Synopsis

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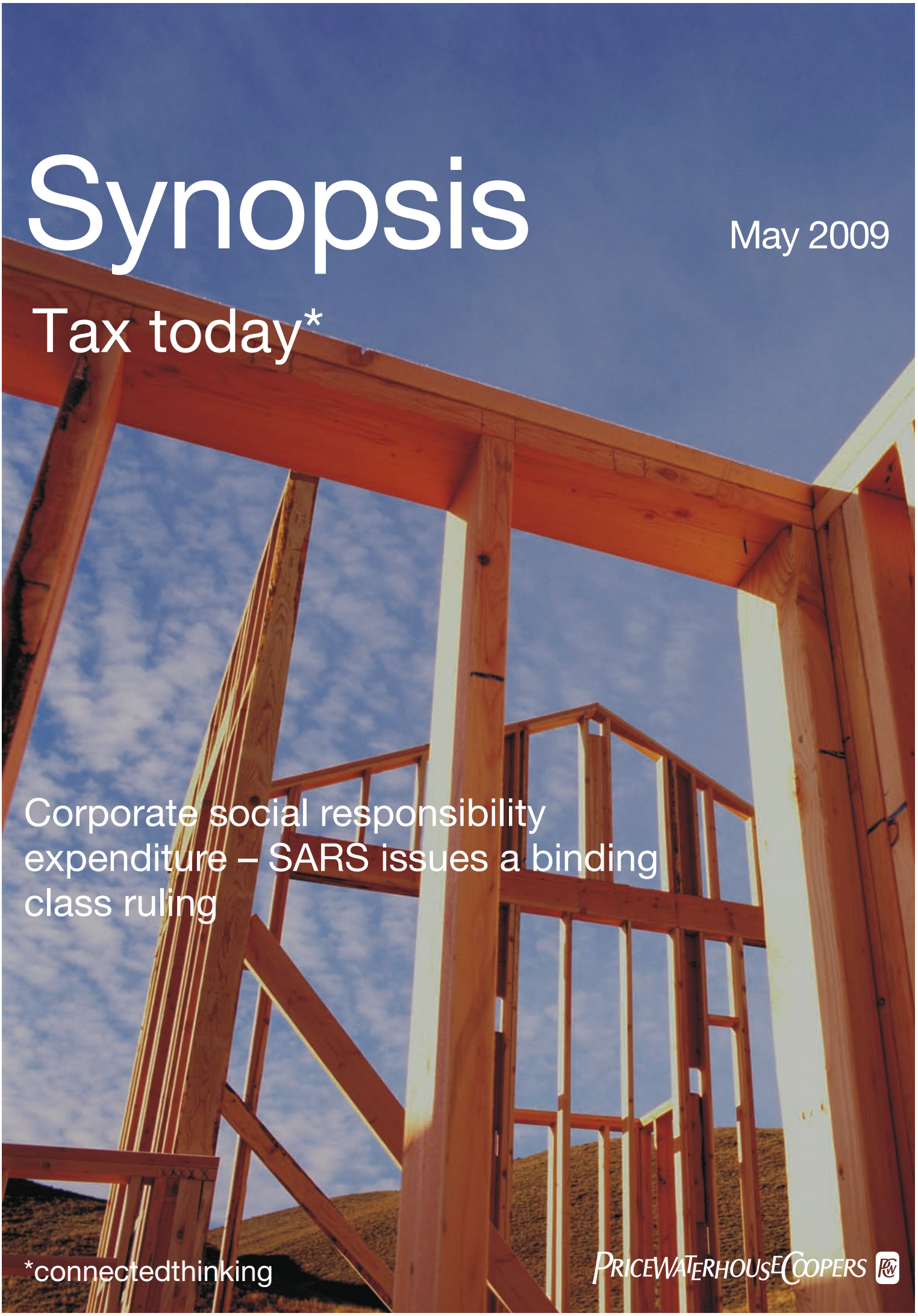

Corporate social responsibility expenditure – SARS issues a binding class ruling

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PRICEWATERHOUSECOOPERS

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Corporate social responsibility expenditure – SARS issues a binding class ruling

For some years there has been doubt concerning the deductibility of corporate social responsibility payments by companies.

