Synopsis

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South Africa shows up well on environmental issues

A recent report from the Organization for Economic Cooperation and Development (OECD) records the proceedings and outcomes of a series of meetings held in mid-September of this year focusing on the economic and tax aspects of climate change and tradable emission permits.

One of the days was devoted to presentations by the OECD's Business and Industry Advisory Committee and some of the topics presented are relevant to legislation that has recently been enacted in South Africa.

Two areas of the proceedings dealt with the broad taxation issues, covering the direct and indirect tax issues and the appropriate economic model that might apply to emission permits, noting that different economic models might be appropriate for different types of tax. The debate arises from uncertainty in international circles as to how to tax recipients of tradable emission permits on the disposal of such permits.

Legislation that passed into law on 30 September 2009 demonstrates decisive action taken by South Africa in this respect.

The Taxation Laws Amendment Act, 2009, promulgated on 30 September 2009, addressed the direct tax treatment of emissions permits and introduced a new section 12K into the Income Tax Act, which provides for an exemption in respect of the disposal of any certified emission reduction derived by any person in terms of a Clean Development Mechanism project carried out by that person.

This is a bold step when considered against a background in which developed countries appear to be prevaricating over the treatment of certified emission reductions, and our lawmakers are to be applauded for their decisiveness in placing climate change priorities at the fore in this debate.

We do not at this stage have legislation specifically dealing with the indirect tax issues relating to tradable emission permits, and this probably reflects the debate that is evident from the OECD report, which revealed that its committee had considered whether these should be classified as intangibles, financial instruments or services on their disposal. The uncertainty in international circles has no doubt been mirrored in the deliberations of SARS in this regard, and it is to be hoped that clarity will emerge in the near future.

The environment and climate change are receiving increasing attention in policy formulation. This is reflected in the medium-term budget policy statement presented by the Minister of Finance on 27 October 2009. The creation of "green" jobs and well structured environmental taxes to mitigate the effects of climate change were identified as elements that will contribute to South Africa's economic recovery and sustainability.

Economic policy measures are important components of a plan to preserve our environment. On their own they can only address targeted areas of the economy. It behoves every South African to commit to the efficient use of resources to improve and sustain our environment.

A generous tax deduction allowed

When allegations were made of corruption and mismanagement in his provincial government, the premier of the province convened a press conference in order to make a public response.

At the press conference, a journalist asked the premier why there was bad blood between A and B, who were, respectively, a former minister in his government and a minister currently in office.

The premier replied that A had been conducting a witch-hunt against B, and that he felt sorry for A, that she should "go for treatment", and that she was trying to destroy the premier's political party.

A took great offence at these remarks – particularly, one may suppose, at the suggestion that she "go for treatment", with its innuendo of mental instability or worse.

A sued the premier for defamation (that is to say, for financial compensation for damaging her good name) and, after a lengthy trial, was awarded damages of R35 000.

