the issuing tax authorities. As TP audits are one of the largest risk for multinationals, this brings huge benefits as it –

- proactively avoids disputes between a revenue authority and taxpayers; and
- creates greater tax certainty.

How will the SA APA system work?

Although SARS openly admits that it currently has insufficient TP capacity, it is planning and drafting legislation for an APA system for approval by the National Treasury and the Minister of Finance. Using the lessons learnt from the existing advance tax ruling system as a basis, SARS intends to put enabling legislation in place to underpin the APA system as discussed in the Paper, which provides a high-level model and draft legislative framework for the APA unit as well as the processes associated with it.

Although not yet finalised, SARS is clearly fairly advanced in developing the model and has a pilot project already in the planning stages. The APA pilot will, however, only accept bilateral APAs and will take the resulting experiences into consideration before branching out into multilateral and unilateral APAs.

The draft APA legislation (which is likely to take between 18 to 30 months to put in place) is envisaged to form part of Chapter 7 of the Tax Administration Act, 2011.

Tax certainty and encouraging investment can only be good for the SA economy, so the progress being demonstrated toward the implementation of an APA system is very positive.

Tuli Nkonki

Regan van Rooy

Acts and Bills

- Tax Administration Act 28 of 2011: Chapter 7.

Other documents

- "Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation" (SARS paper released in December 2021).

Tags: shifting of profits; low-tax jurisdictions; transfer pricing (TP).

COST OF TAX LITIGATION

Tax litigation is no laughing matter. By the time a tax dispute reaches the tax court, it is likely that it has been going on for some time already. This is because, prior to the tax court proceedings, a taxpayer would have first objected to the assessment (most often an additional assessment) issued by the South African Revenue Service (SARS), with SARS then either partly or fully disallowing the objection. Where a taxpayer then elects to appeal directly against SARS' decision to disallow the objection, the taxpayer will have the option of either referring the matter to alternative dispute resolution (ADR) or choosing to appeal to the tax court (or tax board depending on the quantum).

Once the decision is made to approach the tax court (whether directly or after the dispute could not be resolved during ADR), it generally takes at least 18 months to two years (often longer nowadays) before the matter is eventually heard in the tax court. In other words, it is safe to say that the road to the tax court is lengthy and as such, readiness at the time of the hearing is key. If the taxpayer is not ready when the matter is heard, the result can be that the taxpayer is liable for not only the tax debt in dispute, but also the legal costs incurred on the road to the tax court.

Unfortunately, this was the outcome in the matter of *Mr K v Commissioner for the South African Revenue Service*, [2021], (Case No IT24682) (as yet unreported).

FACTS

- The taxpayer had appealed to the tax court, objecting to income tax assessments, following an audit into his income tax affairs for the 2008 to 2013 tax years.
- SARS raised additional income tax assessments for each of the tax years, including amounts of income not declared by the taxpayer in his gross income, and imposed penalties and interest.
- The matter was set down from 30 November 2020 until 4 December 2020, with the court being assisted by both an accountant and a commercial member of the court.
- Counsel for SARS travelled to Cape Town for the matter, as did the Registrar of the Tax Court.
- The interpreter, originally appointed by the taxpayer, remained to assist the court, notwithstanding the fact that he had been informed by the taxpayer that he would not be paid.
- The taxpayer failed to appear in court on 30 November 2020.
- SARS requested default judgment in terms of Rule 44(7) of the Tax Court Rules promulgated under section 104 of the Tax Administration Act, 2011 (the TAA).

JUDGMENT

The tax court dismissed the taxpayer's appeal, confirmed SARS' decision to invalidate the objections against the 2008 to 2010 additional assessments, and ordered the taxpayer to pay the costs of the proceedings, including the costs of the interpreter.

