Issue 27 | 2020
OCTOBER

South African Institute of Tax Professionals

Unstructured CPD 150mins

TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

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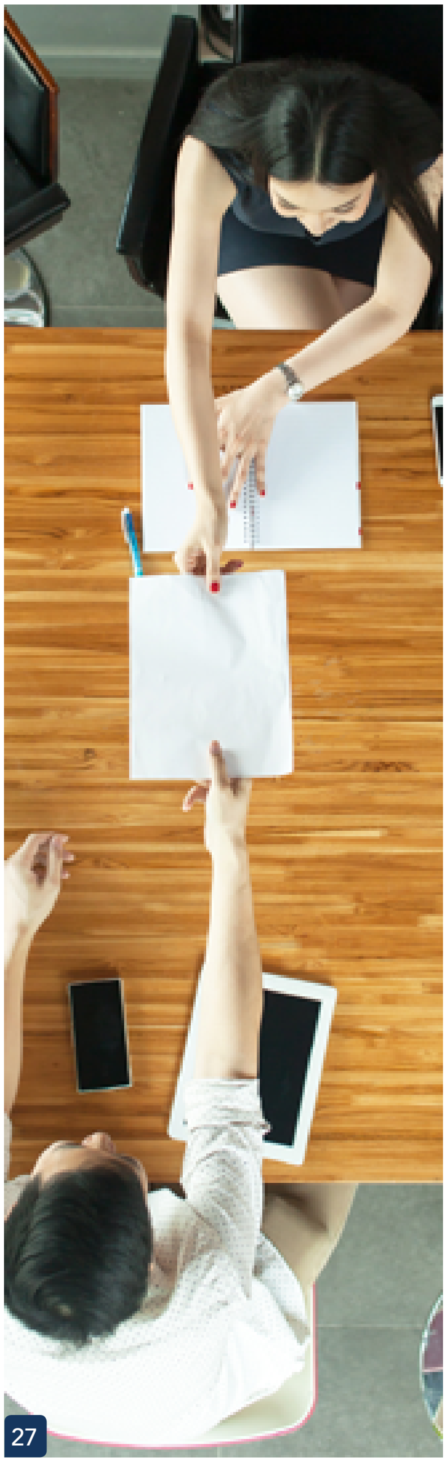

ILLICIT FINANCIAL FLOWS

Under new rules of the Organisation for Economic Co-operation and Development (OECD), South African residents with offshore bank accounts are required to provide information to their banks to enable the authorities to check their tax compliance.

If you are fortunate enough to have an offshore bank account, and have received a questionnaire from that bank asking for information on your residency and tax reference numbers, the reason is simply that banks are now required to provide information relating to their account holders for tax purposes under the Common Reporting Standard (CRS). [*Editorial note*: The CRS is an information standard for the Automatic Exchange of Information (AEOI) regarding financial accounts on a global level, between tax authorities, which the OECD developed in 2014. Its purpose is to combat tax evasion.] Banks are now required to establish where their account holders are tax resident and, if you live outside the country where the account is held, the bank may be required to report on your tax residence and provide information on your accounts. This is a requirement introduced by the OECD under the AEOI proposals which have been adopted by all member countries and the majority of the G20 countries. [*Editorial note*: South Africa is a member of the G20 but not one of the 37 member states of the OECD.] The new requirements stem from the Global Forum initiative to check the tide of perceived illicit financial flows (IFFs) and improve tax transparency and compliance globally.

WHY AND WHO?

As globalisation has allowed greater freedom for the movement of capital, it has created perceptions of hidden capital and a belief that owners of this perceived hidden capital are tax evaders. Enter the Global Forum, part of the OECD Centre for Tax Policy and Administration.

The Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) has been around since 2000, but it was not until 2009 that it gained serious teeth in the fight against IFFs. Arising from the ashes of several tax scandals and the global financial crisis, the G20 mandated the Global Forum to tackle IFFs. Since then the forum's membership has grown to 161 member countries, including at least 30 African countries. [*Editorial note*: The Global Forum includes all G20 countries, and also financial centres; the majority of its members are developing countries. Together they work on an equal footing to put an end to offshore tax evasion.]

The Global Forum operates under three pillars:

- Exchange of information requests (EOIR);
- Automatic exchange of information (AEOI); and
- Technical assistance.

The EOIR was the key means of sharing information between 2009 and 2017. This was a request-based exchange, only initiated if a specific jurisdiction was undertaking an audit which suggested there was tax avoidance or evasion. It is important to note that the EOIR programme is only possible where the tax administration requesting the information has a double tax agreement (DTA) – for example, a document drafted under the OECD Model Tax Convention – in place with the country from which it is making the request. Article 26 of a DTA would permit the exchange of information, if requested.

"It is of concern that the exchange of CbCRs is being grouped with the EOIR and AEOI relating to 'hidden' financial assets associated with tax evasion."

The EOIR standard has been in place for many years and has been continuously reviewed by the Global Forum. It was subject to a round of peer reviews between 2010 and 2016. The purpose of the peer reviews was to check the legal framework to protect the confidentiality and integrity of the information shared as well as the practical implementation.

While the EOIR enabled the recovery of €7.5 billion in additional tax revenue between 2009 and 2017, it has had varying degrees of success. With a growing increase in requests, the gap between requests received and responses sent has become marked, with developed countries generally issuing the largest number of requests. According to the 10th Anniversary Report of the Global Forum (the 10th Anniversary Report), the time in which jurisdictions respond to such requests has improved over the 10-year period, with 92% of requests being answered and with 70% being answered within 180 days.

The introduction of the AEOI changed the playing field significantly. The AEOI was developed in 2014 and all members of the Global Forum were requested to commit to the AEOI standard by 2018 at the latest. Over 100 countries have now adopted it. It is also subject to peer reviews, and the Global Forum has undertaken a review of the completeness of each country's legal framework and effectiveness of its implementation.

In the 10th Anniversary Report, Ms Maria José Garde, the Chairperson of the Global Forum, stated:

> "The implementation of the automatic exchange of information has become a real game-changer by providing tax authorities with a strong tool for detecting tax evasion in the cross-border context. Multilateral cooperation, supported by the G20 and OECD and guided by the principle of the level playing field, has delivered a transformation which was unthinkable just a decade ago."

WHAT IS BEING EXCHANGED?

Under the AEOI, information on financial accounts held by non-residents is exchanged under the CRS. This includes information about the financial account (account number and balance), together with details of the account holder (name, address and tax identification number). Jurisdictions are required to collect the information from financial institutions, banks, hedge funds and various investment trusts, and automatically exchange it with the jurisdiction in which the holder is tax resident.

Countries only share this information if they are signatories to the Convention on Mutual Administrative Assistance in Tax Matters (the Multilateral Convention). The Multilateral Convention was finalised in 2010 and opened for members of the Global Forum to sign. To date all 37 OECD member countries and most G20 member countries, including South Africa, have signed it. The focus has mainly been on sharing information on:

- Offshore bank accounts;
- Offshore ownership of bearer shares; and
- Offshore accounting records.

The 10th Anniversary Report states that information on more than 11 million financial accounts was exchanged in 2017, growing to 47 million in 2018 in 4,500 exchanges covering a total value of €4.9 trillion. By 2019 the number of exchanges had reached 6,100.

To date, the combination of EOIR and AEOI has helped to identify €102 billion in additional tax revenues, arising from over 250,000 information requests and 100 jurisdictions exchanging information automatically.

The Base Erosion and Profit Shifting (BEPS) Final Report on Transfer Pricing Documentation (under Action 13) was issued in 2015 and requires multinational enterprises (MNEs) to provide tax administrations with high-level information about their global business, their global allocation of income, economic activity and taxes paid among countries, according to a common template referred to as a Country by Country Report (CbCR). It also requires MNEs to report the number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities of each entity. In line with the Multilateral Convention, a Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (the CbC MCAA) was developed. The CbC MCAA allows automatic sharing of CbCRs under the AEOI standard.

This will provide tax administrations with a high-level view of the MNEs' operations globally, allow a comparison of functionally similar entities within the group and help them to understand where significant value-adding functions, such as research and development and sales and marketing, are undertaken. It also provides financial information allowing tax administrations to understand where revenue is generated and compare that with the relative tax paid in each jurisdiction. The CbCR is intended as a risk assessment tool, so it should not be used by a tax administration to raise an assessment where it is of the opinion that the entity in its location should be paying more tax.

It is of concern that the exchange of CbCRs is being grouped with the EOIR and AEOI relating to "hidden" financial assets associated with tax evasion. The AEOI, which allows the exchange of financial accounts of non-residents, is intended to allow tax administrations to check that offshore account information is being disclosed by the

"The Africa initiative has two pillars: it seeks to raise political awareness and develop capacities in Africa in tax transparency and exchange of information."

account holders with the sole intention of finding "hidden" accounts and curbing tax evasion. The CbCR, on the other hand, is a compliance tool illustrating the group operations and financial summaries for the group entities. Coupling the two under the AEOI implies that transfer pricing is a path to tax evasion. While transaction mispricing is arguably a means to shift profits within an MNE, transfer pricing itself is a commercial practice used to price the transfer of goods and services, not only between entities within an MNE but also between third parties. Tax administrations typically legislate transfer pricing anti-avoidance provisions to ensure that transfer prices adhere to the arm's length principle (ie, pricing undertaken under the same terms and conditions as would occur between third parties acting independently of each other) to ensure there is no mispricing. We trust that the tax administrations will remember this and do not regard the review of CbCRs as a means to seek out tax evasion.

In June 2019, the OECD further extended the AEOI to include mandatory disclosure rules on avoidance arrangements and opaque tax structures.

> *"Automatic exchange of information is a game changer,"* OECD Secretary-General Angel Gurría said on the eve of a plenary meeting of the OECD/G20 Inclusive Framework on BEPS. *"This system of multilateral exchange created by the OECD and managed by the Global Forum is providing countries around the world, including many developing countries, with a wealth of new information, empowering their tax administrations to ensure that offshore accounts are being properly declared. Countries are going to raise much needed revenue, especially critical now in light of the current COVID-19 crisis, while moving closer to a world where there is nowhere left to hide."* [International Exchange Framework for Mandatory Disclosure Rules on CRS Avoidance Arrangements and Opaque Offshore Structures – OECD June 2019]

EXCHANGE OF INFORMATION IN AFRICA

The Africa initiative was created by the Global Forum with members from the continent and regional and international sponsors. These include the Africa Tax Administration Forum (ATAF), the African Union (AU) and the African Development Bank (ADB), among others.