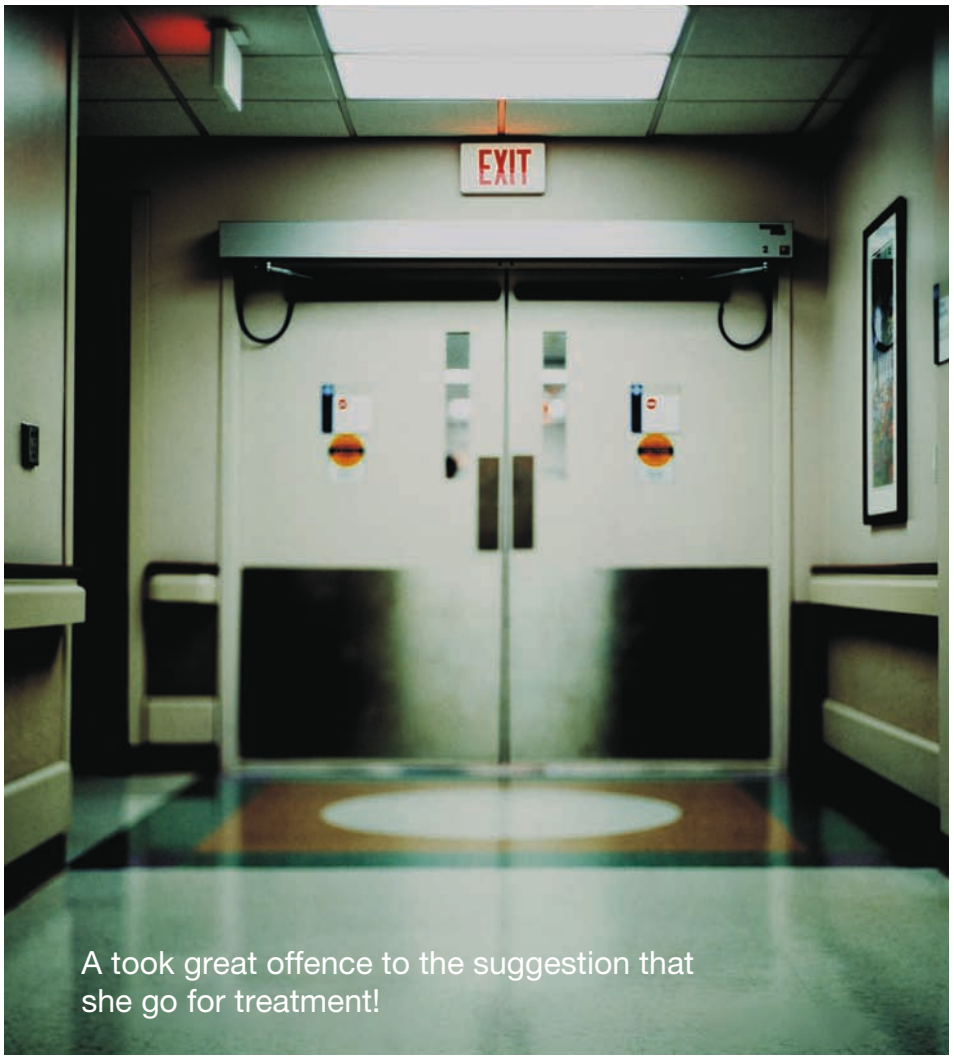
The premier's legal costs in unsuccessfully defending the litigation amounted to some R450 000.

The premier then claimed those legal costs in his personal tax return as an income tax deduction. SARS disallowed the deduction, and the matter proceeded to the Tax Court.

The decision of the Tax Court in respect of his claim to be entitled to deduct the legal costs that he incurred in this litigation has now found its way into the law reports, where it will be closely studied by attorneys and individuals and institutions who are engaged in litigation.

Litigation is notoriously expensive, and if legal expenses are tax-deductible, this can significantly reduce the net cost.

Are the legal costs incurred in litigation tax-deductible, as a general principle, and were they tax-deductible in this particular case?



A took great offence to the suggestion that she go for treatment!

The general deduction formula

The Income Tax Act 58 of 1962 lays down criteria for the deductibility of expenditure in general, and for specific types of expenditure.

Where expenditure is not deductible under a specific provision of the Act, then its deductibility or otherwise depends on whether it falls within the so-called "general deduction formula" contained in section 11(a), which states that –

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 –

(a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

In order to fall within the scope of this provision, the expenditure must thus (inter alia) have been incurred "in the production of income".

The courts have ruled that this expression means that the expenditure

The court pointed out that the offending words were not spoken by him in his private capacity, but on an occasion when he was discharging his official duties as premier.

must have been incurred by the taxpayer for the purpose of producing income, and that it must have been closely linked to his income-producing trade or business.

Where a person is sued for damages, and defends the claim but does not put in a counter-claim of his own, the legal costs that he incurs cannot of course "produce income", because, even if he is successful in court, the litigation will not result in an inflow of money into his hands.

A special statutory deduction for legal expenses

In recognition of the fact that the criteria for deductibility in section 11(a) are, for the reason just given, too narrow to be appropriate for legal expenses, the deductibility of legal expenses is now specifically provided for in section 11(c) of the Income Tax Act which creates a tax deduction for –

any legal expenses … actually incurred by the taxpayer …in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade: Provided that the amount to be allowed under this paragraph in respect of any such expenses shall be limited to so much thereof as—

i) is not of a capital nature; and

ii) is not incurred in respect of any claim made against the taxpayer for the payment of damages or compensation if by reason of the nature of the claim or the circumstances any payment which is or might be made in satisfaction or settlement of the claim does not or would not rank for deduction from his income under paragraph (a) …

An important aspect of this statutory deduction is that, in contrast to the general deduction formula contained in section 11(a), quoted above, the language of section 11(c) does not require that the legal expenses be incurred "in the production of income".