The reasons noted by the tax court for the decision can best be summarised as follows:

- The accountant and commercial member are highly regarded professionals who have been practising for many years in their respective fields and their time is a valuable resource.
- The expenses incurred in respect of the appointment of the accountant, commercial member and SARS' counsel, which were significant, were funded by the fiscus, from taxpayers' money.
- When the taxpayer eventually arrived at court, after the matter was initially stood down, it came to the court's attention that the taxpayer's counsel and attorney had withdrawn, the latter on the morning of the hearing as he had not been paid or had been advised that he would not be paid.
- Furthermore, upon his arrival at court, the taxpayer advised that he was not in a position to fund the services of the court-approved interpreter. Instead, he wanted the court to provide an interpreter and also suggested that SARS pay half for the interpreter. In place of a court translator, he also tendered the services of his wife as translator, which the court did not find acceptable as a replacement for a court-approved translator.
- The taxpayer further alleged that he was not aware of the hearing, which the court found improbable given that the matter had been ongoing for five years and that he was well aware of the fact that pre-trial attendances were concluded on his instructions by his erstwhile legal representatives.
- This had been disputed by SARS, considering that, amongst other things, comprehensive pleadings had been filed on his behalf and as a pre-trial conference took place which his attorney attended on his instruction.
- The court asked the SARS' representative to address the court and take the taxpayer and the court through its heads of argument. It then invited the taxpayer to make representations under oath himself. He, however, suggested that his wife give evidence on his behalf and wished to bring his accountant to give evidence.
- The matter stood down for the taxpayer to consider what SARS' representative had argued. When the parties returned to court a discussion again ensued relating to the costs of the interpreter and the taxpayer did not take the matter any further despite the fact that the interpreter had remained. This was not acceptable to the court and further delayed proceedings.
- Ultimately, the taxpayer failed to prosecute his appeal despite having been given the opportunity to do so – the argument presented by SARS was therefore uncontested by the taxpayer.

COMMENT

The judgment is a reminder of the importance that taxpayers ensure that they manage tax disputes properly, including in terms of the instructions they give to their legal representatives. Whilst one can appreciate that there are costs involved in conducting tax litigation and that these costs can be high, taxpayers should be mindful of the potential costs they may have to incur and manage the dispute accordingly. The failure to do so may result in a taxpayer not being liable for only his own legal representatives' fees, but also being liable for SARS' legal fees, in terms of a cost order. What is interesting about the matter under discussion is that the tax court went a step further by also ordering the taxpayer to pay the costs of the interpreter, which does not generally form part of a cost order. In this case, for example, the taxpayer could have potentially avoided the cost order, by requesting a postponement of a few weeks or months in advance of the hearing.

One must also be mindful that this is not the first time in which the tax court has granted an application for default judgment in terms of rule 44(7) of the Tax Court Rules.

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Section 104.

Other documents

- Tax Court Rules: Rule 44(7).

Cases

- *Mr K v Commissioner for the South African Revenue Service* [4 June 2021] (Case No IT24682).

Tags: alternative dispute resolution (ADR); additional income tax assessments; default judgment.

DEFERRAL OR SUSPENSION OF A TAX LIABILITY

In the current climate with taxpayers having to juggle, amongst other things, the devastating effects of COVID-19 and the unforeseen losses of the civil unrest, it may be that some taxpayers could find themselves in a difficult position to deal with expected and unexpected tax liabilities.

When taxpayers are faced with a tax liability, it must from the outset be decided whether the liability will form part of a dispute with SARS, or whether the taxpayer accepts the liability. This is so, as disputed and undisputed tax liabilities can be treated differently, utilising different tools found in the Tax Administration Act, 2011 (the TAA).

If the taxpayer does not agree with the tax liability based on fact or law, our advice is to engage the dispute process. Unfortunately to bury one's head in the sand will not absolve any taxpayer from the tax liability that remains due and payable in this instance, due to the general rule of "pay now, argue later". When the tax liability is disputed, and circumstances (including financial circumstances) so dictate, taxpayers can apply, and SARS may allow, for a suspension of payment. The suspension of payment is an exception to the general rule of "pay now, argue later". A suspension of payment does not eliminate a tax liability but postpones same whilst the dispute is alive. Naturally the outcome will determine whether the tax liability is due or not. The suspension of payment application is made in terms of section 164 of the TAA, and SARS considers various factors when allowing or disallowing it. A decision by SARS to disallow a suspension of payment is capable of being reviewed.

