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# TAX CHRONICLES MONTHLY

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**CARBON TAX**
FURTHER REGULATIONS

**FRINGE BENEFITS**
CONSEQUENCES OF INCORRECTLY WITHHOLDING EMPLOYEES' TAX

**GENERAL**
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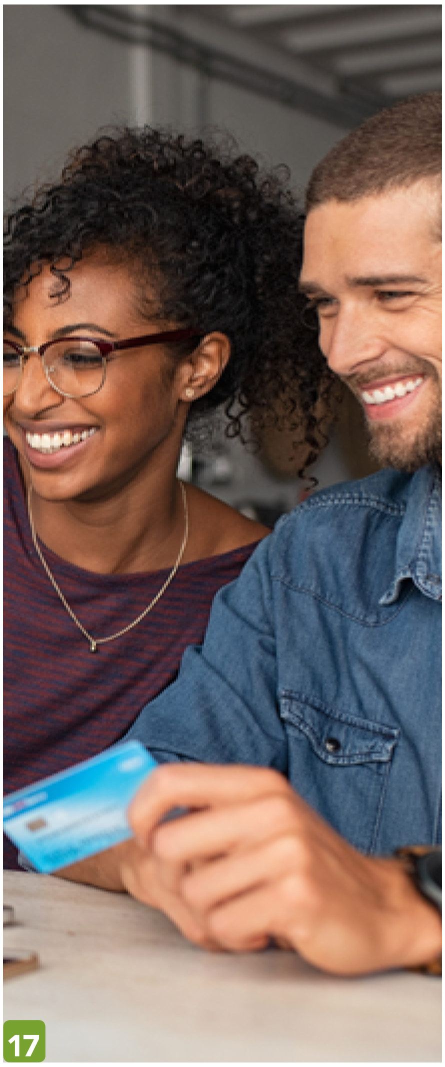

# FURTHER REGULATIONS

*While Greta Thunberg has caught the attention of many in recent times with her climate change activism, on the local front we saw some important developments regarding carbon tax in South Africa, specifically the following:*

- On 29 November 2019, the Carbon Offset Regulations were published in the *Government Gazette* (the Final Offset Regulations);

- On 2 December 2019, the National Treasury (the NT) published the Draft Regulations: Trade Exposure Allowance (the Draft Trade Exposure Regulations), for purposes of the trade exposure allowance catered for in section 10 of the Carbon Tax Act, 2019 (the Act); and

- On 2 December 2019, the NT published the Draft Regulations for the Greenhouse Gas (GHG) Emissions Intensity Benchmarks (Draft Performance Allowance Regulations), for purposes of the performance allowance catered for in section 11 of the Act.

In this article, we briefly discuss the details of each of these regulations and how they will impact entities that will become liable for carbon tax under the Act.

## FINAL OFFSET REGULATIONS

The gazetting of the Carbon Offset Regulations follows a period of approximately three years since the publication of the initial draft regulations in 2016 (Initial Offset Regulations), which was followed by the publication of the amended draft regulations in 2018 (Amended Offset Regulations), on which the public and stakeholders had the opportunity to comment.

A comparison between the Initial Offset Regulations and the Amended Offset Regulations shows, *inter alia*, that changes had been made in respect of the –

- eligibility of a taxpayer to make use of the carbon offset allowance;
- offset utilisation period; and
- procedure for claiming the carbon offset allowance.

The Final Offset Regulations provide finality on these issues. When compared with the Amended Offset Regulations, some of the important amendments are the following:

- Regulations 2(2) and 2(3) of the Final Offset Regulations state that, under certain circumstances, an offset in respect of an approved project in existence prior to 1 June 2019 constitutes an offset for the purpose of these regulations and may be used for the offset utilisation period stipulated in regulation 3.
- Regulation 4(1)*(b)*, which lists activities that cannot qualify for the carbon offset allowance, has been amended to state that a taxpayer conducting an activity in respect of renewable energy generated in respect of a technology with an installed capacity exceeding 15 Megawatt, with a cost equal to or lower than R1,09 per kilowatt hour, may not receive the allowance in respect of an offset in respect of that activity;
- Regulation 4 has also been amended to state that taxpayers conducting an activity in respect of a temporary CDM certified emission reduction may also not receive the allowance in respect of an offset for that activity. A "temporary CDM certified emission reduction" is defined in regulation 4 as a temporary certified emission reduction as defined in the United Nations Framework Convention on Climate Change, Clean Development Mechanism Glossary: CDM Terms.
- Regarding the certificate that is issued in terms of regulation 8 read with regulation 11, reflecting details of the approved project and the offset and which serves as proof thereof, there were two amendments. Regulation 11*(h)* now states that a certificate issued by the administrator as contemplated in regulation 8 must contain a statement that the certificate issued is not transferable. Regulation 11 further states that the certificate will indicate the tax period in which the certificate is issued.

Lastly, regulation 13 states that the Final Offset Regulations are deemed to have come into effect on 1 June 2019 and therefore apply retrospectively.