It was initially set up for a period of three years in 2015, and subsequently renewed. It currently has 32 African member countries.

The Tax Transparency in Africa 2020 report illustrates Africa's ongoing commitment to fight IFFs from the continent. It is the second report commissioned by the Global Forum focusing on the loss of revenue from perceived IFFs across the African continent and it demonstrates Africa's continued commitment to stem this.

The Africa initiative has two pillars: it seeks to raise political awareness and develop capacities in Africa in tax transparency and exchange of information. The 2020 report noted an expansion of exchange information networks among African countries of up to 3,262 in 2019 compared with 2,523 in 2018. It was also noted that progress in using the mechanisms for transparency and exchange of information is patchy. Not all countries have managed to establish an Exchange of Information Unit (EOIU) to analyse both the information requested and received as well as the implementation of the EOIR and AEOI standards. The report notes that the increase in exchange of information in Africa has translated into an additional US$12 million in tax revenue in 2019 for five countries and additional tax revenue of US$189 million for eight African countries between 2014 and 2019.

Peer reviews show that not all African countries are compliant yet in legislative framework and implementation steps for the EOIR and AEOI standards. Interestingly, the report also comments on the success of Voluntary Disclosure Programmes (VDPs) which have been run across a number of African countries, including South Africa, which facilitated the recovery of US$296 million in the programme run between 1 October 2016 and 31 August 2017 and a further US$213 million between 1 April 2018 and 31 March 2019. The report focuses on IFFs, specifically defining these as "money that is illegally earned, used or moved and which crosses an international border". This again suggests the focus is on illegal tax evasion, rather than legal tax avoidance and transfer pricing practices. Identifying trade mis-invoicing as one of the main categories puts this in the same group as the drug trade, human trafficking, illegal arms dealing and smuggling. This seems a little harsh for the reasons cited earlier. Sometimes MNEs simply get it wrong without intending to evade taxes. Do revenue authorities in Africa view these transgressions in the same light as drug dealing?

Corruption is also cited as a key area of IFFs. Africa is not without problems when it comes to corruption, and South Africa has certainly had its fair share, but it would be challenging to quantify IFFs from corruption. Furthermore, corruption's political connection often makes enforcement by the revenue bodies problematic. The report concludes that sub-Saharan Africa suffered a financial loss as a result of IFFs of an average of 6.1% of GDP compared with a global average of 4%, amounting to more than US$50 million annually and increasing. The Global Financial Integrity (GFI) identified trade mis-invoicing as the largest form of IFF from Africa, accounting for 83.4% (2015).

Through the EOIR and AEOI standards, Africa has been successful in targeting elements of these IFFs; however, the report identified two key barriers to the successful implementation of the standards. These were a lack of political awareness and limited capacity. To achieve effective capability in combating IFFs by 2030, African countries need to increase public expenditure by 30% of GDP to meet the sustainable development goals set. The African Development Bank identified the following key areas which need to be addressed to achieve this:

- Developing capacity and capability to tackle tax evasion;
- Support to tax administrations to improve transparency;
- Establish well equipped transfer pricing units;
- Technical support for audit teams;
- Cross-border co-operation through the use of exchange of information;
- Increased disclosure of beneficial ownership; and
- Greater collaboration with international bodies, including ATAF and the Global Forum.

All this predates the impact of Covid-19. The impact of Covid-19 on the economies of Africa is still to be determined but without doubt this will increase the pressure on efforts to meet the sustainable development goals set.

ATAF has been instrumental in assisting tax administrations across Africa. It created the Agreement on Mutual Assistance in Tax Matters (AMATM) specifically for sharing information between African countries. There are nine signatories to these agreements, including South Africa. In addition, 18 African countries, including South Africa, have signed the Multilateral Convention for the AEOI. Between 2018 and 2019, the number of EOIRs sent increased by 48%. The AEOI for financial accounts is seen as a big opportunity to generate additional revenue in Africa. It is estimated that 44% of all of Africa's financial wealth is held offshore, accounting for about €17 billion lost in revenue. South Africa was one of the first African countries to adopt the AEOI in 2017 and received information relating to offshore balances of over €17 billion in 2018 from 63 partners.

If you are therefore one of those wealthy individuals who has received a questionnaire from your offshore bank, be sure you are declaring your assets and paying tax on the income it generates!

Webber Wentzel

Documents and agreements

- 10th Anniversary Report of the Global Forum on Transparency and Exchange of Information for Tax Purposes;
- Agreement on Mutual Assistance in Tax Matters (AMATM) (Africa);
- Convention on Mutual Administrative Assistance in Tax Matters;
- Double tax agreement (DTA – document drafted under the OECD Model Tax Convention);
- International Exchange Framework for Mandatory Disclosure Rules on CRS Avoidance Arrangements and Opaque Offshore Structures (OECD June 2019);
- Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (the CbC MCAA);
- Tax Transparency in Africa 2020 Report (Global Forum);
- The Base Erosion and Profit Shifting (BEPS) Final Report on Transfer Pricing Documentation (under Action 13) (2015).

Abbreviations used in article

- ADB – African Development Bank
- AEOI – Automatic exchange of information
- ATAF – Africa Tax Administration Forum
- AU – African Union
- BEPS – Base erosion and profit shifting
- CbC MCAA – Multilateral competent authority agreement on the exchange of country-by-country reports
- CbCR – Country by country report
- CRS – Common reporting standard
- DTA – Double tax agreement
- EOIR – Exchange of information request
- EOIU – Exchange of Information Unit
- GFI – Global financial integrity
- Global Forum – Global Forum on Transparency and Exchange of Information for Tax Purposes
- IFFs – Illicit financial flows
- MNEs – multinational enterprises
- OECD – Organisation for Economic Co-operation and Development
- VDP – Voluntary disclosure programme

Tags: tax reference numbers; tax evasion; tax avoidance; double tax agreement (DTA); transfer pricing; anti-avoidance provisions.

PREPARATION OF 2019 CARBON TAX RETURNS

The Carbon Tax Act, 2019 (the Carbon Tax Act), which came into effect on 1 June 2019, forms part of government's policy response to climate change and also contributes towards South Africa's Nationally Determined Contribution commitments made under the 2015 Paris Agreement.

As part of the COVID-19 tax relief measures announced by government, it was announced in a media statement on 23 April 2020 that entities liable for carbon tax under the Carbon Tax Act in respect of the 2019 year of assessment, which started on 1 June 2019 and ended on 31 December 2019, would only need to file their returns and make payment in respect of this period by 31 October 2020, whereas the original due date was 31 July 2020.

In this article, we briefly discuss who will be liable for carbon tax for the 2019 year of assessment and what such taxpayers need to do from an administrative perspective before the 31 October 2020 deadline.

WHO IS LIABLE FOR CARBON TAX?

In terms of the Carbon Tax Act, all entities that carry on activities resulting in the emission of greenhouse gases (GHGs) in excess of the thresholds stipulated in Schedule 2 to the Carbon Tax Act will be liable for carbon tax. The threshold depends on the nature of the activities concerned. It is possible for an entity to carry on more than one of the types of activities listed in Schedule 2. For example, an entity could manufacture chemicals on the one hand and bricks on the other hand. Such an entity needs to consider whether each of these activities results in GHG emissions above the threshold(s) for the respective activities, as listed in Schedule 2. Depending on the nature of the taxpayer's activities, it may need to license each of its emissions-generating facilities with the South African Revenue Service (SARS) as a so-called "customs and excise manufacturing warehouse" for environmental levy purposes. [*Editorial note*: The expression "customs and excise manufacturing warehouse" is often used in the Customs and Excise Act, 1964, whereas the Customs Control Act, 2014, which is not yet operational, uses the term "excise manufacturing warehouse".]

"In terms of section 54E of the Customs Act, no environmental levy goods may be manufactured in the Republic except in a customs and excise manufacturing warehouse licensed in terms of the Customs Act."

WHAT DOES REGISTRATION FOR CARBON TAX ENTAIL?

In terms of section 15 of the Carbon Tax Act, the Commissioner for SARS must administer the provisions of the Carbon Tax Act as if the carbon tax were an environmental levy as contemplated in section 54A of the Customs and Excise Act, 1964 (the Customs Act). The Carbon Tax Act also makes provision for the filing of tax returns and payments annually as set out in the Rules of the Customs Act (the Rules).

In terms of section 54E of the Customs Act, no environmental levy goods may be manufactured in the Republic except in a customs and excise manufacturing warehouse licensed in terms of the Customs Act. Taxpayers applying for such a licence must apply on the forms prescribed by the Rules and must comply with all the provisions of the Customs Act and any requirements the Commissioner may prescribe in each case.

On 23 December 2019, SARS issued notice R1700 (the Amendment Notice), which amended the Rules and made provision for the licensing of emissions facilities in terms of the Rules. What is stated in the Amendment Notice is contained in Rule 54FD of the Rules. In terms of Rule 54FD.02*(a)*, taxpayers liable for carbon tax must:

- obtain a consolidated licence for the combination of each of its emissions facilities as its customs and excise manufacturing warehouse for the generation of emissions liable to carbon tax; and
- designate the premises of its operational control in the Republic as the premises for such a consolidated licence.

In terms of Rule 54FD.02*(b)* a taxpayer is exempt from applying for a licence for an emissions facility where an activity listed in Schedule 2 to the Carbon Tax Act exclusively occurs in respect of which:

- such taxpayer has a basic tax-free allowance of 100%; or
- a tax threshold indicated as "not applicable" applies.

Rule 54FD.02*(c)* provides that Rule 19A.02 shall apply, with the necessary changes as the context may require, to any application for a licence or renewal of a licence. Rule 19A.02 provides for the application for and refusals, suspensions or cancellations of a licence. It states that a person applying for a licence or renewal of a licence for a customs and excise manufacturing warehouse must, *inter alia*, apply on form DA 185 and, before a licence is issued, furnish SARS with the security it may require. An example of taxpayers who are exempt from licensing, is entities whose GHG emissions arise from activities falling solely in the road transportation sector. This is because according to Schedule 2, the threshold for such activities is listed as not being applicable.

SUBMISSION OF CARBON TAX RETURNS AND PAYMENT

Rule 54FD.04, which was amended by the Amendment Notice, states the following regarding submission and payment:

> For the purposes of payment of the environmental levy, every licensee must submit for each tax period within the period prescribed –
>
> - a consolidated annual account on form DA 180 and its annexures that calculates the environmental levy liability in accordance with rule 54FD.03 in respect of its licensed customs and excise manufacturing warehouse;
> - a consolidated payment for the total environmental levy liability; and
> - any supporting documents the Commissioner may request.