The decision to make such contributions may be driven by the need to meet the requirements of the Black Economic Empowerment scorecard, in particular, the minimum requirements of the socio-economic development category of the BEE Codes of Good Conduct that business undertakings should expend not less than 1% of their net profit after tax on CSI projects.

A binding class ruling was published by SARS on 15 May 2009, which deals with the deductibility of CSI expenditure to be incurred in order to meet these minimum requirements by a particular group of taxpayers.

Application was made for the issue of a ruling to a group of companies to permit companies within the group to make contributions to a scheme that will provide educational bursaries to needy recipients in communities deserving of assistance. SARS was requested to issue a ruling that the expenditure in question will be allowable as a deduction in terms of section 11(a) of the Income Tax Act and not prohibited in terms of section 23(g) (which prohibits deduction to the extent that the expenditure is not laid out for purposes of trade).

The ruling permits the particular class of taxpayers, comprising of a resident holding company and its wholly-owned subsidiary companies, to claim deduction in respect of the relevant CSI expenditure incurred in the period from 8 August 2008 to 27 August 2013.

The ruling is only binding as between SARS and the relevant class of taxpayers to which it was issued. Nevertheless it is an indication that SARS will regard expenditure on corporate social responsibility programmes as tax deductible in appropriate circumstances.

A tax blow for farmers slips by unnoticed

Of the many tax benefits available only to farmers, and not to other taxpayers, in terms of the Income Tax Act 58 of 1962, one of most valuable is the right to claim an outright tax deduction in terms of paragraph 12 of the First Schedule to the Act for various kinds of capital expenditure, such as expenditure incurred in building dams, installing irrigation systems and constructing roads and bridges.

A farmer has hitherto also been entitled to deduct expenditure incurred in constructing housing for his employees. This, of course, was a considerable incentive for farmers to provide good quality housing for employees, and farm workers benefited accordingly.

Abruptly, without fanfare and without explanation, the Revenue Laws Amendment Act 60 of 2008 amended the Income Tax Act to provide that, as from 21 October 2008, such expenditure in respect of the construction of employee housing ceased to be tax-deductible as farming capital expenditure.

The deduction of farming capital expenditure is contingent on there being taxable income from farming in the year of assessment in which the expenditure is incurred. To the extent that the capital expenditure exceeds current income, the excess is carried forward for deduction as farming capital expenditure in future years.

The effect of the amendment is that farmers are now required to claim deduction in respect of employee housing on the same basis as other taxpayers. In essence the farmer must own at least five units that are used for the purposes of a trade carried on in the Republic. He may claim a deduction equal to 5% of the cost of erection or improvement of any such unit incurred on or after 1 October 2008. An additional annual deduction equal to a further 5% of the cost may be claimed if the unit qualifies as “low cost residential housing”.

“Low cost residential housing” means a housing unit costing not more than R200 000 and in respect of which a rental (if charged) of not more than 1% of such cost per month is levied.

Expenditure on repairs to the housing of a farmer’s employees remains deductible in the year in which incurred; it is only expenditure on construction, additions or improvements to such housing that has been affected by the amendment.

There has been no comment from organised agriculture in regard to this amendment, and it is difficult to assess its impact on farmers in general in these circumstances.

Business sold as a going concern where purchaser assumes liability for seller's contingent liabilities

A decision of the Johannesburg Tax Court handed down on 14 May 2009 (case 12323; not yet reported) raises fundamental issues of great importance in regard to the tax-deductibility of contingent liabilities which are assigned by the seller to the purchaser where a business is sold as a going concern.

In such a scenario, the seller will usually cease trading once the sale of the business has been completed. Naturally, therefore, the seller wishes to divest himself of all contingent liabilities, so that his business entity can be wound up with a clean slate.

The facts of this particular case were that, in 2004, a large retail company had sold its business, as a going concern, to another large retail concern.

The agreement of sale recorded that the purchase price of the business, as a going concern, was "an amount equal to the sum of R800 million and the rand amount of the liabilities".

The "liabilities" were defined as "all the liabilities arising in connection with the business" in respect of any period prior to the effective date.

At the date of the sale of the business, certain "liabilities" were contingent , that is to say they were liabilities that had not given rise – and might never give rise – to accrued legal liabilities for the seller. These contingent liabilities consisted of post-retirement medical aid benefits for the seller's staff, contingent long-term bonuses for such staff, and obligations to carry out repairs in respect of certain leases. The total amount of such contingent liabilities, which the purchaser agreed to assume, as part and parcel of the sale, amounted to some R17 million.

