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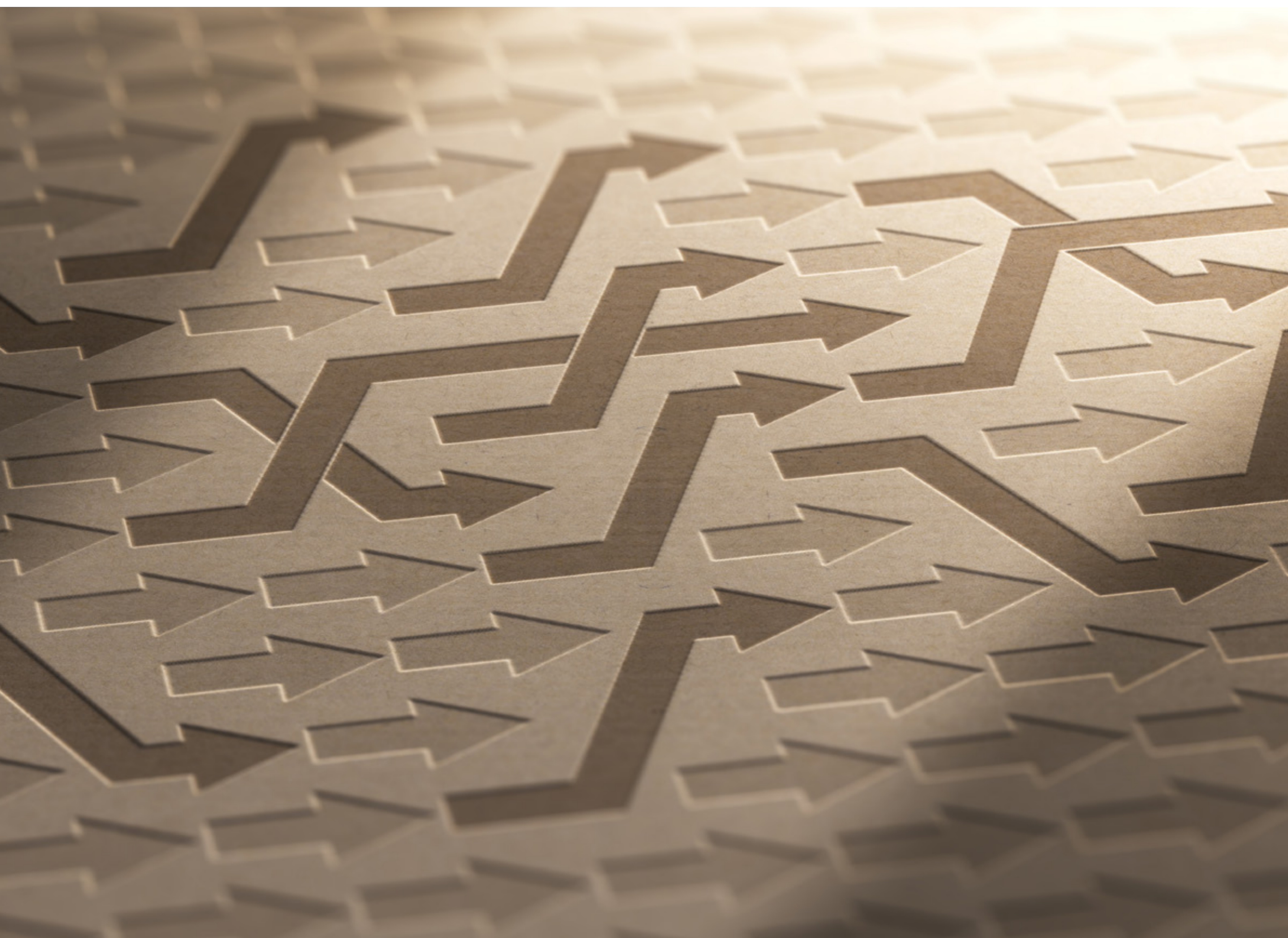

EMPLOYMENT TAX INCENTIVE
QUALIFICATION REQUIREMENTS

INTERNATIONAL TAX
OECD PILLAR TWO – GLOBAL MINIMUM TAX

TRANSFER PRICING
IMPLICATIONS OF A BUSINESS RESTRUCTURE

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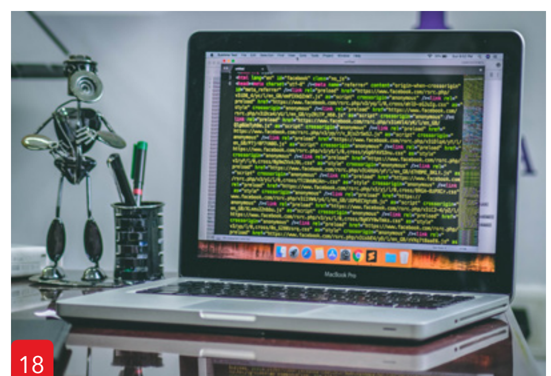

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DEFERRED TAX AT 27% OR 28%?

The South African National Treasury announced on 23 February 2022 that the corporate tax rate is reduced from 28% to 27% for years of assessment that end on or after 31 March 2023. One of the accounting questions that stem from this announcement is how companies should reflect the rate change in their deferred tax accounts. This article revisits the core principle and considers published guidance on this topic.

PRINCIPLE

Deferred tax represents the future tax consequences for an entity if it recovers the carrying amounts of its assets and settles the carrying amounts of its liabilities. Changes in tax rates or tax laws that take effect in future affect this measurement. The relevant principle for the measurement of deferred tax is set out in paragraph 47 of International Accounting Standard 12 (IAS 12):

> "Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period."

The standard alludes to the fact that in some jurisdictions announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. It states that in such situations, tax assets and liabilities must be measured at the announced rates.

SOUTH AFRICAN CONTEXT

The Department of Trade and Industry in South Africa issued Financial Reporting Pronouncement 1 (FRP1) in 2018. It deals with the issue as to when changes in tax rates and law are regarded as substantively enacted in South Africa. FRP1 was based on Financial Reporting Guide 1, published by the South African Institute of Chartered Accountants (SAICA). The consensus in FRP1 is that to be regarded as substantively enacted there should be the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner. In this context, FRP1 indicates that changes in tax rates should be regarded as substantively enacted from the time that they are announced in the Minister of Finance's Budget Statement. If, however, the change in rate is inextricably linked to other changes in the tax laws, it should only be regarded as substantively enacted when approved by Parliament and signed by the President.

"It appears as if the position taken is that although the rate change is still inextricably linked to the base-broadening measures, these measures are no longer considered changes in the tax laws, as contemplated in FRP1, since they have been enacted."

ANALYSIS

The rate reduction is complicated by its linkage with base-broadening measures to counterbalance the effect of the rate change for the fiscus. The base-broadening measures were enacted into the Income Tax Act, 1962, as part of the 2021 legislative cycle. These measures, however, only become effective once the reduced corporate tax rate applies.

SAICA's Accounting Practices Committee published educational material on the announced rate change in 2022. This material indicates that the rate change announced by the Minister of Finance in 2021 was not considered substantively enacted in light of it being inextricably linked to base-broadening changes that were not known at the date of the announcement. The base-broadening measures were, however, enacted in January 2022 and the uncertainty regarding the rate change was clarified in the 2022 Budget Speech. The position is therefore taken in the material that the rate change is now expected to be promulgated in an unchanged manner. It appears as if the position taken is that although the rate change is still inextricably linked to the base-broadening measures, these measures are no longer considered changes in the tax laws, as contemplated in FRP1, since they have been enacted.

Practically this means that South African entities whose reporting periods end after 23 February 2022, the date of the 2022 Budget Speech, should calculate the deferred tax to reflect the announced rate change. Entities with February or March year-ends may find themselves in the peculiar position of having to measure deferred tax in respect of some temporary differences at 28%, being the rate that still applies to their financial years ending 2023, and other at 27%, being the rate that applies to any subsequent financial years, depending on when the temporary difference is expected to reverse.

> "Deferred tax represents the future tax consequences for an entity if it recovers the carrying amounts of its assets and settles the carrying amounts of its liabilities."

Pieter van der Zwan

Acts and Bills

- Income Tax Act 58 of 1962.

Other documents

- Accounting Standard IAS 12 (International Accounting Standard 12): Paragraph 47;
- Financial Reporting Pronouncement 1 (FRP1) (issued by the Department of Trade and Industry in South Africa in 2018 and based on Financial Reporting Guide 1);
- Financial Reporting Guide 1 (published by the South African Institute of Chartered Accountants (SAICA));
- 2022 Budget Speech (by Minister of Finance).

Tags: corporate tax rate; deferred tax; base-broadening measures.

HOME OFFICE EXPENSES

Many taxpayers believe that home office-related expenses are deductible if they work from a home office but that in practice SARS often disallows the deduction of these expenses. In reality, there are many cases in which no deductions for home office expenses are available and, in general, it is the legislation itself that is very restrictive rather than SARS that is unreasonable when disallowing the deductions claimed. There have been calls for the restrictive provisions of the Income Tax Act, 1962 (the Act), relating to home office expenses to be relaxed. The Minister of Finance announced in his 2022 Budget Speech that a discussion document will be published in 2022 on a personal income tax regime for remote work; we hope that this will herald relief in this area.

Section 23*(b)* of the Act disallows the deduction of rent, repairs or expenses in connection with domestic premises or a part of such premises, except if such part is occupied for the purposes of trade (note that "trade" includes employment). This provision also deems such premises or any part of such premises not to be occupied for the purposes of trade unless they are specifically equipped for purposes of the taxpayer's trade, and regularly and exclusively used for such purposes. Unless these requirements are met, no deductions relating to the premises will be allowed. The requirement that the office be exclusively used for purposes of the taxpayer's trade often proves problematic in practice.

Section 23*(b)* also contains a requirement in relation to where an employee's or director's duties must be performed. This requirement is more restrictive in relation to non-commission earners than commission earners. In the case of an employee or director whose remuneration is derived mainly (that is, more than 50%) from commission, no home office deductions at all will be granted unless the earner's duties are mainly (that is, more than 50%) *performed elsewhere than in an office provided by the employer* (for example, at a combination of clients' premises and the home office). If income from employment is not derived mainly from commission, no home office deductions at all will be granted unless the employee's duties are mainly (again, more than 50%) *performed in the home office* and certain additional requirements are fulfilled.