The TAA provides for various other mechanisms which are available to taxpayers, such as the instalment payment agreement or the compromise.

The instalment payment agreement (the deferral) is a hybrid tool, in that it is available whether the tax liability is disputed or undisputed. Sections 167 and 168 of the TAA govern this application. In essence, the deferral allows taxpayers to pay the tax liability in instalments, within an agreed period. The deferral does not eliminate a tax liability. The deferral is generally entered into when taxpayers do not have the necessary liquidity or assets to pay the liability immediately. It is possible to defer a portion of the liability. The deferral is an appropriate tool where circumstances so dictate and has the effect of remedying a non-compliance status.

"The effect of the compromise agreement is that the taxpayer undertakes to pay an amount which is less than the tax liability due, in full and final satisfaction of the tax debt, whilst SARS undertakes to permanently 'write off' the remaining portion of the tax liability."

The TAA provides for SARS to write off or compromise a portion of the tax liability, as opposed to only deferring same. Sections 200 to 207 govern the compromise arrangement. The compromise only applies to undisputed liabilities and where circumstances justify a compromise. It is therefore critical for taxpayers to consider whether their liability is capable of being disputed in a *bona fide* manner, before applying for a compromise. Once the liability is compromised, the taxpayer cannot dispute the debt. The effect of the compromise agreement is that the taxpayer undertakes to pay an amount which is less than the tax liability due, in full and final satisfaction of the tax debt, whilst SARS undertakes to permanently "write off" the remaining portion of the tax liability.

Dealing with the tax liability in one or more of the ways discussed herein (such as a deferral, suspension of payment or compromise) is not an arbitrary decision, but rather fact-specific and these facts must speak to the appropriate legal provisions. For example, the facts will be evidenced by the supporting documents to be evaluated, such as bank statements, management accounts, annual financial statements and no outstanding compliance obligations.

Never take the ostrich approach, as a tax liability left unattended can grow exponentially. Understand what your tax liability is and how it arose, whether you agree with it and then deal with it in an appropriate manner. You'll be well advised to consult with your tax attorney or tax adviser in this regard.

Chrichan de la Rey & Anton Lockem

Shepstone & Wylie

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 164, 167, 168 & 200–207.

Tags: tax liability; pay now, argue later; instalment payment agreement; undisputed liabilities.

REQUESTS FOR EXTENSION OF TIME

In the context of tax court litigation, an order for a default judgment against SARS or the taxpayer will generally only be granted if, in terms of rule 56(1) of the rules (the Rules) promulgated under section 103 of the Tax Administration Act, 2011 (the TAA), the defaulting party fails to remedy its default within 15 days of receiving a notice to apply for a final order under section 129(2) of the TAA.

In *Commissioner for the South African Revenue Service v SAV South Africa (Pty) Ltd*, [2021] (Case No IT25117) (as yet unreported), the tax court was requested to grant a rule 56 application in the taxpayer's favour, while SARS requested the court to find that the application was irregular.

FACTS

- The taxpayer filed its appeal on 22 May 2019.
- On 2 September 2019, more than a year after SARS was required to file its rule 31 statement of grounds of assessment (Rule 31 Statement), the taxpayer addressed a letter to SARS wherein it indicated that SARS had not made a request for extension of the 45-day period in which the Rule 31 Statement should have been filed. The letter also noted that SARS had not indicated its intention to formally apply to the tax court for condonation of the non-compliance with the Rules.
- SARS did not respond to the letter and after the taxpayer had filed a notice on 13 October 2020 indicating its intention to apply for default judgment if SARS failed to remedy the default within 15 business days of the notice, SARS filed its Rule 31 Statement on 20 October 2020.
- Under the circumstances, SARS filed its Rule 31 Statement 310 business days after expiry of the 45-day period.
- On 30 November 2020, the taxpayer applied for a default judgment under rule 56 of the Rules as SARS had not applied for condonation when filing its Rule 31 Statement and had not requested an extension before filing the Rule 31 Statement.
- On 14 December 2020, SARS served a notice to oppose the default judgment application and served a notice in terms of rule 30 of the Uniform Rules of Court, on the basis that the rule 56 application was an irregular step as SARS had filed its Rule 31 Statement within 15 business days of receiving the applicant's rule 56 notice.