## DRAFT TRADE EXPOSURE REGULATIONS

According to the document entitled "Summary – Draft Trade Exposure and GHG Emissions Intensity Benchmark Regulations", which was also released by the NT on 2 December 2019 (the Summary Document), some of the key features of the Draft Trade Exposure Regulations are the following:

- Regulation 2 provides for a list of sectors and the level of trade exposure allowance for which each sector qualifies, as specified in Annexure A to the Draft Trade Exposure Regulations. Annexure A provides a column of the SIC codes for each sector or subsector and the corresponding Intergovernmental Panel on Climate Change IPCC Code for different sectors;
- Regulation 3 provides that the carbon tax payable by a firm will be determined by a sum of the GHG emissions for each category, less the allowances for each emissions category (combustion, fugitive or industrial process). For companies with activities in different sectors with varying SIC code categories but within the same emissions category, and that potentially face different trade intensity risk levels simultaneously, a weighted average of the different tax-free allowance levels will be calculated; and
- Regulation 4 provides for taxpayers considered to be "borderline"; upon the request of such taxpayers, an alternative quantitative approach rather than a qualitative approach (considered to be inherently subjective in nature), can be used for calculating the level of the trade exposure allowance.

A taxpayer can qualify for a trade exposure allowance of up to 10%, depending on the sector(s) in which it operates. According to regulation 5 of the Draft Trade Exposure Regulations, it is intended that once the final version has been published in the *Government Gazette*, the regulations will apply retrospectively from 1 June 2019.

## DRAFT PERFORMANCE ALLOWANCE REGULATIONS

As stated in the Summary Document, section 11 of the Act sets out the formula to be used by taxpayers to determine the level of allowance for which they would qualify, which formula takes into account the actual emission intensity of the taxpayer for a certain tax period relative to an approved emission intensity benchmark factor. Pursuant to section 19*(a)* of the Act, providing for the development of regulations to specify emission intensity benchmarks, these draft regulations outline the emission intensity benchmarks for sectors and subsectors.

According to the Summary Document, emissions intensity benchmark proposals were developed by industry associations for the following industries:

- liquid fuels;
- gas and coal to liquid fuels;
- mining;
- cement;
- iron and steel;
- paper and pulp;
- ferroalloys;
- titanium slag;
- chemicals (nitric acid);
- sugar; and
- clay brick.

According to the Summary Document, the setting of benchmarks was mainly based on the average emissions performance of a sector to ensure alignment with the benchmark approach adopted in many developing countries.

Regulation 2 provides for the sector GHG emission intensity benchmark values as set out in Annexure A to the Draft Performance Allowance Regulations to be used by taxpayers to calculate the performance allowance. Taxpayers can qualify for a performance allowance of up to 5%, to reduce their carbon tax liability. It is also intended that these regulations will apply retrospectively from 1 June 2019, once the final version is gazetted.

**OBSERVATION**

Although it is unfortunate that it took so long for each of the set of regulations to be published, at the very least, the Final Offset Regulations will apply retrospectively from 1 June 2019. If the Draft Trade Exposure Regulations and Draft Performance Allowance Regulations are gazetted in their current form as final regulations without any changes, it appears that they will also apply retrospectively from 1 June 2019, which is the day on which the Act came into effect.

Hopefully, the final versions of the Draft Trade Exposure Regulations and Draft Performance Allowance Regulations will be published before the end of June 2020, which is the date by which taxpayers must pay carbon tax due for the period ending 31 December 2019.

***Cliffe Dekker Hofmeyr***

Act sections:

- Carbon Tax Act 15 of 2019: sections 10, 11 & 19*(a)*.

Other documents:

- Draft Carbon Offset Regulations (20 June 2016);
- Amended draft Carbon Offset Regulations (2 November 2018);
- Carbon Offset Regulations (*GG*: 29 November 2019): Regulations 2(2) & 2(3), 3, 4 (4(1)*(b)*), 8, 11 (11*(h)*) & 13;
- Draft Regulations: Trade Exposure Allowance (2 December 2019): Regulation 2;
- Draft Regulations for the Greenhouse Gas Emissions Intensity Benchmarks (2 December 2019): Regulations 2, 3, 4 & 5; Annexure A;
- United Nations Framework Convention on Climate Change, Clean Development Mechanism Glossary: CDM Terms;
- Summary: Draft Trade Exposure and GHG Emissions Intensity Benchmark Regulations (2 December 2019).

Tags: carbon offset allowance; emission intensity benchmarks.

# EMPLOYEE INCENTIVE SCHEME

*On 26 November 2018 a full bench of the Western Cape High Court confirmed by majority the decision of the tax court and found in favour of the taxpayer in* CSARS v Spur Group (Pty) Ltd*, 2019. The taxpayer had claimed deductions under section 11*(a) *of the Income Tax Act, 1962 (the Act), in respect of a contribution totalling some R48,5 million to its employee management incentive scheme trust (the Trust) deducted in the 2005 to 2012 years of assessment.*

The essence of the argument was whether there was a sufficiently close connection between the expense and the taxpayer's production of income. A secondary question, that of prescription, would arise should the court find against the taxpayer.