So, in the case of a salaried employee whose remuneration is not mainly from commission or a director who uses an office at home for work purposes, section 23*(b)* disallows home office deductions unless –

- the office is used regularly and exclusively for purposes of the employee's work;
- the office is specifically equipped for these purposes; and
- the employee's duties are mainly performed in such part.

In the case of an employee or director whose remuneration is mainly derived from commission, section 23*(b)* disallows home office deductions unless –

- the office is used regularly and exclusively for purposes of the employee's work;
- the office is specifically equipped for these purposes; and
- the employee's duties are mainly performed elsewhere than in an office provided by the employer.

"The requirement that the office be exclusively used for purposes of the taxpayer's trade often proves problematic in practice."

In the case of employees and directors whose remuneration is not mainly derived from commission, section 23*(m)* contains further restrictions in that it only permits a claim for deductions contemplated in section 11 relating to domestic premises under section 11*(a)* (the so-called general deduction formula) or section 11*(d)* (repairs). It also only permits a claim to the extent that such deductions are not prohibited under section 23*(b)*, which has been discussed above.

Assuming the taxpayer is not disqualified by the above requirements, typical deductions that may be claimed are rental, electricity, water and sewerage, rates, monthly security costs, cleaning, body corporate levies adjusted to remove the portion relating to the common property (all apportioned on a floor area basis to the home office) and repairs specifically to the home office. The taxpayer may also claim wear and tear in relation to the costs of capital items that do not form part of the premises itself that are used for trade, for example furniture in the home office, computers and printers, provided that the taxpayer owns these items. As is the case with all deductions, the taxpayer bears the *onus* of proving that the amounts claimed are deductible.

On 4 March 2022 SARS released an updated Issue 3 of their Interpretation Note 28 on *"Deductions of home office expenses incurred by persons in employment or persons holding an office"* (the Interpretation Note). This updates SARS' current approach to deductions claimed by taxpayers working from home and binds SARS but not the taxpayer. It is hoped the discussion document promised in the 2022 Budget will provide an opportunity for taxpayers to comment on some of the limitations indicated in the Interpretation Note. In the Interpretation Note, SARS states that it is advisable to have photographs of the home office area, plans of the house showing the location of the home office and invoices and / or agreements relating to the expenses claimed available in the event of a SARS query. SARS also suggests that a letter be obtained from the employer, on the employer's letterhead, confirming that the employee was permitted to work from home, including the periods that the employee was permitted to work from home and, if available, those periods that the employee did not report to the office. Since a letter from the employer confirming permission for the employee to work from home does not prove that the employee actually worked from the home office, SARS also suggests that the employee maintain a schedule of dates detailing when the employee worked from home during the year of assessment as well as a calculation proving that the employee worked mainly from the home office during the year of assessment.

In the case of employees or directors whose remuneration is not mainly derived from commission, SARS has announced an "about-turn" regarding the claiming of bond interest in relation to home offices.

The Interpretation Note states that in cases where home office expenses are deducted against remuneration income and the individual does not derive remuneration mainly from commission, *interest on bond apportioned to the home office will not be deductible if the bond comprises an instrument that falls into section 24J (which is usually the case).* This new interpretation is effective for years of assessment commencing on or after 1 March 2022, in other words from the 2023 year of assessment and thereafter, and the Interpretation Note clarifies that this interpretation will apply from this date forwards but not retrospectively to years of assessment that commenced prior to 1 March 2022.

"SARS also suggests that a letter be obtained from the employer, on the employer's letterhead, confirming that the employee was permitted to work from home, including the periods that the employee was permitted to work from home and, if available, those periods that the employee did not report to the office."

The reason given by SARS for the non-deductibility is technical in that it relates to the interaction between paragraphs *(m)* and *(b)* of section 23. There has been no amendment to the Act that is effective from 1 March 2022 in this regard, and it seems that SARS has changed its interpretation of the pre-existing law. There is an argument that bond interest that is contemplated in section 24J is not an expenditure, loss or allowance contemplated in section 11*(x)* and therefore that such bond interest should not be hit by the prohibition in section 23*(m)*. It is thus not entirely clear whether this revised interpretation by SARS is correct.

This revised interpretation leads to an anomalous difference in treatment between rental, which is potentially deductible as it would not be prohibited by section 23*(m)* and bond interest, which is not deductible as it would be prohibited by the section.

If the individual derives his or her remuneration mainly from commission, whether or not the above revised SARS interpretation is correct, the above prohibition on the deductibility of section 24J interest does not apply.

A further contentious issue discussed in the Interpretation Note is that monthly fibre subscription fees are not allowable on the basis that they are not expenses in connection with the premises but are expenses in connection with telecommunication services. Because the monthly fibre subscription fees relate to cabling that physically leads into the premises, this appears to be an overly restrictive interpretation by SARS. It may be questioned why similar reasoning should not apply to expenses such as monthly security or electricity costs, which also relate to services supplied to the premises, and which the Interpretation Note states may potentially be deducted. The Interpretation Note also states that household contents insurance is not allowable as it does not relate to the premises itself.

It is important to note that if part of a primary residence is or was used as a home office, upon disposal of the primary residence, the home office portion of the primary residence will not qualify for the R2 million primary residence exclusion from capital gains tax. The result is that a capital gain or loss that arises in respect of the disposal of the primary residence will have to be apportioned between the part of the primary residence that was used as a primary residence (in other words, not used mainly for the carrying on of a trade) and the part that was used as a home office. The home office portion will be "tainted" in that it will be fully exposed to capital gains tax, while the R2 million primary residence exclusion will be available for use against a capital gain that arises on the portion that was used as a primary residence. One may have to take account of a floor area and / or time-based apportionment method to arrive at the correct apportionment of the capital gain. For example, one would use a combination of floor area and time-based apportionment if the residence was used exclusively as a primary residence for a period and then a portion was used as a home office for a period.

In conclusion, it is unfortunate that the provisions governing deductions for home offices are so restrictive, especially given that during the COVID-19 pandemic many employees were forced to work from home and incur expenses in this regard. It is evident from the above discussion that the provisions relating to deductions for home office expenses are complex. It is recommended that taxpayers wishing to claim these amounts seek professional advice before doing so.

Professor David Warneke

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Section 11*(a), (d) & (x)*, section 23*(b), (d) & (m)* & section 24J.

Other documents

- Interpretation Note 28 (Issue 3) *("Deductions of home office expenses incurred by persons in employment or persons holding an office")*.

Tags: domestic premises; home office deductions; remuneration income; primary residence exclusion.

MONEYLENDING

In the tax court judgment of *Taxpayer H v Commissioner for the South African Revenue Service* (IT 14213), handed down on 9 February 2022, the court was tasked with determining whether the interest expense incurred by the taxpayer stood to be deducted in terms of section 24J(2) of the Income Tax Act, 1962 (the Act), and whether the South African Revenue Service (SARS) had successfully discharged the onus on it for the imposition of an understatement penalty against the taxpayer.

FACTS

The taxpayer in this case was a private investment holding company with assets comprising predominantly of unlisted shares in subsidiary entities, loans advanced to those subsidiaries, and cash.

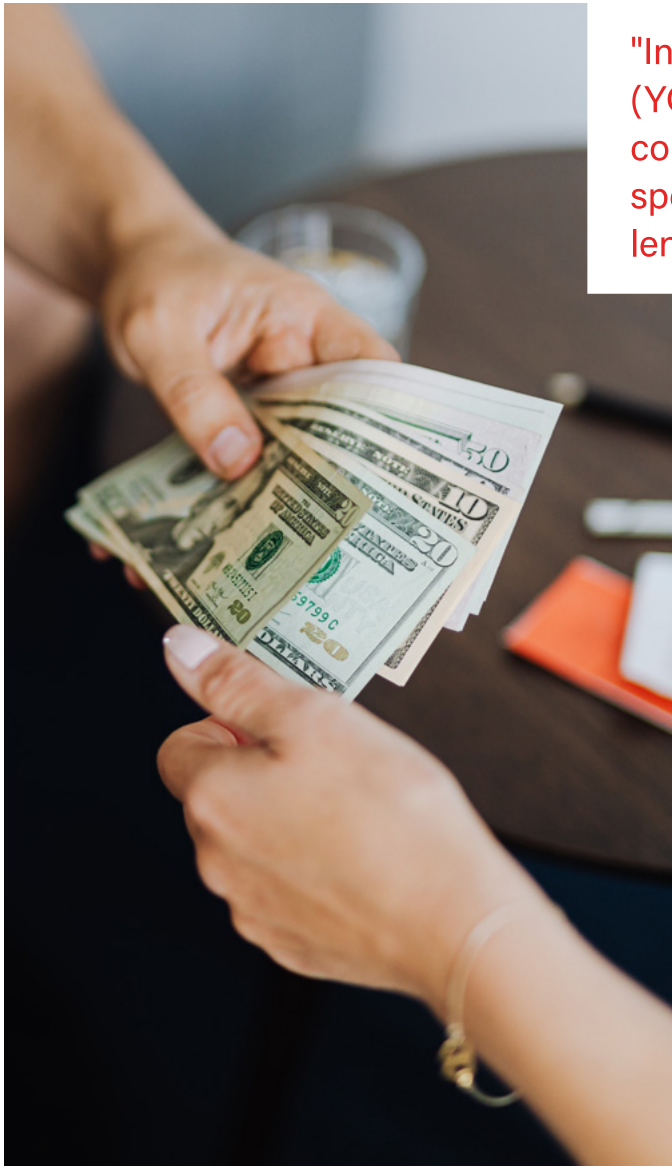
In respect of the 2011 year of assessment (YOA), the taxpayer contended that it conducted a trade in moneylending with the specific purpose of making a profit from on-lending borrowed funds to its subsidiaries. To this end, the taxpayer deducted from its income, in terms of section 24J(2), the interest expense it incurred in respect of the funds that it had borrowed.

SARS disallowed the full interest deduction of R68 133 602 and instead allowed a deduction that was limited to the amount of interest income received by the taxpayer, which was an amount of R34 936 000. This was done in accordance with SARS' long-standing practice set out in Practice Note 31, read with section 5(1) of the Tax Administration Act, 2011 (the TAA). SARS' disallowance of the full interest expense was based on the following facts:

- The taxpayer borrowed funds at an interest rate of 8.29% per annum, yet it extended loans to its subsidiaries at interest rates ranging between 0%, 5.29%, 6.22% and, at times, 8.29% per annum.
- The taxpayer's borrowings in relation to the on-lending were far less than its receivables.
- The lending transactions by the taxpayer extended only to its subsidiaries.
- There were no terms attached to the loans advanced by the taxpayer to its subsidiaries.