For the 2019 year of assessment, the submission of the above must take place by 31 October 2020, but the due date for submission in all future years of assessment will be 31 July. The due date in respect of the 2020 year of assessment will therefore be 31 July 2021; the documents and payment specified above must be submitted in July 2021.

OBSERVATION AND PRACTICAL CONSIDERATIONS

By now, most entities should have determined whether they would be liable for carbon tax or not by considering the provisions of the Carbon Tax Act and in particular, Schedule 2. Entities that are uncertain whether they are liable for carbon tax, would be well advised to consider this as soon as possible. It must be appreciated that even though only participants in certain sectors of the economy will be liable for carbon tax under the Carbon Tax Act, as it currently reads, the list of sectors to which the tax applies is extensive. Any entity that conducts activities falling within the manufacturing, construction, transport, solid fuels, oil and natural gas, carbon dioxide transport and storage sectors, or which carries on an industrial process, as listed in Schedule 2, will be liable for the carbon tax, to the extent that the GHG emissions resulting from their activities exceed the threshold stipulated in Schedule 2.

From a practical perspective, entities must appreciate that the process to register a facility as an emissions facility in terms of Rule 54FD, can be quite burdensome, as SARS often adopts a strict tick-box exercise. Entities liable for carbon tax who have not yet registered their facilities, would be well-advised to start the process of registration sooner rather than later.

It is also noted that a number of the regulations to the Carbon Tax Act were published earlier this year, including those dealing with reduction of one's carbon tax liability under the trade exposure allowance.

Cliffe Dekker Hofmeyr

Acts

- Carbon Tax Act 15 of 2019: section 15 & Schedule 2;
- Customs and Excise Act 91 of 1964; sections 54A & 54E;
- Customs Control Act 31 of 2014.

Other documents

- 2015 Paris Agreement (agreed to on 12 December 2015; ratified by South Africa on 1 November 2016; entry into force on 4 November 2016);
- Notice R1700 of 23 December 2019 (making provision for the licensing of emissions facilities in terms of the Rules of the Customs and Excise Act 91 of 1964 – amending Rules 19A.02 and 54FD (54FD.02, 54FD.03 & 54FD.04) of the Customs and Excise Act);
- Forms prescribed by the Rules of the Customs and Excise Act: forms DA 180 & DA 185.

Tags: carbon tax; emission of greenhouse gases; customs and excise manufacturing warehouse.

GENERAL RULES REGARDING INTEREST DEDUCTIBILITY

In the current environment where there is a huge amount of debt being incurred by taxpayers, it is useful to remind ourselves in what general circumstances interest is deductible for income tax purposes by taxpayers, including companies that form part of a banking group.

In this regard, the provisions of section 24J of the Income Tax Act, 1962 (the Act), regulate, amongst others, the incurral or accrual of interest on financial instruments. It enacts the principle that interest accrues on a "yield to maturity" basis and applies to all "instruments", defined as including "any interest-bearing arrangement or debt".

Section 24J(2) deals with the deductibility of interest. All amounts of interest, determined on whatever calculation basis, falling within a year of assessment are deductible in that year of assessment In particular, in terms of section 24J(2), interest is deductible whether or not the instrument is seen as capital in nature.

Section 24J(2) provides that where a person is the "issuer" in relation to an instrument during any year of assessment, such person shall for purposes of the Act be deemed to have incurred an amount of interest during such year of assessment which is equal to the sum of all accrual amounts in relation to all accrual periods falling, whether wholly or in part, within such year of assessment in respect of such instrument. This amount of interest must be deducted from the income of that person derived from carrying on any trade, if the amount is incurred in the production of the income.

An "issuer" is defined in section 24J(1) as any person who has incurred interest or has any obligation to repay an amount in terms of an instrument.

Accordingly, in terms of section 24J(2), a person (the issuer) may deduct an amount of interest (calculated in accordance with section 24J) "from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income".

For interest to be deductible, it must thus be incurred "in the production of income" as part of a "trade".

THE "TRADE" REQUIREMENT

The term "carrying on any trade" is not defined in the Act. However, the term "trade" is widely defined in section 1(1) of the Act and includes, *inter alia*, every profession, trade, business, employment, calling, occupation or venture, including the letting of any property.

In *Burgess v Commissioner for Inland Revenue* [1993], the court considered whether the appellant was carrying on a trade within the meaning of the general deduction formula contained in section 11*(a)* read with section 23*(g)* of the Act. The court described the principle that "trade" should be given a wide interpretation as being "well established". Regarding the meaning of "venture", the court stated as follows:

> "…although an element of risk is included in the concept of a 'venture' in its ordinary meaning, I must not be taken to suggest that a scheme like the present would only constitute a 'trade' if it is risky. *Whether it would or not, would depend on its own facts*. If there is no risk involved, it might still be covered by giving an extended meaning to 'venture' or by applying the rest of *the definition, which is in any event not necessarily exhaustive*" (own emphasis).

In *Commissioner for the South African Revenue Service v Tiger Oats Ltd* [2003], the court considered whether an investment holding company listed on the Johannesburg Stock Exchange was in fact carrying on a business for purposes of the application of the Regional Services Council Act, 1985. In this regard, the court held, *inter alia*, that:

> "in a very real commercial sense the respondent [was] *actively involved* in the business of its subsidiaries and associated companies and it [was] its making of investments in those companies which [enabled] it to be actively involved;…[the respondent was] *not simply a passive investor* in [its subsidiaries and associated companies], equatable with a member of the public who invests in listed shares on the stock exchange" (our emphasis).

The principles regarding "carrying on any trade" as distilled from case law can be summarised as follows:

- the term "trade" should be given a wide interpretation;
- the definition of "trade" is not exhaustive;
- merely "watching over" investments does not constitute a trade – it requires something more, for example, dealing in securities; and
- the test as to whether a taxpayer carries on a "trade" is a factual enquiry and no single set of rules can be laid down in this regard.

"In practice, the South African Revenue Service (SARS) generally allows the deduction of expenditure incurred in the production of income even though the receipt or accrual of the income does not constitute the carrying on of a trade."

In practice, the South African Revenue Service (SARS) generally allows the deduction of expenditure incurred in the production of income even though the receipt or accrual of the income does not constitute the carrying on of a trade. This practice of SARS is set out in Practice Note 31 (Income tax: Interest paid on moneys borrowed) (PN31). Although PN31 provides that the practice set out therein will be followed by SARS, PN31 is not binding in terms of South African law.

THE "IN THE PRODUCTION OF INCOME" REQUIREMENT

The *locus classicus* on when expenditure will be incurred "in the production of income" (albeit in the context of the general deduction formula in section 11*(a)* read with section 23*(g)* of the Act) is *Port Elizabeth Electric Tramway Company Ltd v CIR* [1936], where Watermeyer AJP formulated the test in terms of which the following questions need to be asked:

- whether the purpose of the act, to which the expenditure is attached, is to produce income; and
- whether the expenditure is linked closely enough to this act.

In respect of the first leg of the test, in accordance with, *inter alia, Commissioner for Inland Revenue v Allied Building Society* [1963], the purpose to be determined, is the dominant purpose of the taxpayer in question. In *Sub-Nigel Ltd v Commissioner for Inland Revenue* [1948] it was established that the words "incurred in the production of the income" do not mean that before a particular item of expenditure may be deducted it must be shown that it produced any part of the income for the particular year of assessment. The important question is whether the expenditure has been incurred for the purpose of earning income as defined in section 1 of the Act, whether in the current or in a future year of assessment.

SECTION 24JB – "COVERED PERSONS"

Section 24JB of the Act deals with the taxation of any profit or loss recognised by "covered persons" in the statement of comprehensive income in respect of "financial assets" and "financial liabilities".

For purposes of section 24JB, the term "covered person", as defined in subsection (1), includes, *inter alia*, a bank, a branch of a bank or any company that forms part of a banking group as defined in section 1 of the Banks Act, 1990 (the Banks Act).

For purposes of section 24JB, the terms "financial asset" and "financial liability" are defined as a financial asset / liability defined in and within the scope of International Accounting Standard (IAS) 32 of the International Financial Reporting Standards (IFRS) or any other International Accounting Standard that replaces IAS 32.

In terms of section 24JB(2), subject to *inter alia* section 24JB(4), there must be included in or *deducted from the income of any covered person* for any year of assessment all amounts in respect of financial assets and financial liabilities of that covered person that are recognised in profit or loss in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that are measured at fair value in profit or loss in terms of IFRS 9, excluding certain specified amounts (such as amounts in respect of a dividend or foreign dividend received by or accrued to a covered person).

The essential elements in order for section 24JB(2) to find application, thus permitting a deduction against the taxpayer's income, are:

- the taxpayer must constitute a "covered person";
- the relevant amounts must be in respect of a "financial liability";
- amounts in respect of the "financial liability" must be recognised in profit or loss in the covered person's statement of comprehensive income; and
- that financial liability must be recognised in profit or loss of the covered person in terms of IAS 39.

As indicated above, section 24JB(2) is subject to the application of section 24JB(4). Section 24JB(4) contains an anti-tax avoidance provision and states that 24JB(2) does not apply to any amount in respect of a financial asset or financial liability of a covered person where:

(a) a covered person and another person that is not a covered person, are parties to an agreement in respect of a financial asset or financial liability; and

(b) the agreement contemplated in paragraph *(a) was entered into solely or mainly for the purpose of a reduction, postponement or avoidance of liability for tax*, which, but for that agreement, would have been or would become payable by the covered person. (emphasis added).

Provided that all the requirements for the application of section 24JB(2) are met, in terms of section 24JB(2) any positive (increase in) fair value movements arising in respect of a "financial liability" would provide a "covered person" with a deduction against its income.

Section 24JB(2A) further requires a covered person to include in or deduct from income for a year of assessment a realised gain or realised loss that is recognised in a statement of other comprehensive income as contemplated in IFRS 9 if that realised gain or realised loss is attributable to a change in the *credit risk* of the financial liability as contemplated in IFRS 9.

Section 24JB(3) provides that any amount to be taken into account in determining the taxable income of a person in terms of any provision of Part 1 of Chapter II of the Act (normal tax), or in determining any assessed capital loss of a covered person in respect of a financial asset or a financial liability contemplated in section 24JB(2), must only be taken into account in terms of section 24JB.