The facts were not in dispute. The taxpayer had implemented the share incentive scheme in 2004, the object being to afford employees the opportunity to participate in the scheme in order to promote the growth and profitability of the group. The selected employees were key managerial staff; the contribution was for the purposes of the scheme; the employees did benefit; the contribution was not capital in nature; the scheme was legitimate and its agreements, implementation and transactions not simulated. On 30 November 2004 the Trust was established. The sole beneficiary was Spur Holdco as to capital, shares and income. The Trust then acquired the share capital of a shelf company, Newco. On 7 December 2004 the taxpayer concluded a contribution agreement with the Trust in terms of which it made the R48,5 million contribution to the Trust. The trustees were obliged to use the contribution to subscribe for preference shares in Newco, redeemable only after five years and carrying a coupon rate equivalent to 75% of SA prime. Newco in turn used the subscription price to purchase 8,2 million shares in Spur Holdco, the listed company of the group. The participating employees were offered ordinary shares in Newco at par in proportions determined by Spur Holdco. They were not entitled to deal in their shares for at least seven years after issue, and the shares of any employee who left within that period were forfeited and used for later allocation to other employees.

In disallowing the deduction, SARS contended that the participating employees had not benefitted from the R48,5 million distribution. The only beneficiary was the sole vested beneficiary, Spur Holdco.

Newco made no distributions during the five-year term of the preference shares, so the participating employees became entitled to the accumulated growth in the Trust's holding in Spur Holdco. By the end of the five-year period, the trust was entitled to accumulated dividends of R22,5 million. This was settled by transferring to the Trust the equivalent value of Spur Holdco shares. Newco then redeemed the preference shares and disposed of the balance of its Spur Holdco shares. Out of the proceeds Newco paid dividends of R28,2 million and R635 000 to the participating shareholders in 2009 and 2011, respectively.

On 13 December 2010 the scheme was terminated and the participating employees became discretionary dividend beneficiaries of the Trust. The taxpayer's R48,5 million, not being repayable to the taxpayer, vested in Spur Holdco, as did the preference share dividends of R22,5 million. It appears from the narration, although not expressly stated, that the trustees distributed these two amounts to the vested beneficiary. Thus the scheme came to an end.

In disallowing the deduction, SARS contended that the participating employees had not benefitted from the R48,5 million distribution. The only beneficiary was the sole vested beneficiary, Spur Holdco. Only if the participating employees had benefitted directly from the contribution could the expense qualify as a deduction under section 11*(a)* and thus as an expense incurred in the production of income.

The tax partner at Spur Group's auditors had given evidence to the tax court and explained the rationale behind the scheme as devised. Under cross-examination by counsel for SARS as to why this scheme had been used and not the simpler provision of loans to the participating employees, he explained that loans can be a disincentive if, as often happens, the increase in value of the shares fails to keep pace with the capital amount of the loan and accumulated interest. The employee bore the risk of the share price falling to the point where the loan liability exceeded the amount the employee could obtain from selling the shares. Making the employees, in effect, dividend beneficiaries removed this risk. It seems that what the tax partner was getting at, without expressing it in these terms, was that the whole scheme had to be looked at holistically. The use of the Trust and Newco and Spur Holdco, and the preference share issue, and the acquisition of Spur Holdco shares, were all parts of a scheme designed to provide incentives to participating employees, to the benefit of the taxpayer and the employees, while mitigating the risk of loss to the employees.

The chief financial officer of the Group was one of the participating employees. She explained that, as a service-oriented business Spur, expected its employees to work irregular hours, not the usual 8 to 5 regime. They needed to be rewarded for this inconvenience. Spur was a very dividend-rich company and in order to derive profits it needed an enthusiastic, committed and competent workforce. She affirmed that her participation in the scheme contributed significantly to her desire to remain employed at Spur.

The court proceeded to traverse the familiar principles from case law relating to deduction of expenditure, beginning with the *locus classicus*, *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue*, 1936. The question is twofold: (a) whether the act to which the expenditure is attached is performed in the production of income; and (b) whether the expenditure is linked to it closely enough. The learned judge, Watermeyer J as he then was, went further to point out that the expenditure itself need not be necessary in order to earn income; the purpose of the act entailing the expenditure must be looked to. If it is performed for the purpose of earning income, then the attendant expenditure is deductible. The learned judge concluded:

*"all expenses attached to the performance of a business operation* bona fide *performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are* bona fide *incurred for the more efficient performance of such operation".*

In *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd,* 1955, the Appellate Division referred with approval to *Port Elizabeth Tramway* and introduced "*the closeness of the connection between the expenditure and the income earning operations*" as a means of applying the test.

More recently, in *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust*, 1992, the court stated that in a tax case one is not concerned with what possibilities the taxpayer foresaw and with which he reconciled himself. "*One is concerned with his object, his aim, his actual purpose*".