Having regard to these facts, SARS concluded that the interest expense incurred by the taxpayer had not been incurred while carrying on a trade, and had further not been incurred in the production of income. On this basis, the requirements set out in section 24J(2) had not been met and the interest was therefore not deductible. SARS then also imposed an understatement penalty of 10% on the basis that the taxpayer had made a substantial understatement.

The taxpayer disputed SARS' conclusions, with its main contention being that, notwithstanding that its lending trade was not profitable in the 2011 YOA, it was profitable in the 2012 YOA. This, it contended, demonstrated its intention to earn a profit such that it could be concluded that it (i) carried on a moneylending trade and (ii) incurred the interest expense in the production of income.



"In respect of the 2011 year of assessment (YOA), the taxpayer contended that it conducted a trade in moneylending with the specific purpose of making a profit from on-lending borrowed funds to its subsidiaries."

JUDGMENT

In issue before the court was whether (i) the interest sought to be deducted by the taxpayer was incurred whilst carrying on a trade; (ii) the interest was incurred in the production of income; and (iii) SARS was justified in imposing an understatement penalty. Each of these issues is dealt with separately below.

Whether the taxpayer was carrying on a trade as a moneylender

At the outset, the court considered whether the taxpayer was indeed carrying on a trade as a moneylender. To this end, it reiterated that the existence of a moneylending trade must be determined based on the specific facts of each case.

The court referred to the guidelines set out in the case of *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue,* [1991], and stated that in order for a moneylending trade to be recognised, "there had to be an intention to lend to all and sundry provided they were, from the taxpayer's view, eligible". The following principles were then highlighted by the court:

- The lending had to be done on a system or plan which disclosed a degree of continuity in laying out and getting back the capital for further use and which involved a frequent turnover of the capital.
- The obtaining of security was a usual, though not essential, feature of a loan made in the course of a moneylending business.
- The fact that money had on several occasions been lent at remunerative rates of interest was not enough to show that the business of moneylending was being carried on. There had to be a certain degree of continuity about the transactions.
- As to the proportion of the income from loans to the total income: the smallness of the proportion could, however, not be decisive if the other essential elements of a moneylending business existed.

Reference was also made to the judgments in *ITC 1771* [2004] 66 SATC 205 and *ITC 812* [1955] 20 SATC 469 in which the following statements were made (respectively):

> "A long-term loan without any repayment terms, in my view, lacks the essential characteristics of floating capital which, if it becomes irrecoverable, constitutes a loss of a capital nature."

and

> "The main difference between an investor and a money lender appears to consist in the fact that the latter aims at the frequency of the turnover of his money and for that purpose usually requires borrowers to make regular payments on account of the principal. This has been described as a system or plan in laying out and getting in his money."

When faced with the facts in light of the principles outlined above, the taxpayer appeared to change its approach during the proceedings and discontinued with its averments that it was a moneylender (although it maintained that it carried on a trade comprising of "interest earning and interest incurring activities").

More specifically, it had to be conceded by the taxpayer that (i) it had no documentary evidence substantiating its moneylending trade or its lending policies; (ii) the loans made to its subsidiaries were not memorialised in any manner and carried no terms (in particular no repayment terms); (iii) there was no security provided for the loans; and (iv) it could not provide evidence of a plan of laying out and getting in its money as evidence of continuity.

In light of the above, considered in conjunction with the fact that the taxpayer had indicated in its 2011 tax return that it had not concluded any transactions in terms of section 24J of the Act, the court concluded that the taxpayer did not carry on a trade in moneylending.

The court then considered whether the taxpayer had a profit-making motive that would indicate that (despite not being a moneylender) it still carried on a trade pursuant to which the interest expense was incurred. The following findings of the court are noteworthy in this regard:

- The taxpayer borrowed money at high interest rates and on-lent that money to its subsidiaries at either zero or at interest rates lower or equal to the rate at which the original funds were borrowed by the taxpayer. On this basis, the taxpayer had no possibility of making a profit in respect of the loans advanced by it and the taxpayer was thus advancing the interests of the group rather than its own profit-making interests.
- Advancing loans to its subsidiaries boosted the earning capacity of those subsidiaries, which made commercial sense for the taxpayer as an investor and the sole shareholder of the subsidiaries. However, at issue was whether the approach adopted by the taxpayer made commercial sense in facilitating the taxpayer's trade and generating trade income (and not facilitating the taxpayer's investment activities and the exempt dividend income derived in respect thereof).
- The lack of terms attached to the subsidiary loans such that there was no objectively ascertainable system for the taxpayer to recover its capital nor the interest suggests that there was no profit-making motive.
- Reliance could not be placed on section 24J(3) (which references "all accrual amounts") to argue that SARS ought to have taken into account the interest earned by the taxpayer from its positive bank balance in assessing the taxpayer's profit-making purpose.

The court therefore concluded that the taxpayer did not have a profit-making motive in respect of its borrowing and on-lending activities.

Whether the interest expense was incurred in the production of income

In considering this issue, the court highlighted that the most important (and sometimes overriding) factor is the purpose for which the expenditure was incurred and what it actually effects. To this end, a court is required to assess the closeness of the connection between the expenditure incurred and the income-earning activities undertaken by a taxpayer.

The taxpayer contended that the fact that the interest it earned did not exceed the interest incurred is not indicative that the interest was not incurred in the production of income. Furthermore, on the basis that the interest received from the subsidiaries constituted income that was not exempt, the taxpayer argued that the "in the production of income" requirement in section 24J had been met.

SARS, on the other hand, contended that the "purpose of the borrowing was to provide the [taxpayer's] subsidiaries with advantageous loans to benefit the group by increasing their earning capacity" and that there was no evidence to suggest that the taxpayer had the intention of generating income.

The court found in favour of SARS and concluded that, on an analysis of the taxpayer's lending transactions, it could not be shown that the taxpayer had a profit-making purpose or an intention to produce income, but rather an intention to further the interests of the group in order to increase the subsidiaries' profits and reap substantial dividends.

The imposition of an understatement penalty

SARS contended that the taxpayer incorrectly adopted the tax position that the interest expense was deductible in full, as a consequence of which the taxpayer understated its income.

Of critical importance to SARS' case was that the taxpayer had been requested to provide documents supporting its contentions that it was a moneylender, but had failed to do so. Moreover, all of the information that was uncovered during the audit had always been within the taxpayer's knowledge and it had thus always known that it had no records to substantiate its moneylending trade assertions. In addition, it was submitted that the taxpayer also failed to lead evidence to (i) demonstrate that the understatement of its income was the result of a *bona fide* inadvertent error or (ii) contradict SARS' findings that the penalty was appropriately levied.

It was the taxpayer's view that (should the interest expense not be deductible) the resultant understatement was the result of a *bona fide* inadvertent error.

The court ultimately rejected the taxpayer's contention that, prior to imposing an understatement penalty, SARS had a duty to satisfy itself that the understatement did not result from a *bona fide* inadvertent error. The court reasoned that such an assertion misconstrues the burden of proof set out in section 102(2) of the TAA. It reiterated that the burden of proving that the interest was deductible and that there was no understatement of income remains with the taxpayer.

In this case, the taxpayer had led no evidence that the understatement was due to a *bona fide* inadvertent error and had also led no evidence to support its claim that it had acted honestly and reasonably and had relied on expert advice when it claimed the interest expense as a deduction.

As such, the court concluded that the understatement penalty was appropriately levied and dismissed the appeal with costs.

COMMENT

This judgment is significant for a number of reasons.

First, it is a firm reminder that care must be taken when completing a tax return in order to ensure that the activities undertaken by a taxpayer and the information pertaining to that taxpayer are accurately reflected in the return. Any failure to do so may have substantial negative consequences for the taxpayer.

It is also a reminder that companies that participate in intra-group loans should be mindful of the structure and terms associated with the loans. In particular, it is generally advisable not to enter into long-term loans but rather to have loans that are payable on demand or repayable in accordance with set terms, the repayment period of which should not be excessive.

Further to the issue of the structure of the "interest earning and interest accruing" operations that ought to be considered in this context, it should be borne in mind that the taxpayer was unsuccessful in claiming the full interest expense, to a large extent, on the basis that the related interest income it received did not exceed the interest expense it incurred. Based on the structure of the lending operations of the taxpayer, the taxpayer was precluded from relying on the interest income it received from the bank in order to prove that the taxpayer's intention was to make a profit. This was primarily because there was a direct link between the money borrowed by the taxpayer and the money lent to the subsidiaries and there was "no basis to add interest from the bank when evaluating the appellant's profit-making purpose on its money-lending".

"Of critical importance to SARS' case was that the taxpayer had been requested to provide documents supporting its contentions that it was a moneylender, but had failed to do so."

Had the taxpayer adopted a "co-mingling" approach to its "interest earning and interest accruing" operations (as was the case in *CIR v Standard Bank of SA Limited,* [1985],) the outcome may have been that the interest income from the bank had to be taken into account to show that the taxpayer had a profit-making motive, such that the interest expense would have been allowed as a deduction.

Lastly, this case is important in the context of understatement penalties because it appears that the court recognised and accepted that a *bona fide* inadvertent error will be present in the event that the taxpayer (i) has acted honestly and reasonably and (ii) has relied on expert evidence in adopting the relevant tax position. On the basis that case law appears to suggest that a *bona fide* inadvertent error would only exist in very limited circumstances, the aforementioned development (that seems to broaden the scope of the circumstances in which such an error may occur) is interesting and well received.

Louise Kotze

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 24J(2) & (3);
- Tax Administration Act 28 of 2011: Sections 5(1) & 102(2).

Other documents

- Practice Note 31.

Cases

- *Taxpayer H v Commissioner for the South African Revenue Service* (IT 14213) (handed down on 9 February 2022);
- *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue* [1991] (2) SA 257 (A); [1991] 1 All SA 39 (A);
- *ITC 1771* [2004] 66 SATC 205;
- *ITC 812* [1955] 20 SATC 469;
- *CIR v Standard Bank of SA Limited* [1985] 47 SATC 179.

Tags: understatement penalty; moneylending trade; profit-making motive; in the production of income; *bona fide* inadvertent error.

QUALIFICATION REQUIREMENTS

In the February 2022 Budget Speech, the Minister of Finance announced a 50% increase in the employment tax incentive (ETI) value, which came into effect on 1 March 2022.