ENSafrica

Acts

- Income Tax Act 58 of 1962: sections 1(1) (definitions of "income" & "trade"), 11*(a)*, 23*(g)*, 24J (including definitions of "instrument", "issuer" & "yield to maturity" in subsection (1)) & 24JB (including definitions of "covered persons", "financial assets" & "financial liabilities" in subsection (1));
- Regional Services Council Act 109 of 1985;
- Banks Act 94 of 1990: section 1(1) (definitions of "bank", "banking group", "branch of a bank" & "company").

Other documents

- Practice Note 31 (Income tax: Interest paid on moneys borrowed) (3 October 1994);
- International Accounting Standard 32 (IAS 32) of the International Financial Reporting Standards or any other International Accounting Standard that replaces IAS 32;
- IAS 39;
- International Financial Reporting Standard 9 (IFRS 9).

Cases

- *Burgess v Commissioner for Inland Revenue* [1993] (4) SA 161 (A);
- *Commissioner for South African Revenue Service v Tiger Oats Ltd* [2003] ZASCA 43;
- *Port Elizabeth Electric Tramway Company Ltd v CIR* [1936] CPD 241;
- *Commissioner for Inland Revenue v Allied Building Society* [1963] (4) SA 1 (A);
- *Sub-Nigel Ltd v Commissioner for Inland Revenue* [1948] (4) SA 580 (A).

Tags: in the production of income yield to maturity; in the production of income; covered person; financial liability.

WORKING FROM HOME

As more and more South Africans adjust to the new normal of working from home, we examine below whether there are any tax deductions available when one works from home.

There are very limited circumstances when salaried employees are able to claim deductions for expenses incurred in providing services to an employer. Travel expenses from home to the employer's office are not claimable as deductions. Expenses incurred in maintaining a home office are also not claimable except in specific circumstances set out in the Income Tax Act, 1962.

An individual who runs a business from home as a sole proprietor or independent consultant is usually not restricted in claiming home office expenses proportionate to the area used for business. Such individuals can claim rent, rates, interest on bond, cleaning, repairs and wear and tear allowances on business equipment.

However, *an individual who earns remuneration from an employer can only claim these home office expenses if:*

- their home office is equipped for and regularly and exclusively used by the individual to work for the employer for which they earn remuneration; and

- at least 50% of their remuneration is variable (such as commissions or bonuses) and at least 50% of working hours are spent away from the employer's office. If the individual has less than 50% of remuneration as variable payments, they can still claim home office expenses if they spend more than 50% of working hours working from home.

The lockdown has demonstrated to individuals and their employers that remote working arrangements can work successfully. It may well be more efficient for an individual to continue working for two or three days in their home office even after the lockdown has eased.

With the easing of lockdown, employers are requiring their employees to return to work for a limited number of days in a week on a shift or teams basis to minimise potential Covid-19 exposure in the workplace.

This means that salaried employees could spend more than 50% of aggregate working hours in the 2021 year of assessment (12 months ending 28 February 2021) working in their home office. These employees would be happier with less time braving peak hour traffic, more time with their families, an earlier productive start in the day, and as a bonus – they will be able to claim home office expenses as deductions.

If these employees intend claiming home office expenses in their ITR12 tax return for the 2021 year of assessment, they should retain invoices and statements of these expenses, and prepare a running spreadsheet of the number of days worked at home for the tax year. Any communication from the employer to work from home during lockdown, or shift days after easing of lockdown would also be useful to justify the number of days worked in this spreadsheet. Repairs to the home office specifically will be allowed in full. Repairs to the building in general, however, must not be included in total costs.

"In the short term, it may be easier for employees who have to work from home during the lockdown to claim home office expenses from their employer on a reimbursive basis with supporting invoices."

These documents will need to be retained for five years and submitted to SARS should the ITR12 return be selected for verification. An apportionment calculation of square meter of home office area relative to the total residence, with the same ratio applied to expenses such as rates and interest will also need to be submitted.

The flip side of claiming home office expenses as deductions is that on selling their homes, these employees would need to exclude any capital gains from the home office portion of the house from the primary residence capital gains exclusion. This exclusion provides for capital gains of up to R2 million on the disposal of a taxpayer's primary residence or all capital gains if the selling price is less than R2 million, to be disregarded.

In the short term, it may be easier for employees who have to work from home during the lockdown to claim home office expenses from their employer on a reimbursive basis with supporting invoices. Costs which can be claimed include fibre connectivity, cell phone, stationery, and computer equipment, if these have been incurred mainly in the employer's business. These amounts would not be part of remuneration and no PAYE would be withheld from the reimbursed payments. However, this method requires more involvement from the employer due to the need to check and approve the expenses.

If the employee is acquiring any asset on behalf of the employer for use in the employee's home mainly for the employer's business, the employer can claim input VAT on the reimbursements. It is preferable for invoices to be in the employer's name if possible. However, if the employee is acquiring the asset as principal, then the employer would not be able to claim VAT on the reimbursed amounts.

For further information on claiming home office expenses, please refer to the SARS *Comprehensive Guide to the income tax return for individuals* and *Interpretation Note 28 (Issue 2)* (Deductions of home office expenses incurred by persons in employment or persons holding an office).

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Acts

- Income Tax Act 58 of 1962.

Other documents

- Comprehensive Guide to the income tax return for individuals;
- Interpretation Note 28 (Issue 2).

Tags: sole proprietor; independent consultant; home office expenses; primary residence.

COVID-19: SOME PRACTICAL TAX ISSUES

Businesses and individuals may well ask themselves what practical, day-to-day tax consequences the COVID-19 pandemic now holds for them.

For example, a company operating a financial services business may be obliged to incur expenditure which it would not incur in the ordinary course, such as sanitisers, gloves, masks and temperature measuring equipment for screening employees and customers. A taxpayer is entitled to deduct expenditure provided certain requirements are met. Notably, to be deductible, the expenditure must be "actually incurred in the production of income" as contemplated in section 11*(a)* of the Income Tax Act, 1962 (the Act).

In the seminal case of *Port Elizabeth Electric Tramway Co Ltd v CIR* [1936] the court held as follows:

> *"The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible...The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, 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 provided they are so closely connected with it that they may be regarded as part of the cost of performing it."*

Now, strictly speaking, the costs of the items listed in the example above do not *per se* lead to the generation of income for the financial services company. However, there is an argument that the costs should be deductible because they are incurred *bona fide* and the costs are necessary to perform the business operations. In other words, if the company did not incur the costs of protecting staff and customers, they would not be able to continue operations effectively, or at all.

Consider also the following scenario. A building contractor is obliged to send his workers home for an extended period of time. The contractor accordingly is unable to deliver the building on time. The customer sues the contractor for breach of contract. The court awards damages to the customer. Will the contractor be able to deduct the amount of the damages for tax purposes?

Our courts have held on a number of occasions that, generally, damages payable which arise from commercial inefficiency, negligence and wilful breach of contract are not deductible in the hands of the taxpayer who is liable to pay the damages: see, for example, *Kangra Group (Pty) Ltd v Commissioner, South African Revenue Service* [2019]. On the other hand, if a taxpayer becomes liable to pay damages through no fault of its own, the damages could be deductible in its hands. In the *Kangra* case, the court provided the example where a coal supplier faces a damages claim from the buyer arising out of non-delivery due to a breakdown in the railway system resulting in the load not reaching the port on time. There is

"Taxpayers should consult their tax advisers when incurring expenses, claiming under insurance policies, and dealing with employees."

a potential argument that, if a taxpayer does not deliver goods or services on time as a result of an innocent act or omission resulting from COVID-19, the taxpayer should be able to deduct the amount of the damages paid for income tax purposes.

The payment of damages may give rise to value-added tax (VAT). Accordingly, from the perspective of the taxpayer paying the damages, the amount should be stated as being exclusive of VAT. In the case where a taxpayer receives compensation under a loss-of-profits insurance policy, the compensation will generally be subject to income tax in the hands of the taxpayer in accordance with *ITC 594* [1945]. The compensation may be subject to VAT in terms of section 8(8) of the Value-Added Tax Act, 1991.

Consider also the position where employees are obliged to work from home.

If, for instance, the company provides a 3G data card to an employee who does not have sufficient data available at home to perform her functions properly during the lockdown period, the company may be able to deduct the expense so long as the 3G data card is utilised for business purposes. The same would potentially apply where the employee purchased the data herself and was then reimbursed by the company. In such case, the employee would potentially not pay income tax on the reimbursement of the data purchases that was used for business purposes.

The employee may incur additional expenses because she has to work from home. Generally, in accordance with section 23*(b)* of the Act, domestic and private expenses are not deductible by an employee. However, an employee may deduct expenses in respect of the part of her house which is used for work purposes, subject to certain provisos. First, that part of her house must be specifically equipped for work purposes. Secondly, that part of the house must be used regularly and *exclusively* for work purposes. Thirdly, the employee must not be paid a fixed salary, or the employee must perform her duties mainly in that part of the house.

The problem that many employees may face is that they may not have a dedicated workspace for the period that they are working from home. For example, if an employee sets up a workspace on the kitchen table, that part of the house will not be used *exclusively* for work purposes, and the employee will not be able to deduct any expenses.

If employers are obliged to retrench employees, the employers should ensure that any severance benefits are structured correctly so that employees get the full benefit of reduced taxes provided for in the Act that may apply in those cases.

It is apparent from the examples above that COVID-19 has given rise to several unforeseen tax consequences. Taxpayers should consult their tax advisers when incurring expenses, claiming under insurance policies, and dealing with employees.

Cliffe Dekker Hofmeyr

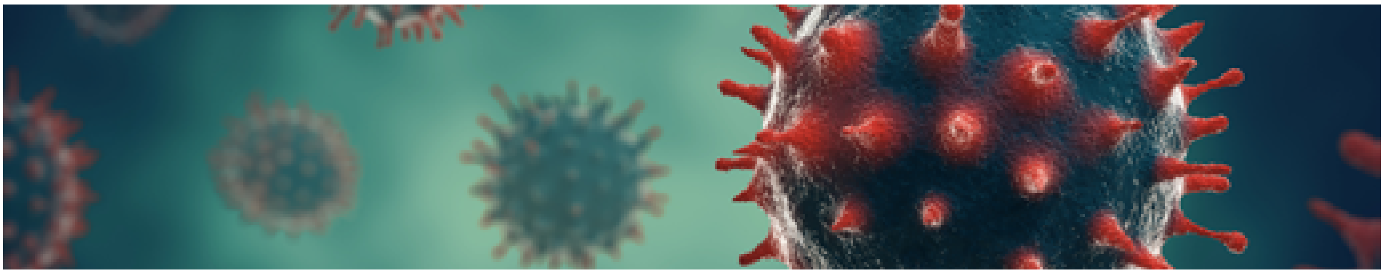
Acts

- Income Tax Act 58 of 1962: sections 11*(a)* & 23*(b)*;
- Value-Added Tax Act 89 of 1991: section 8(8).