RULE 56

Rule 56(1) provides as follows:

> "If a party has failed to comply with a period or obligation prescribed under these rules or an order by the tax court under this Part, the other party may –
>
> *(a)* deliver a notice to the defaulting party informing the party of the intention to apply to the tax court for a final order under section 129(2) of the Act in the event that the defaulting party fails to remedy the default within 15 days of delivery of the notice; and
>
> *(b)* if the defaulting party fails to remedy the default within the prescribed period, apply, on notice to the defaulting party, to the tax court for a final order under section 129(2)."

Rule 56(2) states that the –

> "tax court may, on hearing the application –
>
> *(a)* in the absence of good cause shown by the defaulting party for the default in issue make an order under section 129(2); or
>
> *(b)* make an order compelling the defaulting party to comply with the relevant requirement within such time as the court considers appropriate and, if the defaulting party fails to abide by the court's order by the due date, make an order under section 129(2) without further notice to the defaulting party."

JUDGMENT

The court noted that it was common cause that SARS had complied with the 15-day period in rule 56(2). However, it was asked to consider the taxpayer's argument that SARS was not in full compliance as it did not invoke rule 4(2) of the Rules, which requires that a party request extension of a prescribed time period before expiry of the time period, unless the parties agree that the delivery of a document may take place after expiry of the time period.

The court considered the provisions dealing with tax court procedures, including Supreme Court of Appeal and Constitutional Court judgments regarding the interpretation of legislation and held that the Rules provide for clear time periods to which all parties must adhere. It noted that rule 4 was equally applicable to all the parties and that rule 56 must not be read in isolation unless SARS was exempt from compliance with rule 4(2). The court held that SARS' compliance with the rule 56 notice did not result in a waiver of rule 4(2) as rule 4(2) would then serve no purpose and the court did not interpret the law to state that certain rules are less important than others.

SARS was aware of its non-compliance with rule 4(2) as indicated by its failure to respond to the taxpayer's letter. In the court's view, "SARS went [in]to this trap with eyes open." The court noted SARS' argument that it would suffer prejudice if the rule 56 application were granted as the issues would not have been properly ventilated. However, it found that the prejudice suffered was due to SARS' delay in filing the Rule 31 Statement, which delay in the court's view suggested that the matter may not have had significance for SARS.

The court concluded that the Rule 31 Statement filed was not valid and that SARS remained in default. It dismissed SARS' application and granted the taxpayer's rule 56 application.

COMMENT

The judgment appears to be the first instance where the tax court has granted a rule 56 application despite the default being remedied within the 15-business-day period provided for in rule 56. The judgment illustrates the importance of rule 4(2) and should serve as a reminder to both taxpayers and SARS to comply with the latter rule and request extension of a time period for delivery of a document, before the time period expires. In the current instance, it appears that SARS' extreme lateness in filing the Rule 31 Statement (more than 310 business days late) without any request for extension addressed to the taxpayer, influenced the court's decision.

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Acts and Bills

- Tax Administration Act 28 of 2011: Sections 103 & 129(2).

Other documents

- Rules promulgated under section 103 of the Tax Administration Act 28 of 2011: Rules 4(2) & 56(1);
- Uniform Rules of Court: Rule 30;
- Rule 31 statement of grounds of assessment.

Cases

- *Commissioner for the South African Revenue Service v SAV South Africa (Pty) Ltd*, [2021] (Case No IT25117).

Tags: rule 56 application; default judgment; Rule 31 Statement.