The ETI came into effect on 1 January 2014 and ends on 28 January 2029. The incentive is aimed at encouraging employers to employ young and less experienced employees for them to gain the necessary skills and work experience to further their careers, thereby promoting the national job creation agenda. The ETI effectively reduces the overall cost of employment to an employer by allowing a reduction in the monthly Pay-As-You-Earn (PAYE) liability.

To qualify for an ETI claim, the employer should be a qualifying employer who employs qualifying employees. Below are the requirements, amongst others, for both a qualifying employer and employee.

"An employer is deemed to have displaced an employee if the employer unfairly dismisses one employee and replaces that employee with a qualifying employee, with the intention of obtaining a benefit under the ETI."

QUALIFYING EMPLOYER

An employer is a qualifying employer if the employer –

1. is registered for PAYE and is tax compliant;
2. is not the Government or a municipal entity; and
3. has not been disqualified by the Minister of Finance.

QUALIFYING EMPLOYEE

An individual is a qualifying employee if the individual –

1. has a valid South African ID or an asylum seeker permit/ refugee ID issued in terms of the Refugees Act, 1998;
2. is 18 to 29 years of age;
3. is not a domestic worker;
4. is not a connected person to the employer;
5. was employed by the employer or an associated person to the employer, after 1 October 2013; and
6. is paid the minimum wage or, where a minimum wage is not applicable, a monthly remuneration of at least R2 000 but not more than R6 500.

(Where an employee works less than 160 hours per month, excluding overtime, the remuneration should be grossed up to 160 hours to see whether the employee would qualify)

CALCULATING THE CLAIM

The following table sets out the formula to be used for an ETI claim:

	Formula effective from 1 March 2022 (New)		Formula applicable up to 28 February 2022 (Old)	
Monthly remuneration	Formula - First 12 months	Formula - Second 12 months	Formula - First 12 months	Formula - Second 12 months
R0 – R1 999.99	75% of monthly remuneration	37.5% of monthly remuneration	50% of monthly remuneration	25% of monthly remuneration
R2 000 – R4 499.99	R1 500	R750	R1 000	R500
R4 500 – R6 499.99	R1 500 - (75% x (monthly remuneration - R4 500))	R750 - (37.5% x (monthly remuneration - R4 500))	R1 000 - (50% x monthly remuneration - R4 500))	R500 - (25% x (monthly remuneration - R4 500))

"The ETI cannot be claimed for the month in which the employee turns 30 and can be claimed in the month in which the employee turns 18."

In determining the first or second 12-month period, only the months in which the employee was a qualifying employee are taken into account.

For example, an employee may be a qualifying employee in the first three months but not in the fourth and fifth months. If an employee is a qualifying employee again in the sixth month, the sixth month is month number four as far as the 12-month period is concerned.

The age and the monthly remuneration should be calculated at the end of each month. The ETI cannot be claimed for the month in which the employee turns 30 and can be claimed in the month in which the employee turns 18.

WHERE LESS THAN 160 HOURS HAVE BEEN WORKED

Where the employee was employed for less than 160 hours in a month, the employment tax incentive must be calculated on a grossed-up basis.

> ***Example:***
>
> An employee worked for 120 hours in a specific month, earning R4 000 for the month. This is part of the first 12 months of employment for the employee.
>
> If the employee worked for 160 hours he/she would have earned:
>
> R4 000 /120 hours * 160 hours = R5 333.
>
> The employee is a qualifying employee as the salary would not have exceeded R6 500 if the employee worked 160 hours.
>
> The incentive is calculated as follows (using grossed up salary of 160 hours):
>
> R1 500 – (75% x (5 333 – 4500)) = R875
>
> Then reduced to 120 actual hours:
>
> (R875/160) x 120 = R656.25

EMPLOYER IS NON-COMPLIANT

Where an employer is non-compliant, the ETI may be rolled over to the following month until such employer becomes tax compliant. However, if that employer does not become tax compliant at the time of submission of the EMP501 return, that rolled over amount is reduced to nil.

PENALTIES

A penalty of 100% of the ETI claimed will be imposed by SARS where an employer claimed for an employee who earns less than the minimum wage (or less than R2 000 where the minimum wage is not applicable).

A penalty of R30 000 is imposed by SARS where an employer displaced an employee. An employer is deemed to have displaced an employee if the employer unfairly dismisses one employee and replaces that employee with a qualifying employee, with the intention of obtaining a benefit under the ETI.

Employers are encouraged to make use of this incentive and assist in bringing down the high rate of unemployment in South Africa. However, it is imperative that the criteria for claiming the incentive are met and that the employer is tax compliant at the time of claiming the credit.

> "The ETI came into effect on 1 January 2014 and ends on 28 January 2029. The incentive is aimed at encouraging employers to employ young and less experienced employees for them to gain the necessary skills and work experience to further their careers, thereby promoting the national job creation agenda."

Sharon Bensch

PKF VGA

Acts and Bills

- Refugees Act 30 of 1998.

Other documents

- EMP501 return.

Tags: qualifying employee; ETI claim; tax compliant.

PHANTOM SHARE PLANS

Should phantom shares be taxed in terms of section 8C of the Income Tax Act, 1962 (the Act), or should they be regarded as a bonus, to which section 7B of the Act applies?

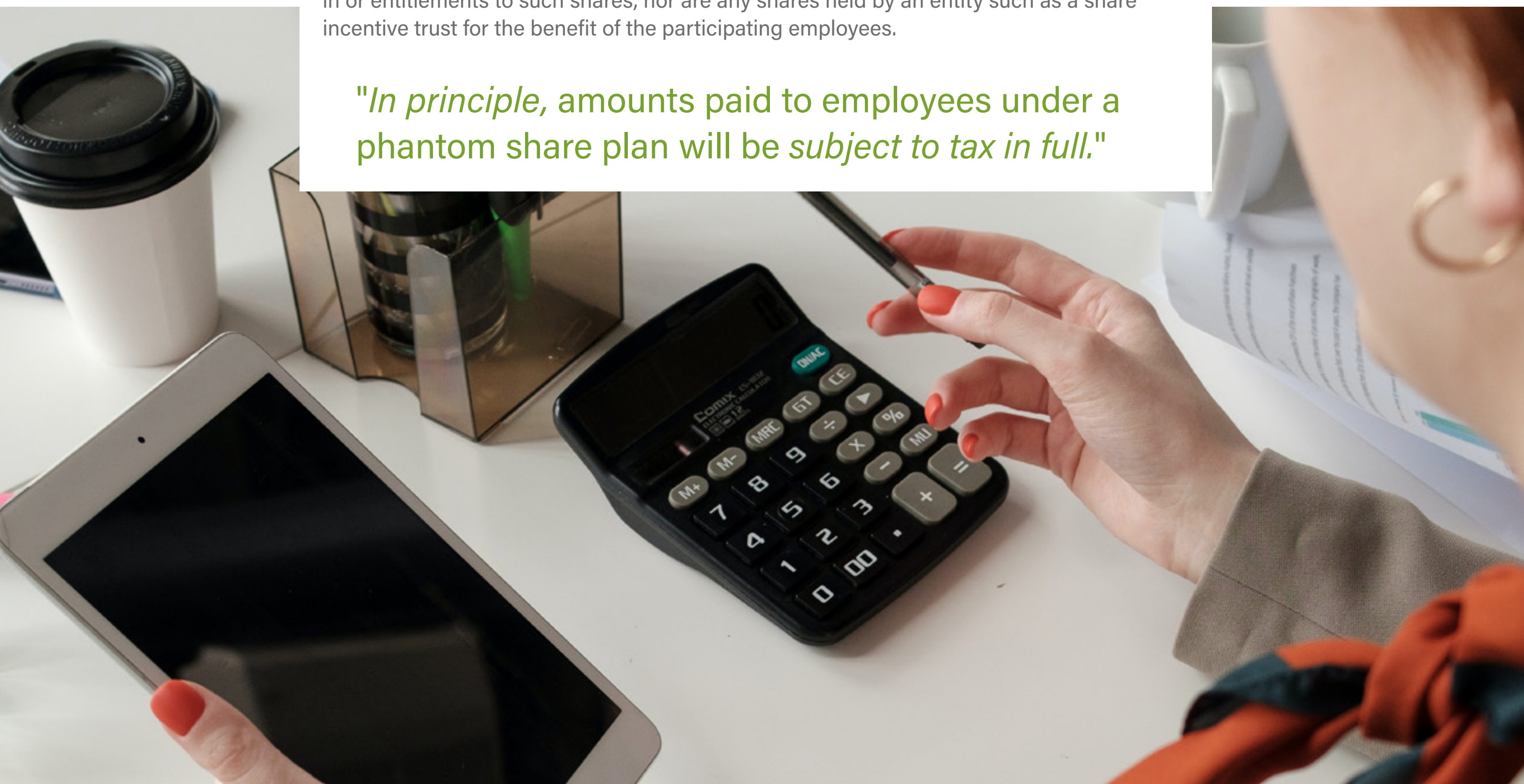
This question is important, firstly, because the *timing* of the occurrence of the tax event may differ depending on which provision is applicable and, secondly, employers have certain *compliance obligations* with regard to section 8C gains, including the requirement to obtain a tax directive from the South African Revenue Service, which do not apply to bonuses.

In a typical phantom share plan, the participating employees are awarded "phantom shares" (or notional units) as an incentive arrangement, in terms of which they may receive cash payments based on dividends and/or growth in the share price of the employer company's shares.

Phantom share plan awards may be granted on a discretionary basis subject to performance or time-based conditions. If these conditions are met, in effect, the employee receives a bonus that is based on the employer company's performance calculated with reference to dividends and/or the share price.

The employer company's shares thus simply represent the basis of calculation of the bonuses paid to the employees, but the employees do not acquire any shares or any rights in or entitlements to such shares, nor are any shares held by an entity such as a share incentive trust for the benefit of the participating employees.

"*In principle,* amounts paid to employees under a phantom share plan will be *subject to tax in full.*"



In principle, amounts paid to employees under a phantom share plan will be *subject to tax in full.*

For purposes of section 8C, an "equity instrument" (as defined in section 8C(7)) includes, among other things, any contractual right or obligation, the value of which is determined directly or indirectly with reference to a share. As such, phantom share awards may constitute a *contractual right* as contemplated in this wide definition. However, it is arguable that section 8C should not be interpreted as including every contractual right which is valued with reference to a share.