Cases

- *Port Elizabeth Electric Tramway Co Ltd v CIR* [1936] CPD 241;
- *Kangra Group (Pty) Ltd v Commissioner, South African Revenue Service* [2019] (1) SA 520 (WCC);
- *ITC 594* (1945) 14 SATC 249.

Tags: incur expenditure; loss-of-profits insurance policy.



EXPANDED ACCESS TO LIVING ANNUITY FUNDS IN RESPONSE TO COVID-19

Editorial note: The article has been amended to make provision for further developments since its original publication by *Cliffe Dekker Hofmeyr* on 8 May 2020: (i) An updated version of the Explanatory Memorandum on the Disaster Management Tax Relief Bill, 2020 (Revised Draft) was published on 19 May 2020; and (ii) the draft government notices published in April 2020 were followed by Notices 618 and 619, published in *Government Gazettes* 43378 and 43380 on 1 June 2020.

The Explanatory Memorandum on the Disaster Management Tax Relief Bill, 2020 (Revised Draft) (Revised EM) states that

> "the COVID-19 outbreak will have significant and potentially lasting impacts on the economy, with individuals facing the risk of cash flow problems or significant losses as the value of asset classes in which living annuitants are invested decrease[s]".

In an effort to alleviate these cash flow constraints and risk of poor performance in what is often people's most important investment, the Minister of Finance, in government notices 618 and 619, published in *GGs* 43379 and 43380 on 1 June 2020, has provided for amendments to the rules regulating the draw down rate and full remaining value lump sum withdrawals, from living annuity investments.

THE CURRENT POSITION

The relevant aspects of "living annuity" are defined in section 1(1) of the Income Tax Act, 1962 (the Act), as:

> "a right of a member or former member of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, or his or her dependant or nominee, or any subsequent nominee, to an annuity purchased from a person or provided by that fund on or after the retirement date of that member or former member in respect of which–
>
> *(a)* the value of the annuity is determined solely by reference to the value of assets which are specified in the annuity agreement and are held for purposes of providing the annuity;
>
> *(b)* the amount of the annuity is determined in accordance with a method or formula prescribed by the Minister by notice in the *Gazette*;
>
> *(c)* the full remaining value of the assets contemplated in paragraph *(a)* may be paid as a lump sum when the value of those assets become at any time less than an amount prescribed by the Minister by notice in the *Gazette*;"

The draw down rate – determining the amount of the annuity as per paragraph *(b)* of the above definition – is prescribed by GN290, *Government Gazette* 32005 of 11 March 2009 (GN290), as being between 2.5% and 17.5% of the total value of the assets referred to in paragraph *(a)* of the above definition. GN290 further prescribes that annuitants may only select a different draw down rate on the anniversary date of the inception of the annuity and at no other time.

Paragraph *(c)* of the above definition provides for the lump sum withdrawal of the full residual value of the invested assets where the value of those assets is below the threshold set in GN1164 (*Government Gazette* 31554 of 30 October 2008). Where there has been a lump sum commutation, this threshold is R50,000; in any other case, it is R75,000.

AMENDMENTS

The government notices published by the Minister of Finance on 1 June 2020 provide for the temporary increase of the range of available draw down rates on living annuities to between a minimum of 0.5% and maximum of 20%, and for this to be altered freely by annuitants during this temporary period. The period during which this is to be effective is from 1 June 2020 to 30 September 2020.

Annuitants whose anniversary date falls within this period may elect to make use of the relief provisions or adjust their draw down rate in the ordinary course. Should the relief provisions be made use of by such annuitants, their draw down rate will automatically revert on 1 October 2020 and they will only be able to make a further adjustment on the next anniversary date.

The government notices further provide for the adjustment of the threshold for the lump sum withdrawal of the full residual value of a living annuity (as provided for in GN1164) to R125,000 in all cases. This amendment is intended to be a permanent change to the regime.

COMMENT

The government notices were published on 1 June 2020. It must be noted that these amendments only relate to investments falling within the definition of "living annuity" in section 1(1) of the Act, as set out above.

The changes to the living annuity regime indeed provide relief, in that annuitants are given more options in terms of what they are permitted to withdraw, depending on their personal circumstances. Retirees currently receiving payments from living annuities have been granted more flexibility in determining the rate at which they receive funds from their investment over the short term. It also allows annuitants to withdraw their entire investment should it fall below the threshold amount, which may provide much needed liquidity.

The amounts withdrawn under the amendments continue to be taxed under the provisions of the Act, specifically the Second Schedule to the Act. The increased or decreased amount received as a result of a change in the draw down rate, will be included in such annuitant's "gross income" (as defined in section 1(1) of the Act). The amount received under a living annuity must be included in "gross income" under paragraph *(a)* of that definition and may be subject to certain deductions and exemptions.

The residual lump sum withdrawals are included in the taxpayer's "gross income", but under paragraph *(e)* of the "gross income" definition. The amount so included is determined under paragraph 2(1)*(a)*(iii) of the Second Schedule, subject to the relevant deductions contained in paragraphs 5 and 6 of the Second Schedule. Specific tax tables and tax rates (other than the normal marginal tax rate tables) apply to the amounts that accrue to the annuitant under these provisions.

"The changes to the living annuity regime indeed provide relief, in that annuitants are given more options in terms of what they are permitted to withdraw, depending on their personal circumstances."

Cliffe Dekker Hofmeyr

Acts

- Income Tax Act 58 of 1962: Section 1(1) (definitions of "gross income" (paragraphs *(a)*, *(b)*, *(c)* and *(e)*) and "living annuity"); second schedule: paragraphs 2(1)*(a)*(iii), 5 & 6.

Other documents

- Explanatory Memorandum on the Disaster Management Tax Relief Bill, 2020 (Revised Draft), published on 19 May 2020;
- GN290, published in *GG* 32005 of 11 March 2009: amount of the annuity, as per paragraph *(b)* of definition of "living annuity", prescribed;
- GN1164, published in *GG* 31554 of 30 October 2008: threshold in respect of full residual value of the invested assets, as per paragraph *(c)* of definition of "living annuity", prescribed;
- GNs 618 and 619, published in *GGs* 43379 and 43380 of 1 June 2020.

Tags: living annuity; draw down rate; gross income.

SARS INTEREST RATES

TAX AND VAT – FURTHER INTEREST RATE DECREASES

The SARS interest rates have been further decreased as detailed below.

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): 7.25% per annum from 1 September 2020 (was 7.75% per annum with effect from 1 July 2020).

  Payable by SARS on refunds of tax (where interest is applicable): 3.25% per annum from 1 September 2020 (was 3.75% per annum with effect from 1 July 2020).

  If the refund is made after a successful tax appeal or where the appeal is conceded by SARS, the interest rate is 7.25% per annum from 1 September 2020 (was 7.75% per annum from 1 July 2020).

- **VAT**

  Payable to SARS on late payments: 7.25% per annum from 1 September 2020 (was 7.75% per annum from 1 July 2020).

  Payable by SARS on VAT refunds after prescribed period: 7.25% per annum from 1 September 2020 (was 7.75% per annum from 1 July 2020).

- **Fringe benefits**

  Official interest rate for loans to employees below which a deemed fringe benefit arises: 4.50% per annum from 1 August 2020. See below for details of historical changes.

- **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: 4.50% per annum from 1 August 2020. See below for details of historical changes.

- **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% on the interest forgone each year.

- **Penalties**

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

"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%."

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 their own studies) in excess of R3 000 from their 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% on the interest forgone each year.

- 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 3.50% per annum.

The "official" rate of interest over the past five years

With effect from		*Rate per annum*
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%
1 April 2020	–	6.25%
1 May 2020	–	5.25%
1 June 2020	–	4.75%
1 August 2020	–	4.50%

Kent Karro

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

TAX BILLS – FURTHER RELIEF MEASURES AND POTENTIAL PROBLEMS

[*Editorial note*: This article has been amended to make provision for further developments since its original publication by *Cliffe Dekker Hofmeyr* on 8 May 2020:

(i) On 19 May 2020 a revised version of the Explanatory Memorandum on the Disaster Management Tax Relief Bill, 2020 (Revised Draft), was published; and

(ii) on 24 June 2020 the Disaster Management Tax Relief Bill 11 of 2020 and the Disaster Management Tax Relief Administration Bill 12 of 2020 were introduced in the National Assembly. Both these Bills were amended by the Standing Committee on Finance and the amended Bills (Bill 11B – 2020 and Bill 12B – 2020), were passed by the National Assembly on 25 August 2020.]

Following the President's announcement on 21 April 2020 that the initial tax relief measures proposed in response to effects of the COVID-19 pandemic would be broadened, on 1 May 2020 National Treasury published a number of documents giving effect to the announcement, *inter alia* the following:

- The Explanatory Memorandum on the Disaster Management Tax Relief Bill, 2020 Revised Draft;
- The revised Draft Disaster Management Tax Relief Bill, 2020 (Revised Draft Tax Relief Bill); and
- The revised Draft Disaster Management Tax Relief Administration Bill, 2020 (Revised Draft Admin Bill), which included the Memorandum on the Objects of that Bill.

A further revised draft of the Explanatory Memorandum on the Disaster Management Tax Relief Bill, 2020 Revised Draft (the Revised EM), was published on 19 May 2020.

On 24 June 2020 the following Bills were introduced in the National Assembly:

- The Disaster Management Tax Relief Bill, 2020 (Tax Relief Bill); and
- The Disaster Management Tax Relief Administration Bill, 2020 (Tax Relief Admin Bill).

Both these Bills were amended by the Standing Committee on Finance and the Bills, as amended, were passed by the National Assembly on 25 August 2020.

The Memorandum on the Objects of the Tax Relief Admin Bill forms part of that Bill.

In this article, some of the provisions of the above-mentioned documents are discussed.

DEFERRAL OF INTERIM PAYMENTS FOR MICRO BUSINESSES

In the first set of draft tax bills, published on 1 April 2020, provision was made for a qualifying micro business to defer 35% of its interim payments in terms of paragraph 11(4) of the Sixth Schedule to the Income Tax Act, 1962 (the Act), for a period of six months. The period ran from 1 April 2020 to 30 September 2020. The Tax Relief Admin Bill, however, provides for a five-month period from 1 April 2020 to 31 August 2020.