TAXPAYER CONFIDENTIALITY

On 16 November 2021, the Gauteng Division of the High Court, Pretoria, handed down a potentially ground-breaking judgment in the matter of Arena Holdings (Pty) Ltd t/a Financial Mail and Others v South African Revenue Service and Others *(Case No 88359/2019) (unofficial citation and as yet unreported, albeit widely available), pertaining to taxpayer information confidentiality.*

The court held, amongst other things, that sections 67 and 69 of the Tax Administration Act, 2011 (the TAA), are unconstitutional and invalid to the extent that –

- they preclude access to information being granted to a requester in respect of a tax record in circumstances where the requirements set out in section 46*(a)* and *(b)* of the Promotion of Access to Information Act, 2000 (PAIA), are met; and
- they preclude a requester from further disseminating information obtained as a result of a PAIA request.

The judgment will undoubtedly be the subject of debate for many months to come, but in this article, we will briefly discuss the court's analysis of the relevant TAA provisions regarding taxpayer confidentiality and some of the practical implications of the judgment for taxpayers.

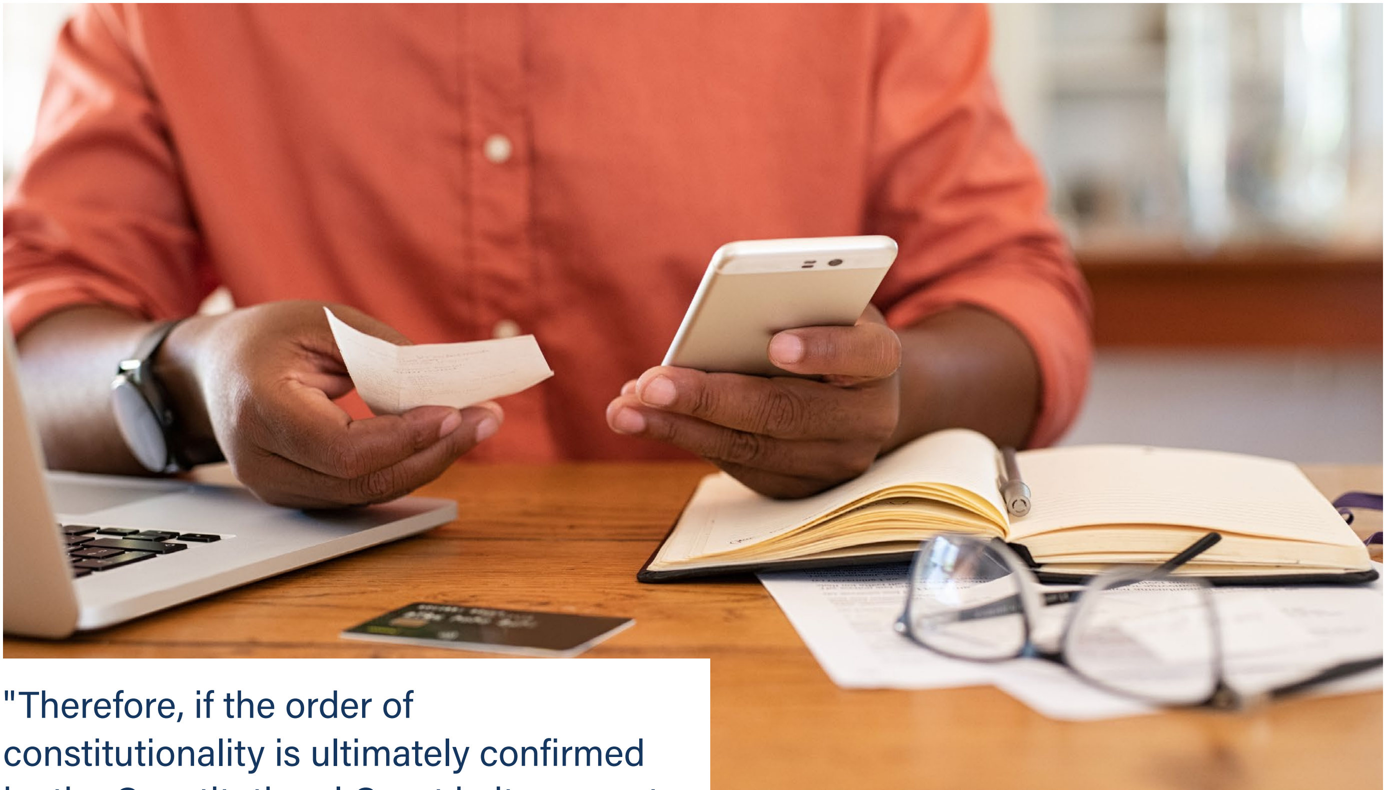
FACTS

- The applicants' case was generated by the requests for access to the IT12 documents (tax returns) relating to Mr Jacob Zuma, for the years that he was President of South Africa.
- The applicants relied on the averments extracted from a book published in October 2017, titled *The President's Keepers* written by Jacques Pauw.
- The averments relied on by the applicants in their papers regarding Mr Zuma's tax affairs during his presidency are the following:
  - that Mr Zuma did not submit any tax returns whatsoever for the first seven years of his presidency;
  - that he owed millions of rand in tax for the fringe benefits he had received because of the so-called security upgrades to his Nkandla residence;
  - that he received various donations from illicit sources – alleged to be tobacco smugglers, Russian oligarchs and the Gupta family;
  - that he had drawn a six-figure "salary" as an "employee" of a Durban security company for the first few months of his presidency (it appears that he had subsequently paid the money back in response to queries);
  - that Mr Zuma had appointed Mr Tom Moyane as the SARS Commissioner to undermine the institution's enforcement capability and to prevent it from prosecuting Mr Zuma for non-payment of taxes and other financial malfeasance, and from investigating people linked to him; and
  - that it was not clear whether Mr Zuma was tax-compliant at the time of publication and that it was probable that SARS was not taking any steps to extract the tax he owed.