In this regard, the rationale for extending the ambit of section 8C by widening the scope of the term "equity instrument" to include such contractual rights (as set out in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008) was to address executive share schemes involving trusts where the executive obtains a right to the value of the shares held in the trust without obtaining any right to acquire the underlying shares themselves.

The Explanatory Memorandum stated that "Hence, section 8C now applies to an interest in a trust even if the employee has a right solely to the value of the shares in the trust (without any direct right in the shares themselves)." The intention of the legislature in making these changes seems to be directed specifically at incentive schemes involving shares held directly or indirectly for the benefit of the executive.

On the other hand, section 7B applies to "variable remuneration", which includes, among other specified amounts, a bonus contemplated in the definition of "remuneration" in paragraph 1 of the Fourth Schedule to the Act. There is no definition of a "bonus" in section 7B or in the Fourth Schedule.

The relevance of which provision should apply in relation to the timing of the tax event is that, in terms of section 8C the tax event occurs when the "equity instrument" is deemed to vest, which in the case of an equity instrument which is subject to restrictions may only occur, amongst other events, when all the applicable restrictions cease to have effect.

For example, if there is a *"malus"* and /or "clawback" provision applicable to a payment made to the employee under a phantom share plan whereby the employee may be required to repay the amount if certain conditions are not met, the equity instrument will not be deemed to vest for tax purposes until the clawback provision no longer applies, regardless of the fact that payment has been received by the employee.

"In a typical phantom share plan, the participating employees are awarded "phantom shares" (or notional units) as an incentive arrangement, in terms of which they may receive cash payments based on dividends and/or growth in the share price of the employer company's shares."

However, in terms of section 7B, any amount to which an employee becomes entitled from an employer in respect of variable remuneration is deemed to accrue to the employee for tax purposes on the date on which the amount is paid to the employee by the employer. The bonus will therefore be taxable on the date of payment regardless of whether there are any clawback provisions applicable.

Accordingly, there are *two different timing rules* that could apply.

There are also different compliance obligations for the employer. In the case of any gains which are taxable in terms of section 8C, the employer must, before withholding employees' tax, apply for a directive from SARS to determine the amount of tax to be withheld. However, bonuses may be processed through the employer's payroll without the need to obtain tax directives.

On the basis that the amendment to the definition of an equity instrument in section 8C to include contractual rights within the ambit of the provision was introduced to counter tax avoidance in the context of share incentive trusts, it is arguable that this aspect of the definition should be interpreted more restrictively to *exclude bonus payments* which are simply determined using the employer's shares as a calculation methodology, without there being any rights or entitlements to shares themselves. Since section 7B specifically applies to bonuses, this provision should apply to bonus payments made under phantom share plans.

Jenny Klein

ENSafrica

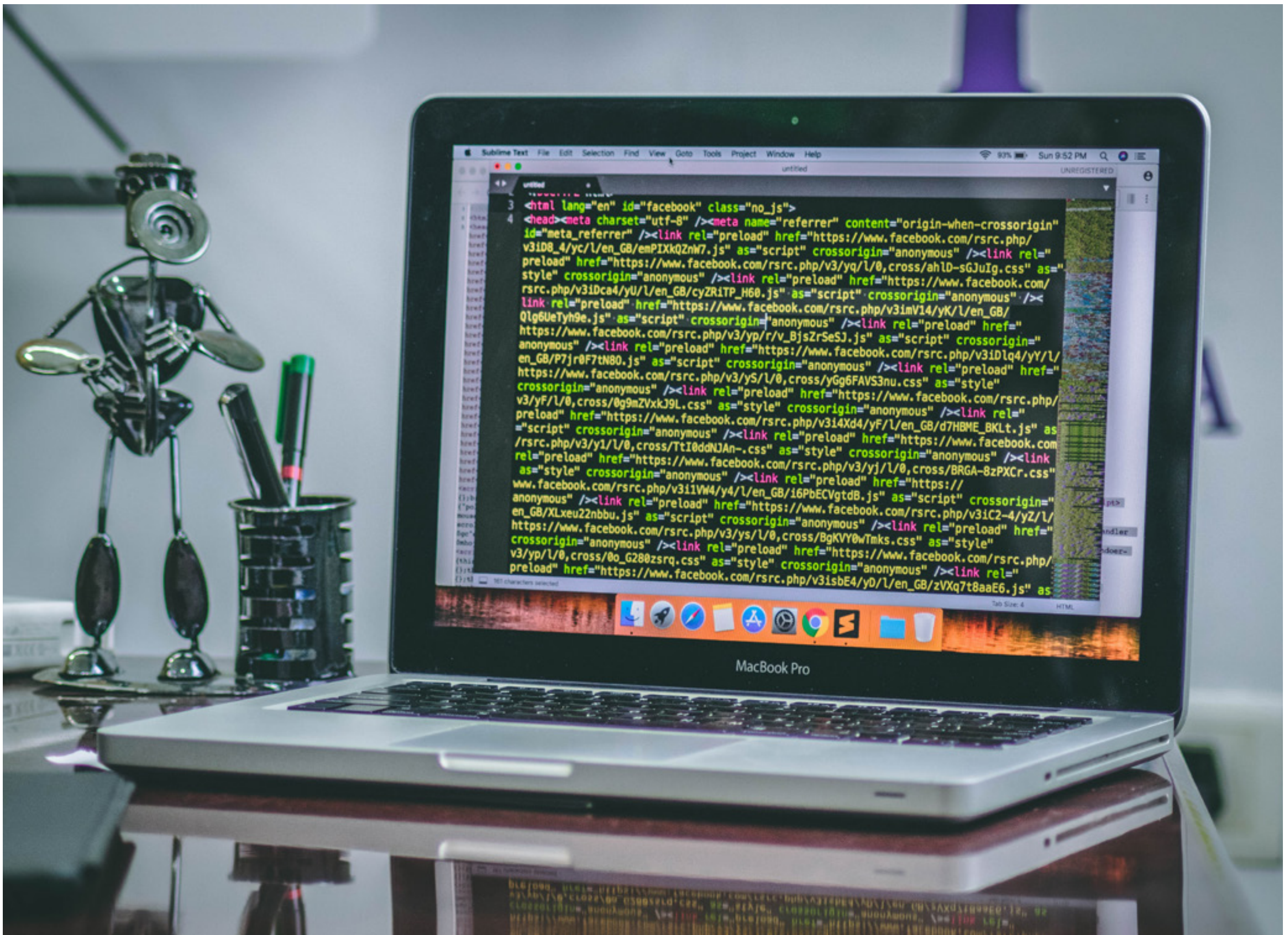
Acts and Bills

- Income Tax Act 58 of 1962: Sections 7B & 8C (specifically also subsection (7): definition of "equity instrument"); Fourth Schedule: Paragraph 1 (definition of "remuneration").

Other documents

- Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008.

Tags: equity instrument; variable remuneration; share incentive trusts.



OECD PILLAR TWO – GLOBAL MINIMUM TAX

Digital business models create value in ways that are not neatly captured by our tax systems, which are designed to tax "bricks and mortar" economic activity. The source and residence rules on which today's tax systems are based were not designed to tax the types of economic interactions that take place online.

Free-to-use digital services provide a good example of the disruption caused by digital business models to existing tax rules. With free-to-use digital services there is no transaction between the service provider and consumer. The payment for the service provided is not how the service provider generates its income. Advertising revenue is often a significant part of how such businesses earn income. However, it is indisputable that the provision and consumption of the free service is at the core of its trading activities.

This, along with the international mobility of the digital service provider's intellectual property (including branding, collected data and software), allows the value generated by a country's advertising eyes to be legally present and taxed in a different country. This means that the country which taxes the income does not necessarily have to host the digital service provider's physical presence or the consumers of the service. Conversely, the countries which in fact host significant real-world economic nexuses for the advertising income earned, through the provision of free services, do not gain a taxing right.

"This means that the country which taxes the income does not necessarily have to host the digital service provider's physical presence or the consumers of the service."

PROGRESS TO DATE

The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (the Inclusive Framework) – consisting of more than 140 states – has produced a two-pillar solution to address the tax challenges posed by digital business models. Pillar One seeks to address the mismatch between digital business models and the current source and residence nexus rules by introducing a new basis for a taxing nexus. Pillar Two intends to ensure that major multinational enterprises (MNEs) with an annual turnover of more than EUR 750 million pay a minimum level of tax in the jurisdictions in which they have economic activities. This is achieved by allowing the imposition of a top-up tax on profits arising in jurisdictions where the effective tax rate is calculated as below a set minimum.

On 20 December 2021, the Inclusive Framework agreed and adopted a set of model rules for the implementation of Pillar Two, called the Global Anti-Base Erosion Model Rules (GloBE Rules or Model Rules). This paved the way for countries to begin putting in place tax rules based on the GloBE Rules.

On 14 March 2022, the OECD published a Commentary to the Global Anti-Base Erosion Model Rules (the Commentary). The Commentary provides detailed technical guidance on the operation and intended outcomes under the GloBE Rules.

The Commentary was published alongside a set of illustrative examples, forming part of a series of interpretative tools being released by the Inclusive Framework. An implementation framework meant to assist revenue authorities in the implementation of GloBE Rules once enacted into local legislation, is also being developed. Public submissions on the implementation framework closed on 11 April 2022.

CONTENT OF THE COMMENTARY

The Commentary follows the same chapter structure as the Model Rules, providing detailed guidance on each article and the interpretation of important concepts and phrases used in the Model Rules. In brief, the Commentary covers the following thematic areas:

SCOPE

Chapter 1 of the Model Rules contains several key definitions for determining the scope of MNE groups and constituent group entities that ought to be subject to the GloBE Rules. The Commentary elaborates on important concepts contained in these definitions, including:

- the methodologies to be applied in determining whether an MNE group has breached the EUR 750 million consolidated group revenue threshold;
- the application of the accounting consolidation test to determine whether an ultimate parent entity (UPE) has foreign subsidiaries or permanent establishments which constitute an MNE group as defined;
- the nature of constituent entities which form the group that are the taxpayers under the GloBE rules; and
- the range and characteristics of entities which qualify as excluded entities, that may otherwise be an ultimate parent entity, intermediate parent entity or constituent entity of an MNE group, but are not subject to the GloBE rules on a policy basis such as certain investment funds and real estate investment vehicles.

CHARGING PROVISIONS

Chapter 2 of the Model Rules sets out the two interlocking charging provisions of the GloBE rules: the Income Inclusion Rule (the IIR) and the Undertaxed Payments Rule (the UTPR).