Similarly, the first set of draft bills provided for a 12-month period in which a qualifying micro business could pay 65% of its interim payments instead of an amount equal to the amount of tax calculated in terms of paragraph 11(4) of the Sixth Schedule. This period ran from 1 April 2020 to 28 February 2021. The Tax Relief Admin Bill now provides for a six-month period, running from 1 September 2020 to 28 February 2021.

The Tax Relief Admin Bill also provides that interim payments that have been deferred will be subject to penalties in terms of paragraph 11(6) of the Sixth Schedule and interest in terms of paragraph 11(3) or (5) of the Sixth Schedule, if not paid when due.

DONATIONS TO THE SOLIDARITY FUND

As anticipated, the Tax Relief Admin Bill contains provisions that regulate the deduction of donations made to the Solidarity Fund. In terms of clause 5 of the Tax Relief Admin Bill, an employer may deduct from remuneration so much of a donation made by the employer on behalf of the employee to the Solidarity Fund either:

- during a period of three months commencing on or between 1 April and 1 July 2020 as does not exceed 33.33% of the monthly remuneration of the employee; or
- during a period of six months commencing on 1 April 2020 as does not exceed 16.66% of the monthly remuneration of the employee.

In both of the scenarios referred to above, the employer will be issued a receipt as contemplated in section 18A(2) of the Act.

Another provision which regulates donations to the Solidarity Fund is found in the Tax Relief Bill. Clause 8 of the Tax Relief Bill provides that if the total amount of deductions under section 18A exceeds the amount allowed to be deducted under section 18A(1)(B) of the Act, the portion of the excess attributable to payment or transfer to the Solidarity Fund must, notwithstanding section 18A(1)(B), be allowed to be deducted up to a maximum of 10% of the taxable income of the taxpayer as calculated before allowing any deduction under this section.

The Revised EM (in 7. III) explains that the tax-deductible limit in terms of section 18A for donations, which is currently at 10% of taxable income, will increase to 20% in respect of donations actually paid or transferred to the Solidarity Fund. There will, thus, be a limit of 10% for any qualifying donations (including donations to the Solidarity Fund) and an additional 10% solely for donations to the Solidarity Fund.

From a practical perspective it is not clear how the amendment to section 18A will be reconciled with the amendment to paragraph 2(4)*(f)* of the Fourth Schedule to the Act in all circumstances. For example, it is possible that an employee's donation to the Solidarity Fund will be taken into account for purposes of paragraph 2(4)*(f)*, but upon assessment of the employee's income tax liability, it then appears that the total amounts deducted for purposes of paragraph 2(4)*(f)* exceed the 20% total deduction limit set in terms of the amendment to section 18A. It is not clear what will happen in this scenario as section 18A states that donations in excess of the 20% limit will be carried over to the following year of assessment, but may have already been taken into account for purposes of paragraph 2(4)*(f)*.

COVID-19 DISASTER RELIEF ORGANISATIONS

In terms of clause 7 of the Tax Relief Bill, it is now possible for non-profit companies and associations of persons who carry on COVID-19 disaster relief activities to also apply for approval as public benefit organisations (PBOs) in terms of section 30 of the Act. Previously, only trusts could apply and obtain approval. It was curious as to why the 1 April 2020 draft bill catered for the approval of trusts as PBOs and not companies or associations of persons which in terms of the Act can on application be approved as PBOs. However, the proposed amendments to paragraph 2(4)*(f)* and section 18A (as discussed above) will not apply to donations made by taxpayers to such approved PBOs. To the extent that a person only makes donations to such an entity in excess of the 10% limit in section 18A, any amount of the donation which has been disallowed solely by reason of the fact that it exceeds the amount of the deduction allowable shall be carried forward and shall be deemed to be a donation actually paid or transferred in the next succeeding year of assessment.

INCREASE IN THE PASSIVE INCOME LIMIT FOR QUALIFYING TAXPAYERS

In the initial draft bills, a "qualifying taxpayer" was defined as a company, trust, partnership or individual that, amongst others, has a gross income of R50 million or less during the year of assessment ending on or after 1 April 2020 but before 1 April 2021. The proviso was that not more than 10% of the gross income for the year of assessment was derived from interest, dividends, foreign dividends, rental from letting fixed property or any remuneration received from an employer. The Tax Relief Bill proposes that this limitation be amended as follows:

- the 10% limit on passive income should be increased to 20%;
- passive income in this regard should be extended to include income derived from royalties and annuities; and
- passive rental income derived from the letting of fixed property should exclude rental income derived by a person whose main trading activity is the letting of fixed property.

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 18A(1)*(b)* and 30; Schedule 4 (paragraph 2(4)*(f)*); Schedule 6 (paragraph 11(3), (4), (5) & (6)).
- The Disaster Management Tax Relief Bill 11 of 2020 & the Disaster Management Tax Relief Bill 11B of 2020; and
- The Disaster Management Tax Relief Administration Bill 12 of 2020 & the Disaster Management Tax Relief Administration Bill 12B of 2020.

Other documents

- The Explanatory Memorandum on the Disaster Management Tax Relief Bill, 2020 (Revised Draft), published on 19 May 2020;
- Memorandum of Objects of the Disaster Management Tax Relief Administration Bill 12 of 2020;
- Memorandum of Objects of the revised Draft Disaster Management Tax Relief Administration Bill, 2020;
- The revised Draft Disaster Management Tax Relief Bill, 2020, published on 1 May 2020;
- The revised Draft Disaster Management Tax Relief Administration Bill, 2020, published on 1 May 2020.

Tags: tax-deductible limit; income tax liability; qualifying micro business; qualifying taxpayer.

THIRD-PARTY APPOINTMENTS BY SARS TO SATISFY TAX DEBTS

Section 179 of the Tax Administration Act, 2011 (the TAA), deals with the liability of a third party appointed to satisfy tax debts. The section states that:

> "(1) A senior SARS official may authorise the issue of a notice to a person who holds or owes or will hold or owe any money...for or to a taxpayer, requiring the person to pay the money to SARS in satisfaction of the taxpayer's outstanding tax debt.
>
> (2) ...
>
> (3) A person receiving the notice must pay the money in accordance with the notice and, if the person parts with the money contrary to the notice, the person is personally liable for the money.
>
> (4) ...
>
> (5) SARS may only issue the notice referred to in subsection (1) after delivery to the tax debtor of a final demand for payment which must be delivered at the latest 10 business days before the issue of the notice, which demand must set out the recovery steps that SARS may take if the tax debt is not paid and the available debt relief mechanisms under this Act, including, in respect of recovery steps that may be taken under this section—
>
> *(a)* ...
>
> *(b)* if the tax debtor is not a natural person, that the tax debtor may within five business days of receiving the demand apply to SARS for a reduction of the amount to be paid to SARS under subsection (1), based on serious financial hardship ...".

Briefly, from the section set out above, it is observed that the TAA gives the South African Revenue Service (SARS) the power to issue a notice to a third party, ie a bank, that holds money on behalf of a taxpayer. This third-party notice will require the bank to pay over to SARS such money in satisfaction of a taxpayer's tax debt. Where the bank can comply with the requirements of the third-party notice, the bank must pay such money to SARS in accordance with the third-party notice.

If the bank parts with the money contrary to the third-party notice, then the bank will be held personally liable for the taxpayer's tax debt. However, before SARS can issue this notice, there is a provision in section 179 which limits SARS' collection powers and safeguards taxpayers' rights, ie the third-party notice may only be issued by SARS after it has delivered a letter of demand to the taxpayer. This letter of demand must be delivered at least 10 business days before the issue of the third-party notice by SARS.

The letter of demand provides the taxpayer with an opportunity to make arrangements with SARS to pay the outstanding tax debt or a portion thereof, before SARS can rely on the appointment of a third party to make payment of the taxpayer's tax debt.

The recent case of *SIP Project Managers (Pty) Ltd v The Commissioner for the South African Revenue Service* [2020] highlighted the importance of due process being followed by SARS when issuing a third-party notice contemplated in section 179.

The taxpayer's case was as follows:

- In October 2019, SARS issued an additional assessment to the taxpayer, via the SARS e-filing system.
- According to the additional assessment, the taxpayer was assessed to owe SARS an amount of approximately R1,2m and the date for the payment of this amount was 30 November 2019.
- The additional assessment did not come to the attention of the taxpayer. According to the taxpayer's accountant, he was alerted to the additional assessment for the first time on 6 February 2020, when the taxpayer informed him that Standard Bank South Africa (SBSA) had received a notification to pay an amount of approximately R1,2m to SARS, from the taxpayer's bank account.
- Upon scrutinising the taxpayer's e-filing profile, the taxpayer's accountant located the additional assessment; however, there was no letter of demand, as contemplated in section 179(5), to be found on the e-filing profile of the taxpayer, pursuant to the non-payment of the assessed amount.
- The taxpayer's accountant contacted the SARS official whose name was reflected on the third-party appointment notice issued to SBSA on 7 February 2020, who informed him that three letters of demand had been sent to the taxpayer before the third-party appointment notice was issued to SBSA, namely on 7 November 2019, on 11 November 2019 and on 22 January 2020.
- The SARS official forwarded copies of these three letters to the taxpayer's accountant. The taxpayer's accountant maintained that none of these letters were sent to him or the taxpayer, nor had they been uploaded on the taxpayer's e-filing profile.
- Upon contacting the SARS call centre to ascertain where he could locate the letters of demand on the taxpayer's e-filing profile, the taxpayer's accountant was informed that there were no letters of demand uploaded on the taxpayer's e-filing profile.
- The taxpayer then approached its legal advisers and a letter of demand for repayment of the amount paid over by SBSA in terms of the third-party notice, was sent to SARS on 10 February 2020.
- SARS did not respond to this letter of demand, which led to the application for declaratory relief being brought in the Pretoria High Court by the taxpayer against SARS. The taxpayer contended that no letter of demand was delivered prior to the issue of the third-party notice as required by section 179. Further, in the event that the court found that such a letter or letters were delivered, the taxpayer contended that the letters were either premature, as the tax debt was not yet payable at the time, or the 10-business-day period prior to the issue of the third party-notice had not yet expired by the time that the notice was in fact delivered.

"The letter of demand provides the taxpayer with an opportunity to make arrangements with SARS to pay the outstanding tax debt or a portion thereof, before SARS can rely on the appointment of a third party to make payment of the taxpayer's tax debt."