This succinct summary was quoted with approval in *Warner Lambert SA (Pty) Ltd v Commissioner, South African Revenue Service*, 2003, a case that the tax court used extensively.in the present matter. Warner Lambert was the South African subsidiary of the US pharmaceutical giant. In terms of the Sullivan Code principles developed during the apartheid era, local operations of US companies had to permit no discrimination in the workplace and had to incur significant expenditure on social responsibility (SR) projects. The case revolved around whether the SR expenditure was deductible. The court found that it was incurred for the purposes of trade and for no other, because without access to the products and formulas of the US parent its income would have

dried up. The SR expenditure had not added to the subsidiary's income-earning structure, which was complete. The SR expenditure had been incurred in order to protect its earnings. The SCA regarded these payments as similar to insurance premiums.

The tax court found that, on the evidence, the dominant purpose of the scheme "*was to protect and enhance the business of the taxpayer and its income by motivating its key staff to be efficient and productive and remain in the taxpayer's employ*". The taxpayer had incurred the expenditure for the purpose of earning income. The majority of the High Court fully aligned itself with these remarks. It acknowledged that the bulk of the benefit inured to the Spur Group, but that did not detract from the actual purpose of the expenditure as affirmed in the evidence. "*It, in fact, is quite clear that maintaining a contented and motivated workforce forms part of the costs of performing the income producing operations and is crucial to the Spur Group's commercial success and profitability*".

Perhaps unconsciously, the court was echoing a 1978 decision of the Swaziland Court of Appeal in *Commissioner of Taxes v Swaziland Ranches Ltd*, 1978, where the court had to interpret the meaning of "*buildings used in connection with farming operations*" as provided for in the Swazi tax legislation. The majority of the court found that the expenditure incurred in erecting a school solely for the use of the children of employees and two beer halls for employees was incurred to achieve a happy and contented workforce. As a result, the buildings were used in connection with farming operations.

There is thus strong argument that, on the correct facts, expenditure incurred to motivate and achieve a satisfied workforce can meet the general deduction formula test. The judgment also validates the use of employee incentive schemes, provided they are properly established and operated.

There is thus strong argument that, on the correct facts, expenditure incurred to motivate and achieve a satisfied workforce can meet the general deduction formula test. The judgment also validates the use of employee incentive schemes, provided they are properly established and operated.

It is necessary to add a note of caution. Salie-Hlophe J issued a strong minority judgment, finding for SARS, fundamentally on the basis that the R48,5 million had not been incurred as contemplated in section 11*(a)* but had merely flowed through the Group as a vehicle through which to create the dividends, which in turn were the incentive. Because of her view, the learned judge was obliged to consider the prescription question. She stated that she would have found that there had been misrepresentation of material facts in the tax returns in that Spur had answered "no" to certain questions. The judgment does not indicate which these questions were. The fact that the financial statements had accompanied the tax return did not avail the taxpayer. Therefore, she would have found that the three-year prescription period provided for in section 99 of the Tax Administration Act did not apply.

Given the strong minority judgment, and the amounts involved, SARS might well launch a further appeal to the Supreme Court of Appeal.

***Prof Peter Surtees***

Act sections:

- Income Tax Act 58 of 1962: section 11*(a)*;
- Tax Administration Act 28 of 2011: section 99.

Cases:

- *CSARS v Spur Group (Pty) Ltd* A285/2019;
- *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue* [1936] 8 SATC 13 CPD;
- *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* [1955] 20 SATC 113AD;
- *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust* [1992] 65 SATC 346 AD;
- *Warner Lambert SA (Pty) Ltd v Commissioner, South African Revenue Service* [2003] 65 SATC 271 SCA;
- *Commissioner of Taxes v Swaziland Ranches Ltd* [1978] 40 SATC 232 SwCA.

Tags: share incentive scheme; discretionary dividend beneficiaries; preference shares.

# CONSEQUENCES OF INCORRECTLY WITHHOLDING EMPLOYEES' TAX

*Introduction*

*It is common for employers to have disputes with their employees regarding labour matters. Often the employees engage their unions to represent them on such labour-related disputes. When the employers and employees or their unions do not succeed in settling matters under dispute, ultimately such matters are referred to the labour courts. What is not common is to see employers and unions (on behalf of employees) engaging in disputes that involve tax-related matters. In a matter between* Amalungelo Workers' Union and Others v Phillip Morris South Africa (Pty) Limited and Another, *2019, the Constitutional Court had to consider the jurisdictional powers of the Labour Court and whether such jurisdiction is deferred until a matter is resolved by a labour inspector.*

In this case, the union and its members alleged that Phillip Morris South Africa (Pty) Ltd (the employer) had deducted tax from the salaries in respect of the use of company cars. They further alleged that these deductions were in contravention of section 34 of the Basic Conditions of Employment Act, 1997 (the BCEA). This section provides that an employer may not make any deduction from an employee's remuneration unless the employee in writing agrees to the deduction in respect of a debt specified in the agreement or the deduction is required or permitted in terms of a law, collective agreement, court order or arbitration award. On the strength of this provision, the union and its members instituted proceedings in the Labour Court for an order instructing the employer to refund the employees the amounts deducted and interdicting the respondents from continuing to make the deductions in future.