The IIR is a top-down taxation rule, which applies a tax to the entities closer to the top of defined ownership chains. The IIR taxes a parent entity (including a UPE, intermediate parent entity or partially owned parent entity) or multiple parent entities in an ownership chain to the extent of that parent entity's economic interest or allocable share of top-up tax on the revenue of any low-taxed constituent entity.

The UTPR is a back-stop measure, which will apply a denial of deductible expenses on constituent entities in the case where a portion of the top-up tax of a low-taxed constituent entity is not taxed under the IIR, as allocated throughout an MNE group.

The Commentary provides an overview of both the IIR and UTPR, as well as specific guidance for its application. The guidance on the IIR includes:

- How the charging provision applies to a UPE and other intermediate parent entities, through the calculation of allocatable share of top-up tax payable by application of a given parent entity's inclusion ratio for a particular low-taxed constituent entity's relevant income.
- How to determine the cascading order in which constituent entities along an ownership chain will bear liability to pay top-up tax, under the top-down principle approach which underpins the IIR.
- Guidance on the dynamics around extending the IIR's scope to domestic constituent entities in order to maintain symmetry in a tax system.

The mechanism for offsetting IIR where multiple MNE groups hold ownership interests in the same low-taxed constituent entity.

The guidance on the UTPR includes:

- Discussion of the mechanisms for applying the deduction denial or equivalent adjustment resulting in a cash tax expense for constituent entities of an MNE group.
- Guidance on the timing and carry-over of the UTPR adjustment.

- The methodologies for calculating the amount of UTPR adjustment to be carried by a particular constituent entity in the jurisdiction(s) carrying the taxing rights under the UTPR's substance-based allocation rules.

COMPUTATION OF GLOBE INCOME OR LOSS

Chapter 3 of the Model Rules contains the articles setting out the mechanisms for calculating, for the purpose of the GloBE Rules, the GloBE income or loss for constituent entities of a particular jurisdiction.

The guidance of the Commentary focuses on the nature of the adjustments to net accounting income. It includes discussions of the various categories of adjustments which are appropriate to determine GloBE income or loss, including the application of the arm's length principle to price both domestic and cross-border transactions between MNE group companies. A particular focus is the exclusion of various amounts which make up net accounting income under different accounting treatments. The categories of amounts discussed include taxes paid by constituent entities, asymmetric foreign currency gains or losses, intra-group financing arrangements, and dividends distributed or received in different contexts.

The Commentary also covers the allocation of GloBE income between constituent entities, their permanent establishments and flow-through entities. The set of rules applicable to pricing international shipping income and certain insurance company income is also discussed.

COVERED TAXES ADJUSTMENTS

Chapter 4 of the Model Rules contains provisions which determine the amount of taxation borne in relation to the GloBE income calculated under the provisions of Chapter 3 of the Model Rules, for the purpose of determining the effective tax rate for an MNE group in a given jurisdiction.

The Commentary provides guidance on what amounts of tax paid by constituent entities will meet the definition of adjusted covered taxes. The discussion of the articles defining covered taxes expands on the types of taxes covered by the definition which are taxes on constituent entities' profits and certain retained income but excludes payroll taxes and indirect taxes.

Guidance is also provided on the mechanisms available to implement the adjustments to the amounts falling within the definition of covered taxes, to reach the amount of adjusted covered taxes that is factored into the calculation of a jurisdiction's effective tax rate. For taxes imposed under controlled foreign company and hybrid entity rules, the adjustments discussed include exclusion of taxes paid as a result of GloBE rules, the allocation of taxes from permanent establishments and tax transparent entities to constituent entities, and the carry forward of GloBE tax losses.

DETERMINATION OF EFFECTIVE TAX RATE AND TOP-UP TAX

Chapter 5 of the Model Rules prescribes the method to calculate a jurisdiction's effective tax rate as applicable to an MNE group and for determining the amount of top-up tax for a low-taxed jurisdiction. The calculation of top-up tax for a low-tax jurisdiction also includes rules for determining the amount of income that is excluded under the GloBE Rules by virtue of its substance-based income exclusion.

The Commentary discusses the amounts to be included in each of the components of the calculation of a jurisdictions' effective tax rate, viz, the adjusted covered taxes of each constituent entity located in the jurisdiction for the fiscal year divided by the net GloBE income of the jurisdiction.

The rules for determining the amount of top-up tax that is due with respect to a jurisdiction and how such top-up tax is allocated amongst the low-taxed constituent entities located in that jurisdiction is set out in the Commentary. It includes methods for determining the minimum rate needed to bring the effective tax rate up to the minimum effective rate, the excess profit to which the minimum rate is to be applied, and how these amounts are to be used to calculate the top-up tax, which is then allocated among the constituent entities present in the jurisdiction.

There is also a discussion of the parameters of the substance-based income exclusion, which is a policy-based carve out from the top-up tax payable, based on amounts of payroll and fixed assets held by particular constituent entities.

REORGANISATIONS AND SPECIAL OWNERSHIP STRUCTURES

Chapter 6 of the Model Rules contains special rules dealing with corporate restructurings (including mergers, acquisitions and demergers), as well as articles that address the application of the GloBE Rules to certain holding structures such as joint venture investments and multi-parented MNE groups.

The Commentary expands on the articles which provide for how the consolidated revenue threshold is applied after a merger and a demerger for the purposes of applying the four-year revenue rule that determines the applicability of the GloBE Rules to an MNE group, and for calculating the functional aspects of the GloBE Rules – GloBE income or loss, effective tax rate and top-up tax payable for constituent entities that have merged or demerged from an MNE group.

Guidance is also provided on the articles which prescribe how the GloBE Rules apply to allocate GloBE income or loss, effective tax rate and top-up tax payable for constituent entities that form part of joint ventures and multi-parent MNE groups.

An important aspect that is discussed is how the restructuring rules contemplated in the Model Rules are applied to reach consistency with other restructuring transaction tax treatment within a jurisdiction.

TAX-NEUTRAL AND FLOW-THROUGH ENTITIES

Chapter 7 of the Model Rules contains rules applicable to certain tax-neutral and distribution regimes in order to avoid unintended outcomes under the GloBE Rules.

The Commentary discusses the special rules for reducing the GloBE income of ultimate parent entities that are tax transparent entities or subject to a deductible dividend regime and whose owners are subject to taxation above the minimum rate on such ultimate parent entities' GloBE income.

ADMINISTRATIVE PROVISIONS

Chapter 8 of the Model Rules contains the administrative provisions relating to the GloBE Rules including the scope of the necessary filings, safe harbours and issuing of administrative guidance.

The Commentary expands on the nature of the filings which are to be submitted by constituent entities, parent entities and ultimate parent entities to compile the GloBE information return and demonstrate compliance with the GloBE Rules. The policy considerations underlying the safe harbour provisions are also discussed, as well as the administrative efficiency basis for authorisation to issue administrative guidance on the GloBE Rules.

> "The rules for determining the amount of top-up tax that is due with respect to a jurisdiction and how such top-up tax is allocated amongst the low-taxed constituent entities located in that jurisdiction is set out in the Commentary."

COMMENT

The Minister of Finance indicated in the 2022 Budget Speech that South Africa, as a key member of the steering committee of the Inclusive Framework, will embark on adoption of the tax rules designed under the two-pillar solution to address the challenges of the digital economy, once the implementation framework for the two-pillar solution is published.

With the work on the GloBE Rules progressing and the publication of the implementation framework for Pillar Two in sight, the South African 2022 taxation laws amendment process may see one of the world's first ventures into grappling with the practical complexities of legislative integration of this new generation of tax rules built for the digital age.

The Commentary on Pillar Two will certainly become an interpretative staple, as much as previous OECD commentaries – most famously the commentary on the model tax convention. Luckily South African tax practitioners will have time to digest them, while the process to develop the implementation framework unfolds, and be prepared should the GloBE Rules become local law.

Tsanga Mukumba

Cliffe Dekker Hofmeyr

Other documents

- Global Anti-Base Erosion Model Rules (GloBE Rules or Model Rules): Chapters 1 to 8;
- Commentary to the Global Anti-Base Erosion Model Rules;
- Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two).

Tags: Global Anti-Base Erosion Rules (GloBE Rules); low-taxed constituent entity; payroll taxes; indirect taxes.

BINDING PRIVATE RULING – DEFINITION OF A PBO

Tax deductible donations to philanthropic and other socially beneficial organisations are a familiar feature of many countries' tax systems – to the extent that such deductible donations can be said to have gained the tinge of infamy in mainstream media. However, the goal of this type of regulation is to incentivise companies and individuals to donate to organisations dedicated to the provision of social goods and services and insulated from the personal financial benefits which are associated with for-profit enterprises.

On 9 May 2022, the South African Revenue Service (SARS) issued Binding Private Ruling 371 (BPR 371), dealing with the proposed operating model of a resident trust that is an approved public benefit organisation (PBO). It specifically deals with the question as to whether the operating model will comply with paragraph *(c)*(i) of the definition of 'public benefit organisation' in section 30(1) of the Income Tax Act, 1962 (the Act).

"The definition of a PBO and approval requirements set out in section 30 work in tandem with section 10(1)*(c*N*)* of the Act, which exempts the receipts and accruals of PBOs from income tax, and section 18A, which governs the deductibility of donations to PBOs."

BPRs are issued by SARS under Chapter 7 of the Tax Administration Act, 2011. BPRs are published with the consent of the applicant(s) and are only binding upon SARS as regards the taxpayer(s) that applied for the ruling.

BINDING PRIVATE RULING 371

The trust in BPR 371 was established to use the donations it received exclusively for the benefit of persons in need, in a specified geographical region. The trust was to assist these communities in certain focus areas, including socio-economic development, skills development, job creation and enterprise development.

The trust determined that it would allocate funding to initiatives sourced from an open public call for proposals through established community forums, such as community hall initiatives. Projects would then be identified through a selection process and funded by the trust from available capital.

RELEVANT PROVISIONS OF THE INCOME TAX ACT

The Act prescribes the requirements for approval as a PBO in section 30. A "public benefit organisation" is defined in section 30(1) as any organisation which –

- is a "non-profit company" as defined in section 1 of the Companies Act, 2008, a trust or an association established in South Africa, or a branch of any tax-exempt entity established outside South Africa;
- has as its sole or principal object the carrying on of one or more public benefit activities as listed in the Ninth Schedule to the Act;
- carries out its stipulated public benefit activity in a non-profit manner and with an altruistic or philanthropic intent;

"When setting up a PBO to implement ESG projects, companies should be mindful that PBOs are by their nature autonomous entities, separate from the structure and control of a corporate group."