SARS issued an additional assessment

Following the sale, SARS issued an additional assessment in respect of the seller for the year in which the business had been sold. In that additional assessment, SARS disallowed an amount of some R23 million which had been claimed by the seller as a deduction in respect of contingent liabilities taken over by the purchaser.

The seller contested the disallowance of all but R4 million of the disputed deductions.

In essence, the seller claimed that it was entitled to deduct from its taxable income, in terms of section 11(a) of the Income Tax Act 58 of 1962, the amounts of three underlying contingent liabilities, namely some R9.8 million in

The court accepted that, if the seller had retained the business and had continued to trade, the contingent liabilities in question would have become deductible by the seller as and when they became unconditional.

respect of post-retirement medical aid benefits for staff, some R6 million in respect of long-term bonuses for staff, and R900 000 in respect of "full repairing leases" – in total, approximately R17 million.

SARS disallowed these deductions claimed by the seller.

In short, SARS contended that the seller's contingent liabilities, assumed by the purchaser in terms of the agreement for the sale of the business as a going concern, were not deductible by the seller because these expenditures did not satisfy any of the several criteria contained in the general deduction formula of the Income Tax Act, as expressed in section 11(a), which reads as follows:

"For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived ... expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature".

SARS also argued that the expenditures in question fell foul of the negative criteria for deductibility in section 23(e) (which bars the deduction of income carried to a reserve fund or capitalised), section 23(f) (which bars the deductibility of expenditure incurred in respect of amounts which do not constitute "income", as defined in the Act), and section 23(g) (which bars the deductibility of expenditure not outlaid for the purposes of trade).

The seller's contentions

The seller argued that it was entitled to deduct the contingent liabilities that had been taken over by the purchaser. There were several bases on which this argument was put forward.

The first basis was that, on a proper construction of the agreement, the seller had foregone part of the selling price in return for the purchaser's assuming the contingent liabilities, and that the amount so foregone constituted "expenditure actually incurred" within the meaning of section 11(a).

The second basis was that the seller had, in effect, incurred expenditure in order to rid itself of anticipated or contingent revenue expenses, and that there was judicial precedent to support the proposition that expenditure incurred for such a purpose was, itself, of a revenue nature, and qualified for deduction.

The court accepted that, if the seller had retained the business and had continued to trade, the contingent liabilities in question would have become deductible by the seller as and when they became unconditional.

The court also accepted that salary and other benefits paid by an employer to employees are ordinarily incurred "in the production of income" and are thus deductible. The court also accepted that, ordinarily, benefits such as post-retirement medical aid subsidies and long-term bonuses are designed to attract and retain high-quality staff and to provide incentives to them to render good service for the benefit of the business, and therefore satisfy the criteria for tax-deductibility. The court accepted that the seller would have been entitled to deduct these expenses as and when they became unconditional.

The seller conceded that expenditure is not deductible so long as it remains contingent, and that it becomes deductible only if and when the liability becomes unconditional. The seller argued, however, that the terms of the sale of the business gave rise to "incurred expenditure" equal to the contingent liabilities in issue. This argument was based on the proposition that there had been a "diminution of the seller's patrimony", which was identical to a "loss", as contemplated in section 11(a).

The seller elaborated on this argument, contending that the phrase, *expenditure and losses actually incurred* as laid down in section 11(a) –

"is a deliberately wide one which is intended to cover all actual, quantifiable diminutions or prejudicial effects suffered by the taxpayer's patrimony and that the diminution of a taxpayer's patrimony will very often arise from liabilities undertaken by the trader".

The seller argued that *expenditure and losses* is an economic or commercial concept, rather than one strictly confined to law and legal obligations.

In response to this argument, the court pointed out that, even if this proposition were accepted, the economic consequences of the sale of the business in question were such that the purchaser took on the risk, and the seller was relieved of the risk, that the contingent liabilities in question would materialise.