Instead, section 11(c) requires only that the claim or dispute that was the subject of the litigation was one–

arising in the course of or by reason of the ordinary operations undertaken by [the taxpayer] in the carrying on of his trade.

This is a wide and generous criterion for deductibility, and far more easily satisfied than having to prove that the expenses were incurred "in the production of income".

However, section 11(c)(ii), quoted above, is explicit that legal expenses are not deductible where they are incurred in respect of a claim for damages where those damages, when paid by the taxpayer, would not qualify as a tax deduction in terms of the general deduction formula in section 11(a).

In other words, the tax-deductibility of the damages and the deductibility of the associated legal costs of the litigation stand or fall together.

The application of these provisions to the particular case

The legal expenses incurred by the premier of the province in defending the defamation action brought against him were therefore deductible, in terms of the above criteria, if the claim against him arose –

in the course of or by reason of the ordinary operations undertaken by [the premier] in the carrying on of his trade

The first question was therefore – was the premier (who is of course, a salaried civil servant, and not a "trader" in the usual sense of the word) engaged in a "trade" for purposes of the Income Tax Act?

The court found no difficulty in answering this question in the affirmative, for the Income Tax Act defines a trade as –

every profession, trade, business, employment, calling, occupation or venture.

The second question was – did the defamation claim against the premier arise –

in the course of or by reason of the ordinary operations undertaken by [the premier] in the carrying on of his trade.

The answer to this depended on the way in which the question was framed.

If the operative question was whether it was part of the "ordinary operations" of the premier, in carrying out the duties of his office, to make defamatory statements, then the answer would clearly have been negative.

However, the court did not regard this as being the way in which the question ought to be expressed.

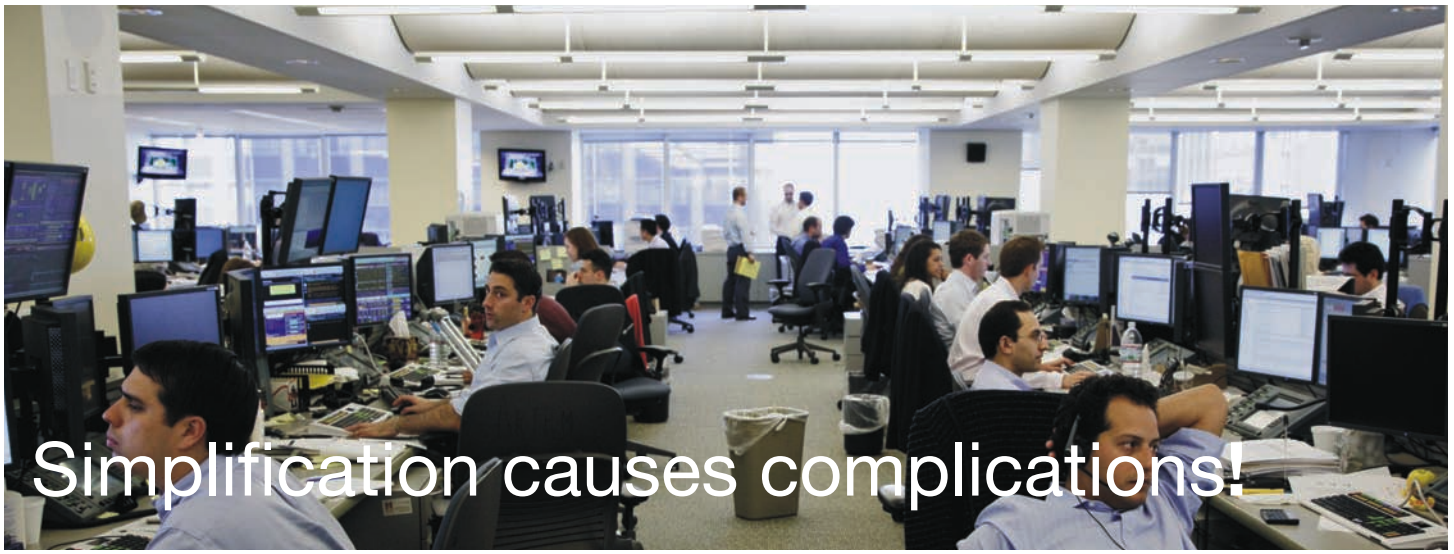
The court pointed out that the defamatory statement in question was made in the course of an official press conference given by the premier. The offending words were therefore not spoken by him in his private capacity, but on an occasion when he was discharging his official duties as premier.