- does not promote the economic self-interest of any fiduciary or employee of the organisation, other than by way of reasonable remuneration; and
- carries on each such public benefit activity for the benefit of, or is widely accessible to, the general public at large, including any sector thereof (other than small and exclusive groups).

The definition of a PBO and approval requirements set out in section 30 work in tandem with section 10(1)*(cN)* of the Act, which exempts the receipts and accruals of PBOs from income tax, and section 18A, which governs the deductibility of donations to PBOs.

For a PBO to be approved for purposes of section 18A of the Act, it must carry on public benefit activities listed in Part II of the Ninth Schedule to the Act, or it must be a conduit PBO that distributes funds to other PBOs carrying on public benefit activities listed in Part II of the Ninth Schedule.

BPR 371 is an instance where SARS determined that the trust's activities being limited to a specific geographical region was consistent with the requirement that a PBO's public benefit activities be carried on for the benefit of, or be widely accessible to, the general public at large, including any sector thereof (other than small and exclusive groups).

COMMENT

The ability to reliably deduct donations made to PBOs provides companies with a useful mechanism to ameliorate some of the costs of pursuing environmental, social and governance (ESG) projects which could otherwise be difficult to justify as being deductible ordinary trading expenses. However, companies should appreciate that only donations made to PBOs approved for purposes of section 18A (read with Part II of the Ninth Schedule) are deductible by the company.

"The trust in BPR 371 was established to use the donations it received exclusively for the benefit of persons in need, in a specified geographical region. The trust was to assist these communities in certain focus areas, including socio-economic development, skills development, job creation and enterprise development."

This means that, if corporates pursue ESG and other social objectives through projects implemented by a PBO, it comes with an administrative burden to establish and obtain PBO status. The PBO must continuously comply with the requirement in section 30(1) and with particular record-keeping and reporting requirements, amongst others.

When setting up a PBO to implement ESG projects, companies should be mindful that PBOs are by their nature autonomous entities, separate from the structure and control of a corporate group. For example, under section 30 no one person (such as the company setting up the PBO) may solely control the decision-making powers of a PBO. This requires the setting of strong guardrails on the scope of activities to be pursued by the PBO when designing its objects. Paramount in this is ensuring that the PBO's activities fall within Part II of the Ninth Schedule, if the intention is for the PBO to receive donations and issue section 18A certificates enabling the donor to deduct the amount.

The alternative to claiming a deduction under section 18A is for a company to incur social expenditure and claim it as a deduction under section 11*(a)* of the Act and other specific deduction provisions of the Act. In this regard, one should consider the judgment in *Warner Lambert SA (Pty) Ltd v Commissioner for the South African Revenue Service,* [2003], and rulings issued by SARS permitting the deductibility of such expenses. Practically, in sectors of the economy where social expenditure is a regulatory requirement, the risk that ESG expenditure would be viewed as non-deductible under section 11*(a)*, read with section 23*(g),* may be lower. In sectors where social contributions are not a regulatory requirement, companies seeking to claim a deduction under section 11*(a)* face an increased risk that ESG or other social expenditure is deemed non-deductible.

The risk involved in having a deduction (including section 11*(a)* deduction) disallowed by SARS is evident from court decisions such as *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd,* [2021], and *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service,* [2021]. These judgments remind us that prudence must always be exercised when deductibility is dependent on interpretation of facts through the sometimes opaque lens of provisions of the Act. It may therefore be prudent for companies in sectors with no regulated social spend that wish to pursue appropriate ESG objectives to do so through a PBO, allowing the company to reliably benefit from a deduction for funding donated to the PBO pursuing the company's chosen altruistic mission.

Tsanga Mukumba

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 10(1)*(cN),* 11*(a)*, 18A, 23*(g)*, 30(1) (definition of "public benefit organisation"); Ninth Schedule: Part II;
- Companies Act 71 of 2008: Section 1 (definition of "non-profit company");
- Tax Administration Act 28 of 2011: Chapter 7.

Other documents

- Binding Private Ruling 371 (issued on 9 May 2022).

Cases

- *Warner Lambert SA (Pty) Ltd v Commissioner, South African Revenue Service* [2003] (5) SA 344 (SCA); [2003] ZASCA 59 (30 May 2003);
- *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd* [2021] ZASCA 145;
- *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* [2021] ZACC 11.

Tags: public benefit organisation (PBO); non-profit company; public benefit activities.

HIGH COURT REJECTS TAXPAYER'S REQUEST TO CONVERT AN URGENT APPLICATION INTO A REVIEW

What happens if you have approached the High Court to compel the South African Revenue Service (SARS) to consider your assessment, but then belatedly realise that you have selected the wrong procedure? Would a quick convert-and-continue be plausible?
In the case of L'Avenir Wine Estate (Pty) Ltd v Commissioner for the South African Revenue Service *(16112/2021) [2022] ZAWCHC 28 the High Court had to consider this question and more.*

THE VINTAGE RETURN

L'Avenir (the Taxpayer) is a South African wine producer. In 2006 the Taxpayer applied to the Registrar of Companies to make March the end of its financial year. Again, in March 2010, the Taxpayer applied to change the end of its financial year, this time to December. This was approved on 25 March 2010.

The Taxpayer believed that the 2010 change had a retrospective effect for its 2009 tax year, meaning that the period from 1 April 2009 to 31 December 2009 (the disputed period) would be included in the 2009 tax year. SARS, on the other hand, maintained that the approval applied to the Taxpayer's 2010 tax year (rather than 2009) and that the disputed period had to be included in the 2010 return.

Despite these arguments, both parties acknowledged that the Taxpayer had not submitted a return (in either the 2009 or the 2010 tax years) for the disputed period. This meant that SARS assessed the Taxpayer for both 2009 and 2010 without the disputed period being included.

The Taxpayer sought relief from SARS contending that this was a "readily apparent undisputed error in the assessment" (by either SARS or the Taxpayer) or that it was a "processing error" (by SARS), as availed in paragraphs *(d)* and *(e)*(ii), respectively, of section 93(1) of the Tax Administration Act, 2011 (the TAA).

Broadly, section 93 deals with reduced assessments and the circumstances under which SARS may reduce an assessment. It appears that the Taxpayer had an alleged loss falling in this disputed period, hence its various attempts at compelling SARS to assess the disputed period.

Despite its arguments, SARS refused to allow the Taxpayer to submit a separate return for the disputed period or issue reduced assessments for the 2009 and/or 2010 tax years.

This refusal resulted in the current case where, in 2021, the Taxpayer brought an urgent application before the High Court requesting permission to submit an income tax return for the disputed period and for SARS to then assess it for that period.

Notably, the Taxpayer did not seek the court's consideration on the merits of its return; only for the court to direct SARS to receive and to assess the return.

In response to the application, SARS raised three main arguments:

1. The relief sought by the Taxpayer effectively sidestepped the dispute resolution process contained in Chapter 9 of the TAA.

2. Section 105 of the TAA states that a taxpayer can only dispute an "assessment" in terms of Chapter 9 – unless a High Court otherwise directs.

3. Since the Taxpayer could not object or appeal SARS' decision to decline the section 93(2) requests for reduced assessments, this meant that Chapter 9 of the TAA did not apply, and the Taxpayer should have followed a review of an administrative decision under the Promotion of Administrative Justice Act 3 of 2000 (PAJA) (it is unclear from the judgment whether this argument was made in the alternative to the first two arguments).

Essentially, SARS submitted to the court that the Taxpayer was not entitled to approach the court to compel SARS to accept the return. Rather, the Taxpayer should have brought a review of SARS' decision before the court. The Taxpayer conceded this point. The parties then made further representations to the court to aid it in determining whether the supplemented papers before it could form the basis for a review – thus, converting the urgent application to a review.

The Taxpayer contended that its papers were sufficiently detailed to form the basis for a review application and that SARS' view that the application should be dismissed on form (rather than merits), was formalistic and does not serve the interests of justice.

SARS argued that the conversion should not be allowed on the basis that the court was duty bound to determine the dispute defined in the papers only. The Taxpayer's notice of motion did not include review relief, and neither of the parties dealt with review in their papers.

THE COURT'S DISTILLING CONSIDERATIONS

The court noted that, as a starting point, even if it permitted the Taxpayer to make out a case under PAJA, it still would have needed to overcome the requirement that PAJA provides a 180-day period in which to bring a review application. Considering that 180 days had passed since SARS' decision, the Taxpayer would have needed to first apply for condonation. Either way, the court held, the Taxpayer would need to make out a fresh case to explain its delay. Furthermore, the court indicated that the Taxpayer is required to set out the specific grounds upon which it is relying for review, and SARS must be afforded an opportunity to deal with these grounds before the matter is ripe for hearing. Before a matter can be reviewed before a court, the record of the impugned decision must also be placed before the court (under Rule 53 of the Uniform Rules of Court) so that it has all the relevant facts against which to consider the lawfulness of the decision.

Lastly, the court held that even if SARS' decision was unlawful, it remains valid and binding (ie, continues to have legally valid consequences) until it is set aside.

Overall, the court found that the Taxpayer, in seeking a conversion, wished to introduce fundamentally different relief when the case in question was essentially aimed at compelling SARS to change the decision it had already made. The court concluded that "there is no reasonable possibility that the two can simultaneously co-exist on the same set of papers". Consequently, the Taxpayer's application was dismissed with costs.

CONCLUSION

It is interesting that SARS submitted that the Taxpayer should pursue a review under PAJA, in terms of its third argument. Historically, SARS has been inclined to rebuff attempts at review under PAJA, preferring taxpayers to pursue recourse under the dispute resolution process in the TAA. Nevertheless, this case confirms that the appropriate mechanism to review SARS' decisions under section 93 is under PAJA. What is more, it is not appropriate for a party to seek a conversion from an urgent application to a review application on the same papers. The correct approach is to institute fresh review proceedings. Like a fine wine, court processes cannot be rushed, and no steps must be overlooked.

"The court noted that, as a starting point, even if it permitted the Taxpayer to make out a case under PAJA, it still would have needed to overcome the requirement that PAJA provides a 180-day period in which to bring a review application."

Taigrine Jones & Howmera Parak

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 93 (in particular subsection (1)*(d)* & *(e)*(ii)) & 105; Chapter 9 (sections 101–150);
- Promotion of Administrative Justice Act 3 of 2000.