SARS' CASE WAS AS FOLLOWS:

- SARS abandoned relying on the letters dated 11 November 2019 and 22 January 2020 and relied only on the letter dated 7 November 2019, as being the demand letter referred to in section 179(5). The letter of 11 November 2019 was merely a reminder and did not comply with the requirements as set out in section 179(5).
- Further, the letter of 22 January 2020 was not issued at least 10 business days before the notice to SBSA was issued on 3 February 2020 and therefore did not meet the requirements for a letter of demand as required by section 179(5).
- SARS' explanation of the issue of the letter of demand dated 7 November 2019 was contradictory in respect of who actually sent the letters.
- SARS did not put forth adequate proof that the letter of demand was uploaded on the SARS e-filing system.
- In addition, SARS did not address the telephonic conversation held between the taxpayer's accountant and the SARS call centre personnel, wherein it was confirmed that the letters of demand had not been uploaded on the taxpayer's e-filing profile.

In respect of whether a letter of demand had in fact been delivered to the taxpayer, the judge referred to the case of *Wightman t/a JW Construction v Headfour (Pty) Ltd and Another* [2008], which states that:

> "When the facts averred were such that the disputing party necessarily possessed knowledge of them and was able to provide an answer (or countervailing evidence) if they be not true or accurate but, instead of doing so, rested his case on a bare or ambiguous denial, the court would generally have difficulty in finding that the test was satisfied."

In this regard, the judge found that no letter of demand had been delivered to the taxpayer by SARS.

In respect of whether the letter of demand dated 7 November 2019 was premature, the court reasoned that it was clear that section 179 deals with a scenario where there is an outstanding tax debt due by the taxpayer. In this instance, this was not the position as at 7 November 2019, as the taxpayer would have an outstanding debt only after the due date for payment, namely 30 November 2019. SARS conceded that on this date there was not yet an outstanding tax debt owed by the taxpayer. The letter of demand dated 7 November 2019 was accordingly premature and therefore not lawful.

In respect of the third-party notice, the court stated that:

> "[22] Subsection (5) to section 179 was introduced by an amendment to the Act in 2015. Prior to this amendment, there was no obligation on SARS to deliver a demand for an outstanding debt before issuing a third-party notice. The context of this amendment is that SARS may only use the method in section 179 to obtain payment through a third party if it complies with the provisions of the requirements of the section. The wording of section 179(5) is unambiguous and clear – the notice to a third party 'may only be issued after delivery of a final demand for payment which must be delivered at least 10 business days before the issue of the notice….' This is a peremptory requirement before the step can be taken to issue a third-party notice for recovery of an outstanding tax debt.
>
> [23] The notice issued to the third party in terms of section 179(1) does not comply with the peremptory qualification as set out in subsection (5), in that the notice was issued in the absence of a letter of demand delivered to the applicant [as] required. The notice issued is therefore unlawful and declared null and void.
>
> [24] A finding that a legislative provision is peremptory is not the end of the matter. The Court must further enquire whether it was fatal that it had not been complied with. The Appellate Division as it then was laid down the test as 'In deciding whether there has been compliance with the object sought to be achieved by the injunction and the question of whether this object has been achieved, are of importance.' [*Maharaj and Others v Rampersad* [1964].]
>
> [25] Once it is established that a legislative provision is peremptory and the question arises whether exact compliance therewith is required, the answer is sought in the purpose of the statutory requirement which is to be found ascertained from its language read in the context of the status as a whole. [*Ex parte Mothulhoe (Law Society, Transvaal Intervening)* [1996].]"

The court ultimately ordered that the third-party notice issued to SBSA be declared null and void.

In addition, not only was SARS ordered to repay the amount of approximately R1,2m to SBSA (together with interest), but SARS was also ordered to pay the taxpayer's costs of the application.

CONCLUDING REMARKS

- SARS has the power to issue a notice to a third party in satisfaction of a taxpayer's tax debt. However, SARS must ensure that it exercises its powers in accordance with the law.
  - As a starting point, the taxpayer's tax debt must be outstanding.
  - Thereafter, SARS is permitted to deliver a letter of demand to the taxpayer in accordance with the relevant rules for electronic communication.
  - Finally, SARS may issue a third-party notice, at least 10 business days after the letter of demand was issued to the taxpayer.
  - Until then, SARS may not commence with any mechanisms for the recovery of the taxpayer's tax debts from a third party.
- Taxpayers must closely monitor their e-filing profiles and check whether assessments, notices and letters have been issued by SARS. This is important, as not only does it dictate what action is required on the part of taxpayers, but it also impacts on the lawfulness of SARS' subsequent actions.

PwC

Acts

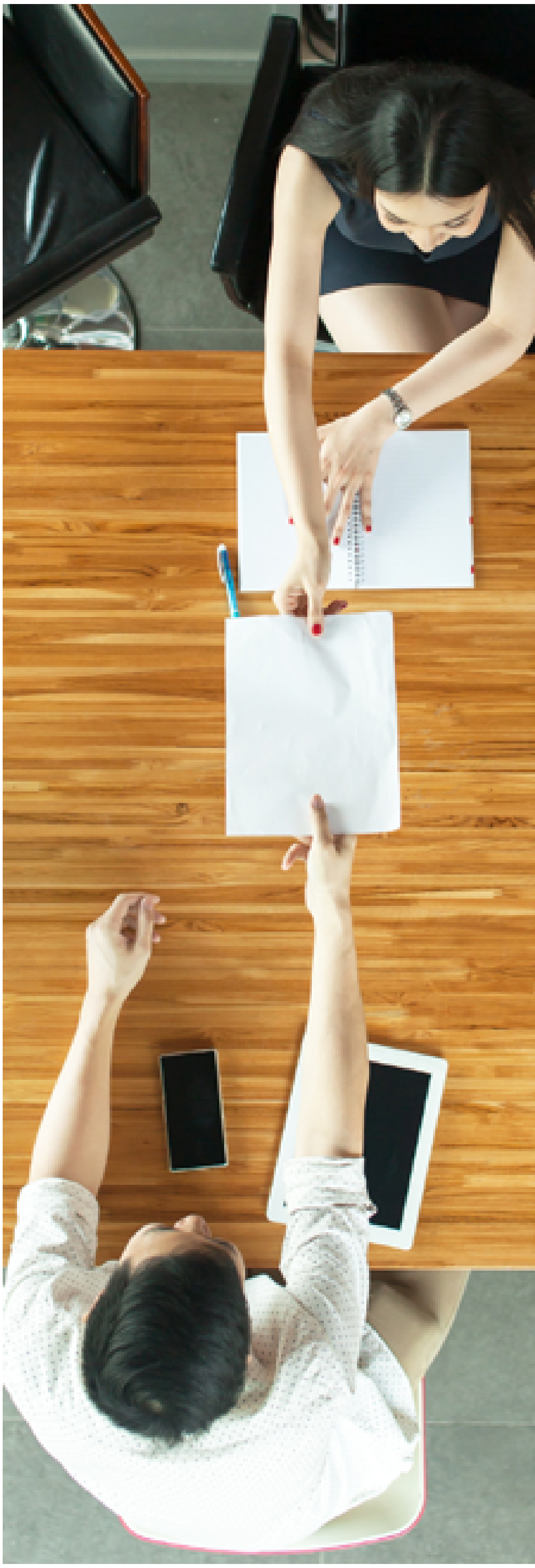
- Tax Administration Act 28 of 2011: section 179.

Cases

- *SIP Project Managers (Pty) Ltd v The Commissioner for the South African Revenue Service* (11521/2020) [2020] ZAGPPHC;
- *Wightman t/a JW Construction v Headfour (Pty) Ltd and Another* [2008] (3) SA 371 (SCA);
- *Maharaj and Others v Rampersad* [1964] (4) SA 638 (A) at 646C;
- *Ex parte Mothulhoe (Law Society, Transvaal Intervening)* [1996] (4) SA 1131 (T) at 1137H–11378F.

Tags: additional assessment; tax debt; letter of demand.

THE IMPACT OF COVID-19 ON CONTRACTUAL OBLIGATIONS



Several articles have been published on the impact of COVID-19 on the contractual obligations of parties, mainly due to the promulgation of emergency legislation impacting performance. This legislation under common law would be regarded as vis maior *or* force majeure *(act of God), and may give rise (to some extent) to a supervening impossibility of performance of contractual obligations.*

Commonly cited examples of affected agreements are leases in respect of commercial property, where a landlord's obligation to provide undisturbed use and enjoyment of the premises for the purpose for which it was let may be affected by such legislation. In this article we touch on a number of different types of contracts.

The manner in which such circumstances affect the parties' rights and obligations under the affected agreement will depend on the terms of that agreement, as well as the particular facts at hand.

While we provide some comments on hypothetical scenarios below, it would be critical for parties to obtain both legal and tax advice in respect of their specific circumstances and the consequential tax effects.

SCENARIO 1 – SUSPENDED PERFORMANCE

Generally, when a contracting party cannot perform through no fault of their own, due to *vis maior*, they are not in breach of contract, but their counterpart is not required to perform due to the concept of reciprocity in contract. (Contractual reciprocity will not necessarily render each counter performance suspensively conditional).

In certain cases, this may affect only the timing of performance – for example, delayed delivery of non-essential goods purchased online. While in these circumstances performance is not possible during the lockdown, performance will be possible after the lockdown. Typically, the contract would effectively be "suspended" in this scenario.

In our view, the ordinary tax consequences of the transaction, in this scenario, are unlikely to be affected.

"In cases where performance is not merely 'suspended' or delayed and there is consequently a complete legal defence to any claim for payment, a party cannot be said to have "unconditionally incurred" expenditure for income tax purposes."

This is on the basis that the supplier of goods or services remains entitled to the consideration payable by the recipient, albeit that the delivery will be delayed. Thus, a tax accrual will be triggered.

Similarly, the recipient remains contractually indebted to the supplier, albeit that payment may be delayed, thus a tax incurral will be triggered.

In the case of the unconditional agreement, where performance is merely delayed, formally valid tax invoices issued and received for value-added tax (VAT) purposes should give rise to output tax liabilities and input tax claims, respectively, in accordance with ordinary principles, despite the suspension of delivery and payment. (The timing of those liabilities and claims for vendors operating on a payments basis may, however, be affected.)

The timing of such tax consequences may be affected, for example, if the agreement is such that performance and counter performance are reciprocally *conditional* for tax purposes. Where such conditionality is contained in the agreement or arises by virtue of the nature of the performance, expenditure might not yet be incurred, and income might not yet be accrued (if not yet received) until the conditionality is resolved by performance. Thus, the tax effects (and possibly the VAT effects) might be suspended too whilst one or both parties are unable to perform due to the *vis maior* and the obligations remain conditional.