Hence, said the court, the agreement resulted in an increase in the seller's patrimony, rather than a decrease, because –

"The truth is that if one takes a holistic economic and commercial view of the transaction ... there was no diminution of the [seller's] patrimony: the contrary is true; and if one looks strictly at the assignment of obligations, including the contingent liabilities of the [seller] to the purchaser, as if this was a 'stand-alone' transaction, [the seller] suffered no loss; ... the purchaser took on the risk and the [seller] was relieved of the risk that the contingent liabilities in question would materialise."

The court said that the claimed deductions would constitute "expenditure", within the meaning of section 11(a), only if one accepted the seller's construction of the agreement as being that the seller had "paid" the purchaser an amount equivalent to the contingent liabilities in order to be relieved of the seller's liabilities.

However, said the court, even if this interpretation of the agreement were accepted (despite being in conflict with the seller's accounting records) it did not overcome the difficulty faced by the seller. The difficulty was that the liabilities in question had not yet become unconditional on the date when the business was sold and the liabilities were transferred to the purchaser. Until the liabilities were uncontingent, they did not constitute expenditure that had been "incurred", as interpreted in the 1986 Appellate Division decision in *Nasionale Pers Bpk v KBI.*

The court also held that, even if the contingent liabilities in question could

be regarded as *expenditure*, such expenditure had not been incurred by the seller "in the production of the income", as required by section 11(a), because the expenditure was linked to income earned by the seller prior to the sale of the business, and not to income that would be generated by the sale.

The "notional expenditure" represented by the contingent liabilities in issue, said the court, had been incurred –

"in order to induce [the purchaser] to assume the liabilities, rather than incurred in the production of income prior to the sale of the business".

Moreover, said the court, even if all these difficulties which stood in the way of the seller's arguments being accepted could be overcome, the "expenditure" in issue was of a capital nature (and therefore not deductible) since the consequence of the sale was that the seller ceased trading, and the expenditure therefore ceased to have the requisite link to the seller's income-earning operations.

Furthermore, said the court, the expenditure in question had not been laid out for the purposes of the seller's trade, and the expenditure therefore fell foul of section 23(g), as the transaction in question was undertaken for the purpose of disposing of the seller's business and bringing its trading activities to an end.

The court pointed out that, if SARS were to succeed on any one of the grounds relied upon for its contention that the expenditure or loss in question failed to satisfy the criteria for deductibility in section 11(a) or section 23, the result would be that the expenditure would not be deductible.

In the result, the court held that the seller's claim for deduction of the contingent liabilities in question failed to satisfy any of the criteria in section 11(a) and section 23. The court therefore upheld SARS's disallowance of those deductions.

Recovery in the Republic of taxes due to a foreign country

At common law, the courts of the Republic will not entertain a claim by a foreign government for taxes due to it and will not enforce a foreign judgment for such taxes.

However, section 108 of our Income Tax Act empowers the National Executive to enter into agreements with the governments of foreign countries with a view to preventing or mitigating double taxation and for reciprocal assistance in the collection of tax.

Most of the double tax agreements entered into by the Republic contain provisions for such reciprocal assistance.

In the absence of such an agreement, there is no legal means for the enforceability, within the Republic, of a tax debt due to a foreign country.

Where there is such an agreement, the tax due to the foreign country can be collected in South Africa in terms of the procedure laid down in section 93 of our Income Tax Act.

Section 93 has recently been replaced in its entirety

The Revenue Laws Second Amendment Act 61 of 2008 replaced the old section 93 in its entirety. The wording of the new provision differs significantly from that of the old.

In terms of the new provision, if the Commissioner has, in accordance with arrangements made with any foreign government by an agreement entered into as contemplated in section 108, received a request for the collection from any person in the Republic of an amount alleged to be due by him under the tax laws of such other country, the Commissioner may, by notice in writing, call on such other person to state, within a specified period, whether or not he admits liability for such amount or for any lesser amount.

If such a person admits liability, or fails to respond to the notice, or denies liability but the Commissioner, after consultation with the competent authority of such other country, is satisfied that the liability for such amount is not disputed in terms of the laws of such other country, or is so disputed only to delay or frustrate collection of the amount alleged to be due, or that there is a serious risk of dissipation or concealment of assets by such person, then the Commissioner may by notice in writing require such person to pay the amount in question on a specified date, for transmission to the competent revenue authority in such other country.