Other documents

- Uniform Rules of Court: Rule 53.

Cases

- *L'Avenir Wine Estate (Pty) Ltd v Commissioner for the South African Revenue Service* (16112/2021) [2022] ZAWCHC 28 (11 March 2022).

Tags: retrospective effect; reduced assessments.

DRAFT INTERPRETATION NOTE ON INTRA-GROUP FINANCIAL ARRANGEMENTS

On 11 February 2022, the South African Revenue Service (SARS) released a new Draft Interpretation Note (Draft IN) on Intra-Group Financial Transactions for public comment ("Determination of the taxable income of certain persons from international transactions: intra-group loans"). *This Draft IN was welcomed by the South African transfer pricing community as intra-group financial arrangements have been a contentious issue for a number of years.*

The release of the Draft IN also reinforces that this is an area which SARS will actively be placing under scrutiny. Intra-group financing arrangements have been known to create opportunities for base erosion and profit shifting (BEPS). [*Editor's note:* SARS gives the following background information on its website: "A Note was released as a draft in 2013 and 2017. Due to changes in legislation (for example, changes to the secondary adjustment mechanism), changes to the content of the Note in terms of additional detail and the inclusion of new sections (for example, the interaction between section 31 and section 23M, section 23N and the interest withholding tax provisions) and the release of the OECD Transfer Pricing Guidance on Financial Transactions in 2020, this latest draft is issued for comment." The due date for commentary on this Draft IN was 29 April 2022 – a final interpretation note arising from this Draft IN has not been published.]

During 2013, SARS released a Draft Interpretation Note which provided guidance on how SARS would expect a South African resident taxpayer to support the arm's length nature of all the cross border intra-group financial arrangements it has entered into. Since then, SARS has maintained that guidance in respect of inbound financial assistance will be provided only once the Organisation for Economic Co-operation and Development (the OECD) releases the final version of the transfer pricing implications on financial transactions.

Having regard to this, the Draft IN has now been aligned with Chapter X of the OECD Guidelines, issued in January 2022. As anticipated, continuous emphasis was placed on the significance of the arm's length principle, which should ideally consider all economically relevant circumstances in respect of intra-group financing arrangements.

Key considerations of the Draft IN are:

- Transfer pricing rules and their applicability to both direct and indirect funding, which includes back-to-back funding and guarantee arrangements.
- SARS will consider the quantum of debt, the duration of the intra-group financing arrangement and other terms such as the interest rate, repayment terms, etc, in determining whether the intra-group financing arrangement does in fact satisfy the arm's length principle.
- There are no safe harbours with regard to ratio analyses.
- The importance of distinguishing what constitutes debt and equity.

"It can be complex to determine an arm's length consideration for loans and interest. We recommend that taxpayers with such transactions seek professional advice to not fall foul of the transfer pricing rules that come into play for such transactions."

- The substantive nature of an intra-group financing arrangement and whether a purported loan should be regarded as a loan as opposed to a contribution to equity capital.
- The key commercial and financial relations in order to accurately delineate the intra-group financial arrangement. This is inclusive of an analysis with regard to the options realistically available to all parties involved in the arrangement.
- Guidance provided on comparability analysis, which involves the use of credit ratings, factors which could potentially affect the credit rating of an entity, covenants and guarantees.
- The use of the comparable uncontrolled price (CUP) method to determine the arm's length interest rate(s) to be applied to intra-group financing arrangements.
- Guidance provided on loan fees and charges.
- The cost of funds as an alternate approach in the absence of comparable uncontrolled transactions.
- Risk-free and risk-adjusted rates of return and the methodologies to be used in this regard.
- The consequences to be faced by the South African resident taxpayer in the event that the level and cost of the intra-group debt is not at arm's length, ie, primary and secondary adjustments.
- The importance of preparing and retaining the appropriate transfer pricing documentation which supports the taxpayer's position regarding the arm's length nature of the intra-group financing arrangement.
- How SARS would treat this in relation to permanent establishments.
- The headquarter company exclusions and the ring-fencing of interest expenditure incurred on inbound intra-group financial arrangements.
- Advance pricing agreements and that SARS may potentially make use of this on intra-group financial arrangements.
- Withholding tax on interest and that this will not be affected by transfer pricing adjustments.

Even though the Draft IN is welcomed and does in fact provide more clarity around intra-group financial arrangements, there are several key issues which still need to be addressed. The key issues identified are:

- Debt and interest have not been defined.
- All safe harbours in relation to intra-group financing arrangements have been removed over time. This places an additional burden on the taxpayer with regard to support of the arm's length nature of the intra-group financial arrangement and is unfortunate, particularly where there is no risk to the SA fiscus.

- The Draft IN seems to be moving away from a ratio-type analysis and is purely focused on an arm's length debt test. Such a test may still include a ratio analysis but may require additional analyses which can be time-consuming and subjective.

- The Draft IN seems to indicate that SARS may not accept interest charges between a head office and its South African PE, as it deems this to be a notional charge with the exception of an external link to an actual charge.

- The Draft IN mentions that the underlying transaction is not adjusted through a transfer pricing adjustment and therefore the amount of interest paid or due and payable to the lender remains the same. As such, the adjustment does not have an impact on the calculation of withholding tax on interest; this means that double tax may arise on that portion of the adjustment as both potential interest-withholding tax and the secondary adjustment are applicable.

- The South African Reserve Bank also places certain limitations on interest rates that can be charged into South Africa from a cross-border related party. It would be very useful if these limitations were aligned to section 31 to ensure that an acceptable loan from an arm's length perspective is not further limited.

- The Draft IN only refers to the OECD Guidelines. Even though the UN TP Model is aligned to the OECD Guidelines, there are some minor differences. It would be useful to understand if the taxpayer can make use of the UN TP Model for additional support/analyses.

Overall, the Draft IN on intra-group financial arrangements does provide guidance to South African taxpayers, especially considering that this is now aligned with global guidance, ie, the OECD Guidelines. However, as mentioned, a number of key issues need to be addressed prior to the finalisation of this Draft IN, and we look forward to the feedback on the above concerns and recommended approaches, which SARS is yet to provide.

It can be complex to determine an arm's length consideration for loans and interest. We recommend that taxpayers with such transactions seek professional advice to not fall foul of the transfer pricing rules that come into play for such transactions.

"Even though the Draft IN is welcomed and does in fact provide more clarity around intra-group financial arrangements, there are several key issues which still need to be addressed."

Shazia Raviduth & Marcus Stelloh

BDO

Other documents

- Draft Interpretation Note on Intra-Group Financial Transactions *("Determination of the taxable income of certain persons from international transactions: intra-group loans")* (released by SARS on 11 February 2022);

- OECD Guidelines: Chapter X (issued in January 2022);

- UN TP Model.

Tags: base erosion and profit shifting (BEPS); intra-group financing arrangement; comparable uncontrolled price (CUP) method; advance pricing agreements.

IMPLICATIONS OF A BUSINESS RESTRUCTURE

BUSINESS RESTRUCTURING OPPORTUNITIES, RISKS, AND TRANSFER PRICING

A business restructure is usually a normal occurrence at some point in the lifespan of a Multinational Enterprise group (MNE group) and is undertaken for various business reasons, such as, to maximise synergies and economies of scale, centralise controls, and management, or increase efficiencies to lower operational cost.

The Organisation for Economic Co-operation and Development (OECD) defines a business restructuring as "the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements". In this context, a business restructure typically consists of the following transaction types:

- The conversion of an enterprise with a relatively higher level of functions and risks into an enterprise with a relatively lower level of functions and risks.
- The transfer of intangibles or rights in intangibles to a central entity within the group.
- The concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally.
- The allocation of more intangibles or risks to operational entities.
- The rationalisation, specialisation, or de-specialisation of operations (including the downsizing or closing of operations).

It is, however, important to bear in mind that without realising or even intending, business restructurings automatically trigger transfer pricing (TP) obligations as they may bring about increased profit potential or profit shift between group entities.

It is vital that the TP aspect of a business restructuring is analysed in order to accurately determine the commercial and financial relations, and the conditions attached to those relations that lead to a transfer of "something of value" (ie, a valuable asset, right, or activity/goodwill) among the members of the MNE group.

The OECD TP Guidelines propose the following methodology to determine the arm's length conditions of the business restructuring:

1. **Understanding the restructuring itself** – examining the economically relevant characteristics of the commercial and financial relations between the associated enterprises and the contractual terms of the business restructuring.

"It is, however, important to bear in mind that without realising or even intending, business restructurings automatically trigger transfer pricing (TP) obligations as they may bring about increased profit potential or profit shift between group entities."

2. **Reallocation of risk and profit potential as a result of a business restructure** – where there is a transfer of "something of value" or the termination or substantial renegotiation of an existing arrangement, that transfer, termination, or substantial renegotiation should be compensated as if it were between independent parties in comparable circumstances.

3. **Transfer of something of value** – an analysis of whether something of value has been transferred and determining the estimated arm's length price of this transfer.

4. **Indemnification of the restructured entity upon the termination or substantial renegotiation of existing arrangements** – the business restructuring needs to take into consideration whether the restructured entity should receive compensation in the form of indemnification as a result of the termination or substantial renegotiation of its existing arrangement. The compensation may be considered in either an up-front payment, a sharing in the restructuring costs, of lower (or higher) purchase (or sale) prices in the context of the post-restructuring operations or of any other form.

DISCLOSURE OF BUSINESS RESTRUCTURINGS IN TP DOCUMENTATION

The OECD requires the following disclosure about business restructuring in TP documentation:

- All important business restructuring transactions occurring during the year must be detailed in the master file.

- The local file should detail whether the local entity has been involved or affected by business restructuring occurring during the year or immediately past year and explain the aspects of such transactions affecting the local entity.

- MNE groups are advised to document their decisions and intentions regarding business restructurings (especially with regard to the decision to transfer or assume significant risks) *before* the actual transactions occur and to document the evaluation of the consequence on the profit potential of significant risk allocations resulting from the restructure.

If your business has recently undergone any changes (or is expected to do so in future), reach out to experts in the field who can help you to ensure that your TP obligations are met and business model opportunities optimised.

"The Organisation for Economic Co-operation and Development (OECD) defines a business restructuring as 'the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements'".

Regan van Rooy

Tags: transfer pricing (TP) obligations; business restructuring; arm’s length price.

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