SCENARIO 2 – PARTIAL PERFORMANCE

In certain scenarios, only part of a party's contractual obligations may become impossible due to *vis maior* or *force majeure*.

In these scenarios:

- to the extent that timeous performance is possible, the ordinary tax implications should apply;
- to the extent that performance may be "suspended", see scenario 1 above; and
- to the extent that performance is not possible or the agreement may be cancelled, see scenario 3 below.

SCENARIO 3 – NO PERFORMANCE / CANCELLATION

In certain circumstances, the fact that performance is not currently possible, is fatal to the performance itself. For example, if one had ordered catering or entertainment for a function that is cancelled, not merely postponed.

In our view, unperformed obligations which will never be performed should have no tax effects, or the effects should be unwound.

In cases where performance is not merely "suspended" or delayed and there is consequently a complete legal defence to any claim for payment, a party cannot be said to have "unconditionally incurred" expenditure for income tax purposes. The counterparty in turn cannot be said to have an accrued right to payment for income tax purposes.

For VAT purposes, the analysis is different but leads to a similar conclusion. VAT is fundamentally predicated on the supply of a good or a service. In the case of supervening impossibility of performance, by definition, the vendor is unable to provide the good or service.

Even if a valid VAT invoice were to be issued and/or even if the recipient were to pay for the supply which has become impossible due to *vis maior* or *force majeure*, we have some doubt that this will give rise to output tax liability or an input claim. The vendor has not "supplied" any good or service to the recipient due to *vis maior* or *force majeure*, ie no "supply" has taken place for VAT purposes.

In this event, there might be a common-law liability to return the affected contractual payment.

SCENARIO 4 – AGREED ALTERNATIVE PERFORMANCE

Where circumstances necessitate a renegotiation of or amendment to existing terms of an affected agreement, careful consideration should be given to the tax effects of both:

- the amendment itself (specifically any alteration of parties' existing legal rights and/or obligations); as well as
- the agreed alternative performance (which may affect or have different tax implications to those envisaged in any tax advice provided in respect of the original transaction).

COMMERCIAL LEASES – AN INTERESTING EXAMPLE

It seems unlikely that scenario 1 would apply to the commercial lease agreement example cited in our introductory paragraphs. In our view, such cases would more likely fall within the ambit of scenarios 2 or 3.

Specifically, a landlord's obligation to provide undisturbed use and enjoyment of the premises for the purpose for which it was let may be limited by the regulations requiring retailers to close (in the case of retailers selling "non-essential" goods) or limit their operations (in the case of retailers stocking both "essential" and "non-essential"

goods) for the duration of the lockdown. Thus, for the lockdown period all or part of the use will be unavailable. This impossibility of performance would apply for so long as the *vis maior* continues and would erode that part of the lease period. Thus, it seems unlikely that it could merely cause a delay in performance. There is no principle which would for example merely extend the period of the lease to compensate for the lost period of use. During the suspension period the prohibited use or portion of use is lost.

For tax purposes, the ordinary consequences would seem to continue to apply only to that part of the contract which is able to be performed, for instance a partial use of leased premises.

However, insofar as part or all of the obligations under the lease cannot be performed, it would seem that the tax effect for the period is the same as if there was no contract at all, despite the fact that the lease continues to bind the parties. Accordingly:

- for income tax purposes:
    - the lessee should not be said to have "unconditionally incurred" expenditure; and
    - the lessor, in turn, should not be said to have an accrued any right to payment; and
- for VAT purposes, arguably there is no "supply", meaning:
    - no VAT output liability can arise for the lessor;
    - nor may an input credit be claimed by the lessee.

CONCLUDING REMARKS

It is critical that parties to affected contracts accurately assess the legal implications of COVID-19 on their obligations, as this will inform the tax implications.

Even where legal advice in this regard is obtained, uncertainty regarding *inter alia* the duration of the lockdown may have an impact on parties' ability to assess their legal position, which as noted above informs the tax considerations relevant to them. This is particularly true where, due to factual uncertainties, parties can only in due course discover which of the above scenarios are relevant to their circumstances. Consequent complexities may be aggravated where the lockdown crosses a taxpayer's year end.

ENSafrica

Tags: *vis maior*; *force majeure*; VAT output liability.

SECOND-HAND GOODS INPUT CLAIM

Where fixed property is purchased by a VAT vendor from a non-vendor, transfer duty is payable thereon by the purchaser. The fixed property purchased from a non-vendor is regarded as second-hand goods in terms of the Value-Added Tax Act, 1991 (the VAT Act).

To the extent that the property is purchased for the purpose of making taxable supplies, the purchasing VAT vendor is entitled to a notional input tax deduction equal to the tax fraction (15/115) of the lesser of the consideration in money paid by the vendor for the supply of the fixed property, or the open market value thereof.

The relevant provisions of the VAT Act that should be considered to determine the value on which the notional input tax deduction should be calculated are the definitions of "input tax" and "consideration" as contained in section 1(1) of the VAT Act.

Paragraph *(b)* of the definition of "input tax" states that it means "an amount equal to the tax fraction . . . of the lesser of any consideration in money given by the vendor for or the open market value of the supply (not being a taxable supply) to him by way of a sale . . . by a resident of the Republic . . . of any second-hand goods situated in the Republic".

On the other hand "consideration" is defined to mean, "in relation to the supply of goods or services to any person, . . . any payment made or to be made (including . . . tax), whether in money or otherwise, or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or any other person…".

Where fixed property is acquired from a seller who is not registered for VAT, the purchaser will generally incur four separate types of expenses, namely the purchase price of the property payable to the seller; the transfer duty payable to the South African Revenue Service (SARS); the transfer costs payable to the deeds office; and the conveyancing costs payable to the conveyancer.

Given the broad definition of the term "consideration", questions have arisen regarding exactly which costs associated with the purchase of fixed property may be taken into account for purposes of determining the input tax deduction. For example, where fixed property is purchased from a non-vendor, should the transfer duty and conveyancing costs be included in the "consideration" paid?

SARS has previously ruled that the transfer duty incurred by a purchasing vendor may not be included in the amount of "consideration" when calculating the notional input tax credit. This is on the basis that the transfer duty paid is not an amount in respect of any consideration in money paid for the supply of *the* property. The transfer duty is not an amount paid by the purchaser to the seller for the supply of the fixed property, but rather constitutes a separate tax amount paid in terms of the Transfer Duty Act, 1949, on the value of fixed property acquired by the purchaser. Although the definition of "consideration" includes "tax", this tax refers only to VAT for purposes of the VAT Act, and not to any other taxes such as transfer duty paid in relation to the acquisition of goods or services.

It is, accordingly, only amounts paid by the purchaser to the seller for the supply of the fixed property which SARS considers to be "consideration" for purposes of calculating the notional input tax deduction.

The established views of SARS, which have been widely accepted and applied, have been challenged by a taxpayer in the Cape Town Tax Court (Case No VAT 1857 [2020]). The Tax Court was tasked with determining whether the amount of consideration for purposes of calculating the notional input tax deduction should include the amount of transfer duty paid in respect of the fixed property purchased.

THE FACTS

The taxpayer, a property developer, purchased five fixed properties from sellers who were not registered VAT vendors and was accordingly required to pay transfer duty in respect of the acquisition of such properties. The taxpayer claimed notional input tax deductions in respect of the properties acquired. The notional input tax deductions were calculated on the purchase price paid by the taxpayer to the seller and the transfer duty paid by the taxpayer.

SARS disallowed the inclusion of the transfer duty in the amount of consideration to which the tax fraction was applied, thereby reducing the taxpayer's notional input tax deduction. The taxpayer appealed to the Tax Court against the assessments issued by SARS in this regard.

LEGAL CONSIDERATIONS AND THE JUDGMENT

The Tax Court, in an as yet unreported judgment, acknowledged that a fundamental principle of the VAT system is that VAT is a tax on added value imposed at each step along the distribution chain, and is a cost ultimately borne by the final consumer. In deciding the matter, the Tax Court considered the definition of "input tax" and the definition of "consideration" as contained in section 1(1) of the VAT Act.

The Tax Court applied the principles applicable to the interpretation of statutory provisions, being that consideration must be given to the language used, the context in which it appears and the purpose of the provision. The Tax Court identified the question before the court as being whether the words "any consideration in money given by the vendor" includes the payment of transfer duty payable in respect of the purchase of the fixed properties.

In applying the principles of interpretation, the Tax Court applied the plain meaning of the words and held that the broad definition of "consideration" in section 1(1), which includes any payment made in respect of the properties, is unambiguous and held that the clear language used includes transfer duty paid.

SARS led evidence and made submissions that it is SARS' practice to regard the purchase price paid in respect of the sale of immovable property to be the only "consideration" that is used for the purpose of calculating the notional tax credit, and that the transfer duty paid must not be included for such purposes. The Tax Court disregarded SARS' submissions on the basis that SARS' practice should not play a role in the objective and independent interpretation of legislation by the courts.

The Tax Court concluded that transfer duty must be included in the "consideration" paid for fixed property. It stated that its conclusion is based on the clear language of the legislation, and that the conclusion reached is sensible and not unbusinesslike. Furthermore, the Tax Court held that its conclusion is supported by the purpose of the notional input tax deduction allowed in respect of second-hand goods; this purpose being that it was introduced to eliminate double VAT charges on the same value added by allowing notional input relief in the absence of actual inputs.

COMMENTS

We understand that SARS, in view of the significance of the judgment, has filed for leave to appeal, and that the appeal has been granted. The court of appeal (the High Court or the Supreme Court of Appeal) will therefore be required to clarify whether the "consideration" is only the amount paid to the seller, or whether it includes the transfer duty amount paid, when calculating the notional input tax deduction on the purchase of fixed property from a non-vendor. Vendors who seek to claim notional input tax deductions on the acquisition of fixed property should apply this judgment with caution, lest they find themselves liable for penalties and interest resulting from input tax overclaimed, should a court of appeal find in favour of SARS and overturn the Tax Court judgment.

Cliffe Dekker Hofmeyr

Acts

- Value-added Tax Act 89 of 1991: Section 1(1) (definitions of "consideration" and "input tax");
- Transfer Duty Act 40 of 1949.

Cases

- Cape Town Tax Court (Case No VAT 1857 [2020]).

Tags: fixed property; input tax; consideration.