If such person fails to comply with such a notice, the amount in question may be recovered, for transmission to the competent authority in such other country, as if it were a tax payable under this Act. In other words, SARS can proceed to file a notice with the clerk of the court in terms of section 91(1)(b) of the Income Tax Act, which then has the effect of a civil judgment, and can be enforced in the same way as such a judgment.

These draconian provisions allow for a fast-track process to recover taxes due to a foreign country from a person who is in the Republic, and involves a more summary process than the provisions of section 93 in its old form.

Under the old provisions, the person in question only became liable for the tax due to the other country if the president of the Tax Court certified that he had afforded that person the opportunity of presenting his case, and that on the information submitted to him, the amount in question appeared to be payable by such person.

Only then was the Commissioner empowered to issue a notice to the person concerned requiring him to pay the specified amount.

Under the new section 93, all that is required to impose liability for the foreign tax is that the Commissioner must “after consultation with” the competent authority of the foreign country be “satisfied” either that liability for the tax is not disputed or that it is disputed only to delay or frustrate collection of the tax, or that that there is a serious risk of dissipation or concealment of assets by such person.

Constitutional aspects of proceedings under section 93

Whether the new section 93, or any action taken in terms of the section, will survive a constitutional challenge is debateable.

Even if the section does not infringe the constitutional Bill of Rights, it seems clear that if the Commissioner were, after the requisite “consultation” with the revenue authorities of the foreign country, to declare himself “satisfied” that the tax in question was indeed due to the foreign country, this decision would constitute “administrative action” as envisaged in the Promotion of Administrative Justice Act 3 of 2000, and the person declared liable for the tax would have the remedies provided for in that Act.

This Act requires that any administrative action be “procedurally fair”. What this entails depends on the circumstances of each case but, in terms of section 3(2)(b) of that Act, SARS would have to give the

person in question adequate notice of the proposed declaration of liability for the tax due to the foreign country and a reasonable opportunity to make representations.

The person in question would be entitled, in terms of section 5 of that Act, to request reasons for the decision, and to take that decision on review in terms of section 6(1).

Transactions between companies in the same group – caveat emptor?

The provisions of sections 41 to 45 of the Income Tax Act provide for tax neutral transfers of assets and trading stock in specified circumstances. One such circumstance is found in section 45, which deals with "intra-group transactions".

The effect of section 45 is that where a transaction is entered into between two companies that form part of the same group of companies (as specially defined in section 41 for this purpose), then the transferor is deemed to have transferred assets at their base cost and trading stock at its income tax value to the transferee who is deemed to have acquired the said items at those same values.

The Revenue Laws Amendment Act, 2008, amended section 45 to provide that its provisions would apply automatically to all transactions that met its requirements, unless the transferor and transferee jointly elect that it should not apply to the particular transaction.

The amendment appears to have had an unintended effect.

Assume company A is a primary producer, say of a mineral. Assume further that part of A's production is sold to B, a company in the same group of companies as A (as required for the application of section 45) and is then used as a raw material input in the manufacturing process carried on by B. A charges B a price that is the same as the price that is charged to its other unrelated customers.

The effect of the transaction is that, unless A and B specifically elect that the provisions of section 45 shall not apply to these transactions, A will be deemed not to derive a profit on the disposal of the mineral to B, and B will be required to treat the input as having been acquired at its tax value to A. Essentially then, the accounting profit will be realised by A, whereas the liability to tax on that transaction will arise in the hands of B.

It is considered that this result was not in the contemplation of the legislature when the amendment was enacted.

The preferred solution would be for an amendment to be made to the legislation. It is considered that this may be effected either by excluding transactions that are undertaken in the ordinary course of trade from the ambit of section 45, or by reverting to the status that applied before the amendment, and again provide that the provisions of section 45 will not apply to a transaction unless the parties jointly so elect.

In the event that the legislation is not amended, management would have to examine the company's transactions with other companies within the same group of companies, either as supplier or recipient, and implement policies that will ensure that the unintended result does not materialise.

The only effective means is by procuring mutual election to disapply section 45 in relation to the relevant transactions. Even here there may be uncertainty, and the wording of the joint election would need to define clearly the transactions covered by the election.

As an alternative, a company might consider taking a board resolution that the company elects that the provisions of section 45 shall not apply to any intra group transactions in which it is involved unless the contract specifically so states. It is considered that this form of "negative election" would not be an effective solution under the present circumstances.