## SUMMARY OF THE FACTS

The claim that was advanced by the union and the employees can be summarised as follows. It seems some employees were entitled to the use of company cars. The value of these cars was depreciating from the date of acquisition by the employer and then during the use of these cars by the employees. Based on this depreciation in value, the argument said, the tax on the fringe benefit should be reduced annually. However, from the date on which the car was granted to each affected employee the employer made the same tax deduction of employees' tax from the remuneration of the employees who qualified for and received this fringe benefit. This was done without any prior written agreement between the employer and the employees. In addition, argued the union and employees, the deductions are not required or permitted in terms of a law, collective agreement, court order or arbitration award. In particular, the union and the employees argued that the deductions are unlawful because they are not permitted in terms of tax laws. Consequently, these parties claimed refunds of the said deductions with full retrospective effect, together with applicable *mora* interest.

## DECISIONS BY COURTS

The Labour Court held that it had no jurisdiction on the claim in terms of section 77 of the BCEA. The Labour Court relied on the decision that was previously held by the same court in *Ephraim v Bull Brand Foods (Pty) Ltd*, 2010, and concluded that to hold a different view would undermine the system of enforcement created by chapter 10 of the BCEA. The union and its members sought leave to appeal this decision and their application was dismissed. They then decided to take up this matter with the Labour Appeal Court but there they did not succeed either. As the last resort, they approached the Constitutional Court for leave and there succeeded.

If the employer refunds the amount that was incorrectly withheld as employees' tax, it remains debatable whether the employer will qualify to claim the paid amount as a deduction.

## TAX IMPLICATIONS THAT MAY ARISE FROM THIS CASE

Clearly both the Labour Court and the Constitutional Court did not deal with the merits of the case. But what is of interest will be the impact of the judgment for other employers based on the merits of this case once the court addresses the merits. Obviously, if the matter is decided in favour of the employer there are no further implications from a tax perspective, as tax would have been correctly withheld and paid to the South African Revenue Service (SARS). However, if this matter is decided in favour of the employees, will the refund payment made by the employer to the employees be tax deductible? If this payment is not tax deductible, can the employer be in a position to ask SARS to refund the amounts paid? Will employees be taxed on the interest that they want to claim from the employer? If yes, will the employer have an obligation to withhold employees' tax on such interest? In other words, can the interest be viewed to be part of remuneration?

## PAYMENT TO BE MADE TO EMPLOYEES

If the employer refunds the amount that was incorrectly withheld as employees' tax, it remains debatable whether the employer will qualify to claim the paid amount as a deduction. The deductibility of this payment will depend on whether the expenditure meets the requirements of section 11*(a)* of the Income Tax Act, 1962 (the Act). In particular, one should assess whether this expenditure is in the production of income. There are a number of factors to consider in deciding whether or not the expenditure is in the production of income. In *Joffe and Co (Pty) Ltd v Commissioner for Inland Revenue*, 1946, the court considered the deductibility of costs paid in respect of damages. The court had to decide whether there was any evidence of negligence on the part of the taxpayer. Even in this particular case, the question of whether or not there was negligence in calculating the amount incorrectly deducted will have to be answered. If it is proven that indeed there was negligence, it will be difficult, if not impossible, for the employer to deduct the amounts refunded to employees. If there was no negligence on the part of the employer, then the expense should be deductible as it will be in the production of income. This view does not hold for all taxpayers. For example, section 23*(o)* of the Act prohibits the deduction of fruitless and wasteful expenditure (as defined in section 1 of the Public Finance and Management Act, 1999).

## REFUND FROM SARS

If the amount is not tax deductible, the taxpayer will be worse off by the full amount refunded to its employees. Then the question that arises is whether or not the employer can ask SARS to refund the overpayment of employees' tax that was incorrectly deducted. Taxpayers will know that it remains a mountain to climb for them to receive any refund from SARS. Perhaps, the most appropriate name is the old one, ie Receiver of Revenue, simply because they do not hesitate to receive while they are reluctant to give (whether or not the amount is a refund). The long route to follow, which could be suggested by SARS, would be for the taxpayer to refile the reconciliation between the EMP201 and EMP501, coupled with the reissue of the IRP5s to the affected employees. Any taxpayer who can negotiate anything different will be extremely lucky.

Taxpayers should deal with their tax matters upfront, whether it is corporate tax or one of the indirect taxes.

## TREATMENT OF INTEREST

The interest to be received by employees will clearly constitute gross income. As mentioned above, SARS will be delighted to hear that employees will be receiving interest and will expect the ITR12 to reflect this receipt or accrual. The question of whether or not this interest amount will be subject to employees' tax for each employee who receives the interest hinges on the definition of the word "remuneration". The definition of remuneration in the Fourth Schedule to the Act does not include interest. Besides, remuneration must be paid by an employer to an employee. In this case, once the court delivers the judgment on this matter, the employer will owe the employee. However, the relationship between the two parties in respect of this amount will be that of a debtor and creditor. The company will be paying the interest on the basis that it owes the amount to the employee, not because it employed the employee. Therefore, although the interest will be subject to tax, there will be no obligation on the part of the employer to withhold employees' tax on interest paid or payable to employees.