- Based on these allegations, some of which are confirmed or corroborated by the findings of the Nugent Commission, the applicants aver that "credible evidence" exists that Mr Zuma was not tax-compliant while he was president.
- In SARS' opposing affidavits and in arguments presented on its behalf, it pleaded "agnostic" to the tax affairs of former President Zuma, based on its obligations not to disclose the tax affairs of any taxpayer in terms of section 69 of the TAA and in circumstances as the present.
- The applicants argued that the tax compliance of a South African head of state, where accusations of non-compliance are in the public domain, entitle them to invoke their rights of access to information and if those rights are statutorily limited, to challenge the constitutionality of those limitations.

JUDGMENT

- The court held that SARS' argument that without taxpayer secrecy, tax administration cannot properly function, is not a universal truth.
- The court noted that the expert research relied on by the parties reflected that in those tax regimes where there is less taxpayer secrecy, tax administration is neither hampered nor prevented.
- The court referred to various academic writings which in its view, cast some doubt on SARS' assertion that voluntary compliance, at least as far as disclosure goes, is dependent on the secrecy "compact" written in law.
- In the court's view, there is no direct or factual evidence that taxpayers in South Africa rather make disclosure of their affairs because of the secrecy provisions as opposed to the coercion of the penalties and sanctions which follow upon disclosure.
- In light of the applicants' arguments that the "public override" requirements in section 46 of PAIA should apply to taxpayer confidentiality where there is reason to believe that the disclosure of the taxpayer information would reveal evidence or failure to comply with the law, the court considered the constitutionality of sections 67 and 69 of the TAA.
- In considering the constitutionality of sections 67 and 69, the court considered whether these sections infringed on the rights of access to information and freedom of expression, in sections 32 and 16 of the Constitution of the Republic of South Africa, 1996 (the Constitution). In doing so, it also considered whether the limitation of these rights was justifiable in light of section 36 of the Constitution.
- After undertaking this analysis, the court held that the limit imposed by the absolute taxpayer secrecy on the rights to freedom of speech and access to information, was not justifiable in the circumstances.

In other words, it held that the TAA needed to include a public interest override provision.