In this sense, therefore, the defamation arose "in the course of the ordinary operations" of the premier's duties.

Moreover, said the court, politicians are often required to take a stance on issues of public concern and the possibility of defamatory statements being made was therefore –

an inherent risk associated with that situation.

The court pointed out that the premier had testified that, although in hindsight he should have chosen his words more carefully, he was put in a position of having to answer a question, without forewarning, and in a situation where he was required to give an immediate answer with no time for reflection.



Simplification causes complications!

Lawmakers frequently attempt to simplify laws, in an effort to smooth administration and aid taxpayers in compliance. This is a welcome sentiment in fiscal legislation which, to say the least, can be extremely complex. However, simplification may result in unwelcome, and perhaps unintended, hardship.

CFC rules

For South African companies with foreign subsidiaries, a body of law has built up over the past 10 years, governing the taxation in South Africa of income derived by these subsidiaries, in terms of which the income of a subsidiary may, in appropriate circumstances, be attributed to the SA parent, by way of imputation. These are the controlled foreign company provisions (CFC rules).

Where the proportional share of the income of a CFC is imputed in the income of a SA shareholder, the shareholder becomes entitled to claim a rebate from South African normal tax in respect of the foreign taxes incurred on such imputed income, subject to the limitation that the rebate may not exceed the attributable South African tax on the imputed income. This rebate is determined on a pooled basis, wherein the foreign imputed income from all jurisdictions and the foreign taxes from all jurisdictions are pooled, and a single rebate is determined. This system (referred to in technical terms as "onshore mixing") was preferred to a territorial system in terms of which the income and taxes from each foreign jurisdiction would be the subject of a separate calculation, each with its own limitation.

Onshore mixing of income and tax for the purpose of determining the rebate had certain advantages for residents who were required to impute income from a variety of jurisdictions with differing tax rates. In effect, it treated all of the imputed income as if it had been subjected to the weighted average of the foreign rates of tax. Hence, taxes paid in high tax jurisdictions that might have been limited on a per territory basis could be used in part to provide shelter for tax on imputed income from low tax jurisdictions.

A secondary relief was then permitted to the shareholder upon receipt of a dividend from a CFC whose income had been imputed. The dividend enjoys exemption to the extent that it does not exceed the amounts previously imputed less the taxes incurred thereon.

The court concluded that, on the basis of the evidence laid before it, the fact that the premier –

inadvertently made statements that might later be construed as defamatory constituted a risk inseparable from or necessarily incidental to the discharge of his duties as premier.

Statutory criteria fulfilled

Thus, the court ruled that, properly interpreted, the criterion laid down in section 11(c) in terms of which legal expenses are deductible if incurred "in the course of the ordinary operations undertaken by the taxpayer in the carrying on of his trade" means legal expenses that are the result of an event that is an inherent risk of the particular taxpayer's occupation – in this case, the inherent risk for a provincial premier of making defamatory statements when making an impromptu statement at a press conference.

The statutory criteria for the deduction of legal expenses as laid down in section 11(c) were therefore fulfilled, and the legal costs incurred by the premier in unsuccessfully defending the defamation action brought against him were held to be tax-deductible.

Perhaps simplification and the concessions can live side by side, for instance if taxpayers have the right to elect for high tax treatment in terms of the amendment.

Tertiary relief is found in the capital gains tax provisions in the Eighth Schedule to the Income Tax Act, whereby the imputed income is added to base cost and reduced by the dividends received, so that, on disposal of the shares, the shareholder will not incur capital gains tax on profits that have already been included in income (by imputation) and would have been exempt had they been distributed as a dividend.