## CONCLUSION

Taxpayers should deal with their tax matters upfront, whether it is corporate tax or one of the indirect taxes. There are a number of fringe benefits which attract employees' tax other than the use of company cars, which is just one of many. The legislation, however, provides exemption and exclusion of certain fringe benefits from employees' tax. Taxpayers should navigate their responsibilities to withhold tax carefully to avoid being taken to task by their employees and trade unions. During these tough economic conditions, no one is voluntarily paying taxes. It is clear in this case that even trade unions are looking for ways of reducing the burden for their members, even if it means looking for these opportunities in the tax legislation. The costs of non-compliance cannot be avoided by blindly adopting a conservative approach of deducting more employees' tax with the hope that employees will recover, as refund, the over-deducted amount when they are assessed after filing their tax returns. It should also be borne in mind that certain employees are below the filing threshold.

***Priority Tax Solutions***

Acts:

- Basic Conditions of Employment Act 75 of 1997: sections 34 & 77; chapter 10 (sections 62A–81);
- Income Tax Act 58 of 1962: section 11*(a)* & 23*(o)*;
- Public Finance and Management Act 1 of 1999: section 1 (definition of "fruitless and wasteful expenditure").

Cases:

- *Amalungelo Workers' Union and Others v Phillip Morris South Africa (Pty) Limited and Another* [2019] ZACC 45;
- *Ephraim v Bull Brand Foods (Pty) Ltd* [2010] 31 ILJ 951 (LC);
- *Joffe and Co (Pty) Ltd v Commissioner for Inland Revenue* [1946] 13 SATC 354 AD.

Tags: tax deduction; gross income; fringe benefits.

# INTEREST RATES

*Tax and VAT – interest rate decreases*

*The SARS official interest rate has been decreased as detailed below. It is possible that the other interest rates may also be adjusted in due course.*

It is important to remember that interest and penalties paid to SARS are not deductible expenses for income tax purposes. On the other hand, interest received from SARS is fully taxable (after deducting the current initial exemption of R23 800 per annum (R34 500 if you are 65 or older) for all local interest income earned by natural persons).

- **INCOME TAX, PROVISIONAL TAX, DIVIDENDS TAX, ETC**

  Payable to SARS on short payments of all such taxes (other than VAT): 10% per annum from 1 November 2019 (was 10.25% per annum with effect from 1 March 2019).

  Payable by SARS on refunds of tax (where interest is applicable): 6% per annum from 1 November 2019 (was 6.25% per annum with effect from 1 March 2019).

  If the refund is made after a successful tax appeal or where the appeal is conceded by SARS, the interest rate is 10% per annum from 1 November 2019 (was 10.25% per annum from 1 March 2019).

- **VAT**

  Payable to SARS on late payments: 10% per annum from 1 November 2019 (was 10.25% per annum from 1 March 2019).

  Payable by SARS on VAT refunds after prescribed period: 10% per annum from 1 November 2019 (was 10.25% per annum from 1 March 2019).

- **FRINGE BENEFITS**

Official interest rate for loans to employees below which a deemed fringe benefit arises: 7.25% per annum from 1 February 2020 (was 7.50% per annum from 1 August 2019). See below for details.

- **DIVIDENDS TAX**

Official interest rate for loans (designated in rands) to shareholders below which the interest on such loans can be deemed to be dividends on which dividends tax is payable: 7.25% per annum from 1 February 2020 (was 7.50% per annum from 1 August 2019). See below for details.

## The penalties for late payments (where applicable) are substantial (at least 10%) and are in addition to interest charged.

- **DONATIONS TAX**

  Loans to trusts by natural connected persons with interest charged at rates below the official rate create a donation subject to donations tax at 20%.

- **PENALTIES**

  The penalties for late payments (where applicable) are substantial (at least 10%) and are in addition to interest charged.

### FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX – INTEREST RATES

- If inadequate interest is charged to an employee (including working directors) on loans (other than for the purpose of furthering his own studies) in excess of R3 000 from his employer (or associated institution), tax on the fringe benefit may be payable.

  Unless interest is charged at the "official" rate or greater, the employee is deemed to have received a taxable fringe benefit calculated as being the difference between the interest actually charged and interest calculated at the "official" rate.

  For employees' tax purposes, the tax deduction must be made whenever interest is payable; if not regularly, then on a monthly basis for monthly paid employees, weekly for weekly paid employees, etc.

- Subject to a number of exceptions, distributions of income and capital gains from a company / close corporation are normally subject to dividends tax at the flat rate of 20%. Loans or advances to or for the benefit of a shareholder / member will be deemed to be dividends but only to the extent that interest at less than the "official" rate (or market-related rate in the case of foreign currency loans) is payable on the loan, or fringe benefits tax is payable on an interest-free (or subsidised interest) loan to an employee.

  It is not the amount of the loan but the interest reduction which is deemed to be a dividend. Low-interest loans are accordingly subject to dividends tax payable by the company and only in respect of the interest benefit.

- Loans to trusts by natural connected persons with interest charged below the official rate create a donation subject to donations tax at 20%.