"Therefore, if the order of constitutionality is ultimately confirmed by the Constitutional Court in its current form, it is important that taxpayers understand what the potential impact will be on them."

COMMENT

Firstly, the court appears to have interpreted the confidentiality provisions in the TAA as prescribing an absolute bar to the disclosure of taxpayer information. In providing the backdrop and context against which the judgment is given, the court referred to numerous provisions in the TAA, but only made mention of parts of section 69. If one considers section 69(1) and (2), there is a general bar to disclosure of confidential taxpayer information, subject to certain exceptions. One of these exceptions is that disclosure of taxpayer information is not prohibited where the disclosure is ordered by the High Court. Furthermore, section 69(5) then states that the court may only grant the order if it is satisfied that specific circumstances apply. Section 69(4) also mentions that SARS may oppose an application for disclosure on the basis that it may seriously prejudice the taxpayer concerned or impair a civil or criminal tax investigation by SARS. It is strange that in its limitations analysis, the court did not consider these subsections in section 69, which provide for disclosure if certain requirements are met, in greater detail. Had it considered these provisions, the extent of the finding on constitutionality might have potentially been different.

Secondly, one must appreciate the potential effect of altering the taxpayer information confidentiality provisions as they currently stand. While the court did not agree with SARS' arguments as to why there should not be a public interest exception to confidentiality, one can appreciate that if taxpayer information was generally available and more easily accessible by persons other than the taxpayer, taxpayers would justifiably be concerned that their personal tax information could appear in the public domain. Therefore, if the order of constitutionality is ultimately confirmed by the Constitutional Court in its current form, it is important that taxpayers understand what the potential impact will be on them.

Louis Botha

Cliffe Dekker Hofmeyr

Editorial comment: Whilst the point made in this article will be of great concern to some taxpayers, one would suspect that there would be little argument of it being in the "public interest" to disclose the tax returns of the majority of ordinary taxpayers.

Acts and Bills

- Promotion of Access to Information Act 2 of 2000: Section 46*(a)* & *(b)*;
- Tax Administration Act 28 of 2011: Sections 67 & 69(1), (2), (4) & (5);
- Constitution of the Republic of South Africa, 1996: Sections 16 & 32.

Other documents

- *The President's Keepers* (Jacques Pauw; NB Publishers, 2017);
- IT12 documents (tax returns).

Cases

- *Arena Holdings (Pty) Ltd t/a Financial Mail and Others v South African Revenue Service and Others* [2019] (Case No 88359/2019).

Tags: fringe benefits; tax compliance; taxpayer information confidentiality.

LOYALTY PROGRAMMES

The number of loyalty reward programmes has increased drastically over the past few years. Although the programmes vary, the business rationale is more or less the same: they encourage sales, they aim to retain existing customers and attract new customers and they assist businesses in monitoring spending trends so that they can develop and implement focused marketing campaigns.

There has always been a degree of uncertainty regarding the value-added tax (VAT) treatment of loyalty programmes, specifically where the loyalty points are issued and redeemed as part-payment for goods or services.

The South African Revenue Service issued Interpretation Note 118 (IN 118) on 4 November 2021 to clarify the VAT implications resulting from participation in points-based loyalty programmes. IN 118 does, however, not deal with loyalty points issued where such points are regarded as a discount on future purchases.

IN 118 specifies the characteristics of a loyalty programme as follows:

- membership of the loyalty programme is open to any customer or to the public as a whole;
- members are entitled to be allocated a reward in the form of loyalty points based on the value of goods or services acquired from certain entities;
- the member is not liable for any additional payment before becoming entitled to loyalty points, other than paying a membership fee, where applicable;
- members may, in some instances, pay less for goods or services than other customers, but they will not pay more;
- loyalty points allocated have a value attached to them, whether specific or notional; and
- the loyalty points can be redeemed by the member for goods or services with the value of the loyalty points as payment for goods or services.