Taxpayers who held significant interests in foreign investments (more than 10% but less than 20%) could elect that the foreign company be deemed to be a CFC, and, as a result, enjoy the treatment set out above. This concession recognised that high taxed income in the investee would in effect be taxed again when a dividend was received, because the shareholder could not avail of the exemption that is allowed to persons who hold 20% of the equity in a foreign investee.

With the stroke of a pen, the legislature has upset these arrangements

An amendment to the CFC rules enacted in the 2009 Taxation Laws Amendment Act, backdated to years of assessment commencing on or after 1 January 2008, provides that, where the foreign tax paid or payable by a CFC is not less than 75% of the South African tax that would have been payable by the CFC if it had been taxed as a South African resident, the net income of the CFC (the amount that forms the basis for proportional imputation to a shareholder) is deemed to be zero.

It would seem that the amendment would not prohibit onshore mixing of foreign taxes for rebate purposes, there being a technical argument that net income, being the result of income less deductions, is an amount, even if it is deemed to be zero. The possibility therefore exists that a greater amount of foreign tax may be available as a rebate in respect of tax on the income from low tax jurisdictions whose effective tax rate is less than 75% of the comparable South African tax. However the application of onshore mixing in these circumstances is far from clear.

Further, it is clear that the secondary and tertiary relief, namely the exemption of foreign dividends and the base cost supplementation that previously applied to imputed income from CFCs will not be available in relation to the dividends obtained from high tax CFCs whose net income has been deemed to be zero.

Similarly, shareholders holding between 10% and 20% of the equity in a foreign company that incurs high foreign taxes will not be able to avail of the relief that the election of CFC treatment was intended to give them.

At this early stage, it is not possible to divine whether the amendments were intended to have such far-reaching consequences, and it is to be hoped that the intention was to simplify the compliance burden of taxpayers without removing carefully crafted concessions that had been developed over the span of ten years.

Perhaps simplification and the concessions can live side by side, for instance if taxpayers have the right to elect for high tax treatment in terms of the amendment. The alternative would be to place exceptions in the secondary and tertiary relief provisions, which might prove considerably more complex.

Giving away more than you bargained for

The deduction of input tax by associations not for gain was recently considered by the Tax Court in Case No. VAT 711. The judgment, which was delivered on 14 August 2009, has created quite a stir as to whether input tax may be deducted when businesses distribute goods or services, including gifts and samples, free of charge.

The facts

The appellant was KCM, an interdenominational Christian ministry with its sole objective being to promote, minister and spread the Word of God. Its headquarters are in the USA and it has established branches in several countries, including South Africa.

KCM's teachings and messages are spread by the use of television presentations, radio broadcasts, conventions, books, CDs, DVDs, videos, tapes, magazines, the internet and personal correspondence. In South Africa, KCM prints a magazine, 'The Believer's Voice of Victory', which it distributes free of charge. KCM also operates a bookshop where it sells books, CDs, DVDs and other religious material. However, the profits generated from these sales contributed to no more than 15 per cent of its total income. The major source of its income consisted of voluntary donations received.

KCM claimed the VAT incurred by it for purposes of printing and distributing the magazine as input tax. SARS raised an assessment to disallow input tax credits claimed by KCM relating to – what SARS called – 'non-taxable supplies', being the religious magazine distributed free of charge.

The judgment

The Johannesburg Tax Court held that the concept of 'consideration' is fundamental to an enterprise and that a gratuitous act, therefore, cannot constitute a supply of goods or services for a consideration. It was held that the supplies of the magazines, 'having been made by the appellant not for consideration, but for distribution free of charge accordingly do not qualify as taxable supplies and must therefore be regarded as non-taxable supplies".

The VAT Act provides that where a supply is made for no consideration, the value of the supply is deemed to be nil. KCM argued that this provision does not say that a supply made for no consideration is not a taxable supply and that input tax can be claimed even in the absence of consideration. However, the Tax Court disagreed and held that KCM's appeal must fail.

The implications of the judgment

A Tax Court judgment merely has persuasive value, as it is binding only on the parties involved. Nevertheless, the judgment has created concern amongst VAT practitioners as many VAT vendors would be at risk if the judgment represents the approach which will in future be followed by SARS and the courts.