- With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African "repo rate" plus 1%. For foreign currency loans, the rate is the equivalent of the foreign "repo rate" plus 1%. The South African repo rate is currently 6.25% per annum.

### THE "OFFICIAL" RATE OF INTEREST OVER THE PAST FIVE YEARS

| ***With effect from*** | | ***Rate per annum*** |
|---|---|---|
| 1 August 2015 | – | 7.00% |
| 1 December 2015 | – | 7.25% |
| 1 February 2016 | – | 7.75% |
| 1 April 2016 | – | 8.00% |
| 1 August 2017 | – | 7.75% |
| 1 April 2018 | – | 7.50% |
| 1 December 2018 | – | 7.75% |
| 1 August 2019 | – | 7.50% |
| 1 February 2020 | – | 7.25% |

***Kent Karro***

Tags: deductible expenses; natural connected persons; taxable fringe benefit; low-interest loans; repo rate.

# APPORTIONMENT OF INPUT TAX

*The stated policy of the South African Revenue Service (SARS) not to make value-added tax (VAT) rulings effective retrospectively to prior financial years has been questioned on several occasions. The matter was recently considered by the tax court in the case of* Taxpayer v Commissioner for the South African Revenue Service*, 2019, where the tax court found in favour of SARS.*


The taxpayer in this case provides money-transfer services within Africa, mobile phone credit and *bureau de change* services. The taxpayer therefore makes both taxable and exempt supplies for VAT purposes and is thus required to apportion the VAT it incurs on its expenses between taxable and exempt supplies.

The taxpayer apportioned the VAT on its expenses but did not have prior written approval for the apportionment method it applied. The taxpayer then applied in its 2017 financial year to SARS for approval to apply an appropriate apportionment method. SARS issued a binding private ruling ("VAT ruling" in terms of section 41B of the Value-added Tax Act (the VAT Act), dealt with as if it were a binding private ruling) to the taxpayer in which it approved the application of a transaction count-based method (the TCB method). The ruling was made effective from 1 March 2016, being the commencement of the financial year in which the taxpayer applied for the ruling.

The taxpayer requested SARS to make the ruling effective retrospectively to 1 February 2014, which request SARS refused. The taxpayer appealed to the tax court against the decision of SARS. The tax court found in favour of SARS on the basis that the standard turnover-based method (the STB method) as set out in Binding General Ruling 16 (BGR 16) was the only ratio applicable to the taxpayer until SARS issued the binding private ruling, and that proviso (iii) to section 17(1) of the VAT Act expressly precluded SARS from issuing a ruling that had effect prior to 1 March 2016.

Proviso (iii) to section 17(1) provides that where a method for determining an apportionment ratio has been approved by the Commissioner, that method may only be changed with effect from a future tax period, or from another date which the Commissioner considers equitable, but such other date must be within the taxpayer's year of assessment for income tax purposes.

The issue under consideration was whether proviso (iii) prohibits SARS from granting a ruling to apply an appropriate apportionment ruling retrospectively to prior financial years, or whether a taxpayer is, in the absence of a specific ruling, compelled to apply the STB method for those years even if it does not yield a ratio which fairly represents the extent to which the taxpayer applied its resources for making taxable supplies.

The Constitutional Court in *Metcash Trading Ltd v Commissioner, South African Revenue Service, & Another*, 2001, stated that to evaluate the cogency of a constitutional challenge of certain provisions of the VAT Act, one must have some understanding of the VAT system, which is sophisticated, and its provisions are numerous and complex. It stated further that the VAT Act is interlarded with many terms of art, some of which are defined, and others bear a special meaning in their context. It is considered that the same approach should be followed in considering the context and purpose of the VAT Act and determining the application of its provisions.

A fundamental and important feature of a VAT system, unlike any other tax, is the entitlement to deduct VAT incurred on expenses from the VAT charged on the supply of goods or services, to determine the VAT payable on the "value added" by the taxpayer in each tax period. Where a deduction is not granted, it impacts on pricing, distorts consumer and producer choices and has a cascading effect (tax is levied on tax). One of the reasons why South Africa replaced its sales tax system with VAT was to eliminate these distortions and the cascading effect of the sales tax system, which did not allow for deductions.

The right to deduct VAT is however limited to the extent that a vendor acquires goods or services for the purpose of consumption, use or supply in the course of making taxable supplies. Where a vendor makes both taxable and exempt supplies, the VAT may only be deducted to the extent that expenses are fairly attributable to making taxable supplies.

Section 17(1) of the VAT Act provides that the extent to which VAT is deductible in these circumstances, is determined by the Commissioner in terms of a binding general ruling or a binding private (or class) ruling. The extent to which the deduction may be made must be determined by the Commissioner on a fair and reasonable basis which fairly represents the application of goods or services for making taxable supplies.

The taxpayer apportioned the VAT on its expenses but did not have prior written approval for the apportionment method it applied.

SARS issued BGR 16 in terms of section 17(1), which prescribes the application of a turnover-based method of apportionment. A taxpayer may apply this method without any specific prior written approval by the Commissioner, on the condition that it may only be used if it is fair and reasonable. If it is not fair and reasonable, BGR 16 requires that the taxpayer must apply to SARS to use an alternative method.