IN 118 identified two main structures of loyalty programmes:

- The exclusive programme – which is administered in-house where the supplier is the only stakeholder to the loyalty programme.
- The multiple entities programme – where multiple loyalty partners are involved. A customer becomes a member of the loyalty programme by entering into a membership agreement with a loyalty programme operator that administers the programme. Various suppliers become partners to the loyalty programme. The member earns loyalty points on purchases made from loyalty partners. The member is then entitled to redeem the loyalty points on future purchases from a redemption partner.

VAT IMPLICATIONS

IN 118 explains the VAT implications of the various transactions under a points-based loyalty programme as follows:

- Any fee paid by a member to participate in the loyalty programme is subject to VAT.
- When a member makes a purchase of goods and services which results in loyalty points being awarded, VAT is payable at the applicable rate on the total sales consideration of such goods or services. The loyalty points are awarded for no consideration and the value on which VAT is payable is therefore nil.
- Any points fee which the loyalty partner pays to the loyalty programme operator equal to the monetary value of the points awarded, is a manner of monetising the loyalty points and falls outside the scope of VAT.
- When loyalty points are redeemed for goods or services, VAT is payable by the redemption partner on the total sales value of the goods or services, including the consideration settled by way of the redemption of the loyalty points.
- The settlement by the loyalty programme operator of the redemption cost with the redemption partner equal to the value of the loyalty points redeemed, comprises the payment of money which falls outside the scope of VAT.

IN 118 also sets out the VAT implications of related transactions as follows:

- Where loyalty points are sold to a customer for a consideration, such loyalty points comprise a voucher as contemplated by section 10(18) of the Value-Added Tax Act, 1991 (the VAT Act) (commonly known as gift vouchers). The sale of such vouchers is not subject to VAT, but VAT is payable at the applicable rate when the voucher is redeemed for goods or services.
- The transfer of loyalty points between members has no impact on the VAT liability of the loyalty programme operator, the loyalty partner or the redemption partner.
- The awarding of loyalty points under an employment incentive scheme is, in itself, not subject to VAT but it constitutes a taxable fringe benefit for VAT purposes, ie, if there is any value to the taxable fringe benefit there will be a VAT implication.
- The conversion of loyalty points in one programme into loyalty points in another programme comprises the redemption of the loyalty points in the first programme and the issue (sale) of loyalty points in the other programme. The sale of the loyalty points in the second programme comprises section 10(18) vouchers and therefore neither the redemption nor the sale attracts VAT.
- The expiry of loyalty points issued but not redeemed has no VAT implications.

IN 118 does not deal with the VAT implications of tokens, vouchers or stamps as contemplated by section 10(18) and 10(19) of the VAT Act, as loyalty points are generally issued for no consideration. Accordingly, section 10(18) will only apply in instances where the loyalty points are issued for a consideration. IN 118 specifically states that section 10(20) vouchers, being vouchers issued for no consideration which entitles the holder to a discount of goods or services purchased from another vendor, do not apply in the context of points-based loyalty programmes that fall within the scope of the interpretation note.

IN 118 achieves neutrality for all the participants concerned where the programme operates in the manner described in the interpretation note. However, it should be noted that the interpretation note stipulates that where the loyalty programme operator reimburses the redemption partner an amount which is less than the value of the points redeemed, there is no deduction available to the redemption partner for the difference. In such case the redemption partner will pay VAT on a higher amount than the actual consideration received for the supply, which is contrary to the operation of the VAT system.

CONCLUSION

IN 118 provides useful clarity on the VAT implications of points-based loyalty programmes. However, IN 118 does not deal with the VAT implications of loyalty programmes which operate in any different manner. It is therefore advisable to consider the VAT implications of the underlying transactions of loyalty programmes where they do not operate in the same manner as those described in IN 118.

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Cliffe Dekker Hofmeyr

Acts and Bills

- Value-Added Tax Act 89 of 1991: Section 10(18), (19) & (20).

Other documents

- Interpretation Note 118 ("Value-added tax consequences of points-based loyalty programmes") (4 November 2021);
- section 10(18) & section 10(20) vouchers.

Tags: loyalty reward programmes; redemption cost; taxable fringe benefit.