While the judgment relates to a non-profit organisation, the impact of the judgment could be much wider. Since the input tax requirements of the VAT Act do not distinguish between non-profit organisations (other than welfare organisations, which may generally deduct all VAT incurred as input tax) and commercial businesses, the effect of the judgment is also that commercial businesses handing out gifts or free samples, or rendering services for free, are not entitled to deduct VAT relating to those free supplies as input tax.

Such a result would, however, conflict with the practice which has applied since the introduction of VAT. In fact, SARS previously issued rulings confirming that VAT vendors may deduct input tax in respect of gifts and samples (unless the input tax denial relating to entertainment applies).

Requirements for claiming input tax

When determining whether VAT incurred by a VAT vendor on the acquisition of goods or services may be deducted as input tax, the only question is whether (and, to what extent) the goods or services have been acquired for the purpose of consumption, use or supply in the course or furtherance of making taxable supplies. A 'taxable supply' is a supply by a VAT vendor of goods or services made in the course or furtherance of an enterprise carried on by the VAT vendor. An 'enterprise' is an activity carried on continuously or regularly, wholly or partly in South Africa, in the course or furtherance of which goods or services are supplied for a consideration, whether or not for profit.

Therefore, the first test is whether a person carries on an 'enterprise'. Assuming all other requirements are met, it is evident that a business which generally sells goods or renders services for a consideration will be carrying on an 'enterprise'. It is thus not required that all supplies must be made for a consideration for the activity to constitute an 'enterprise'. (This is, of course, quite logical, otherwise very few businesses would have been regarded as carrying on VAT enterprises, as the distribution of gifts, samples and other free goods or services is often the rule rather than the exception.)

Having established that the business carries on a VAT enterprise, the second test is whether a specific supply of goods or services will be made 'in the course or furtherance' of that enterprise. If the answer is 'yes', the supply will be a taxable supply and VAT incurred to make such a supply qualifies as input tax. But if the answer is 'no' the supply is not a taxable supply and VAT incurred to make the supply cannot be deducted as input tax.

Thus, whether or not that specific supply is made for a consideration, is not an issue when determining whether input tax may be claimed. Instead, the crucial question is whether an 'enterprise' is carried on and whether the specific supply is made in the course or furtherance of that enterprise.

Accordingly, it is largely a factual question whether a vendor carries on a VAT enterprise and whether a supply is made in the course or furtherance of that VAT enterprise. Unfortunately, the Tax Court did not deal comprehensively with the facts of the case in the judgment, as it was stated that the appeal 'fails to be decided by reference to and interpretation of the relevant provisions of the VAT Act'. It is thus not possible to form a view, on a mere reading of the judgment, as to whether input tax should have been allowed or not.

Has a binding private ruling (BPR 053)cleared the confusion?

The confusion created by the judgment may have been clarified to some extent (whether intentionally or not) by the issuance of BPR 053 by SARS on 16 October 2009.The facts are that Vendor A pays for the construction of certain buildings, which will subsequently be donated to B (not a VAT vendor). B will merely acknowledge the receipt of the donation in its financial statements and annual report and by prominently displaying a sign at the entrance to each building and by allowing A to display a permanent plaque on each building.

SARS ruled that B does not have to account for output VAT on the receipt of the donation; A does not have to account for output tax, as it will supply the buildings for no consideration; and A will be entitled to claim the VAT incurred on the construction costs of the buildings as input tax.

This BPR is welcomed, as it reconfirms SARS' established approach to the claiming of input tax, where goods or services are distributed free of charge under taxable supplies.

Summary

The judgment in Case No VAT 711 has created a risk that input tax may not be deductible where goods or services are supplied by a VAT vendor for no consideration. However, the view is held, on an analysis of the relevant provisions of the VAT Act, that:

- VAT vendors giving away promotional products may claim VAT incurred in acquiring or producing these products as input tax;
- Associations not for gain (other than welfare organisations, which may generally claim all VAT incurred as input tax), may claim input tax if the free-of-charge distributions take place in the course or furtherance of a VAT enterprise;
- VAT vendors expending VAT on social responsibility activities (e.g. building a school and donating it) will be entitled to input tax deductions, provided the goods or services are supplied in the course or furtherance of the VAT enterprise (see BPR 053).

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