A turnover-based method such as the STB method as prescribed by BGR 16 will only yield a fair and reasonable result if there is a constant relationship between every output transaction (taxable or exempt) and the VAT incurred on expenses. It also assumes that the profit margin of taxable and exempt transactions is substantially the same. In practice, this will hardly ever be the case. The only real advantage of a turnover-based method is that it is simple to calculate (K Zacharopoulos, *Value-Added Tax: The Partial Exemption Regime*).

It was common cause in Case No VAT 2063 that the STB method as prescribed by BGR 16 did not yield a fair and reasonable apportionment ratio, and that the TCB method was a suitable or appropriate apportionment method for the taxpayer's enterprise. Yet the tax court effectively ruled that the taxpayer was required to apply the STB method in prior financial years even though it had no resemblance to the extent to which the taxpayer actually applied its resources for making taxable supplies. The tax court's decision was based on its interpretation of proviso (iii) to section 17(1).

With reference to proviso (iii) to section 17(1), the tax court stated that it cannot be that a vendor who is enjoined to apply to use an alternative method, but fails or refuses to do so, should be placed in the same position as a vendor who applies timeously. However, one of the generally accepted principles of VAT policy is that it must ensure neutrality, i.e. that taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

## Taxpayers who make both taxable and exempt supplies are best advised to apply timeously for prior approval to apply an appropriate apportionment method.

Proviso (iii) to section 17(1) applies where a taxpayer applies an approved apportionment method, and then seeks to change such an approved method. Once an appropriate apportionment method has been determined and approved, the taxpayer should apply such method consistently from year to year. Where circumstances change which warrant the application of a different, more appropriate method, then the new method may only be applied from a current date or from the commencement of the current financial year, whichever is equitable. Proviso (iii) does not seem to find application where a taxpayer has never previously applied any apportionment method or has applied an unapproved apportionment method.

The STB method is rarely representative of the extent to which a taxpayer applies its resources for making taxable supplies. Requiring a taxpayer to apply an inappropriate apportionment method seems to be contrary to the overall construct and mechanism of the VAT Act. A taxpayer should not be required to pay substantially more VAT than what is properly levied in terms of the VAT Act, simply because of an omission to timeously apply for approval to apply an appropriate apportionment method. Section 17(1) and proviso (iii) are not intended to serve as penalty provisions.

The application of an apportionment method which does not fairly reflect the extent to which a taxpayer actually applies its resources for making taxable supplies, impacts on the neutrality principle and on pricing and has a cascading effect, which are all best avoided under a VAT system. To avoid a similar situation, taxpayers who make both taxable and exempt supplies are best advised to apply timeously for prior approval to apply an appropriate apportionment method.

***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 *between SARS and the applicant only*. A VAT ruling in terms of section 41B of the VAT Act is dealt with as if it were a private binding ruling, but it is not published. Its content is therefore only known to SARS and the applicant, and 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, including VAT 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:

- Value-added Tax Act 89 of 1991: sections 17(1) (proviso (iii)) & 41B;
- Income Tax Act 58 of 1962: section 11*(a)*.

Other documents:

- Binding General Ruling 16;
- Binding Private Ruling (VAT ruling in terms of section 41B of the VAT Act).

Cases:

- *Taxpayer v Commissioner for the South African Revenue Service (VAT2063)* [2019] ZATC 2 (15 November 2019);
- *Metcash Trading Ltd v Commissioner, South African Revenue Service, & Another* [2001] (1) SA 1109 (CC).

Tags: exempt supplies; transaction count-based method; standard turnover-based method; taxable supplies.

# INTRA-GROUP FINANCE TRANSACTIONS

*This article focuses on an often overlooked VAT exposure, namely, the potential taxable supplies involved in low- or nil-cost intra-group financing and security transactions.*

Everyday intra-group financing arrangements such as, for example, the provision of interest-free loans, and the provision of intra-group guarantees, suretyships and/or subordination agreements, may constitute the supply of taxable services for VAT purposes, even if for no or low consideration.

These services may be deemed to be supplied for market value consideration in terms of section 10(4) of the Value-added Tax Act, 1991, if:

- the supplier and the recipient are "connected persons" in relation to one another; and
- the recipient would not have been entitled to a full input tax credit in respect of the supply, had a market value consideration been charged (which is very often the case).

Careful, detailed analysis is required to determine the correct VAT treatment of affected intra-group financing transactions, having regard to the specific facts and profiles of the parties involved, in order to identify and mitigate potential leakage. This is an area which has thus far received surprisingly little attention and guidance, and is an important area for consideration both in relation to existing, and future group finance arrangements.

Careful, detailed analysis is required to determine the correct VAT treatment of affected intra-group financing transactions, having regard to the specific facts and profiles of the parties involved, in order to identify and mitigate potential leakage.

***ENSafrica***

Acts:

- Value-added Tax Act 89 of 1991: section 10(4).

Tags: taxable supplies; interest-free loans.