Synopsis

Tax today

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A monthly journal, published by PwC South Africa, that gives informed commentary on current developments in the tax arena, both locally and internationally.

Through analysis of and comment on new laws and judicial decisions of interest, Synopsis helps executives to identify developments and trends in tax law and revenue practice that may affect their business.

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Doubtful debt allowance on lease receivables – does it fail the simplicity test?

In his Wealth of Nations (1776), Adam Smith proposed that in order for a tax system to be fair and efficient, it should be equitable, efficient, certain and convenient. Underpinning these four canons is the notion of simplicity, which is necessary to facilitate at least three of the canons. Simple tax laws are easy and cost-effective to administer and are therefore efficient. Simple tax laws are clear and unambiguous, and therefore facilitate a determination of tax liability with reasonable certainty. And simple tax laws enable tax collections with minimal effort on the part of the administrator, with minimal disruption to the taxpayer.

Tax legislation is, however, inherently complex – largely as a result of the complexity of the commercial environment in which it operates. Thankfully, though, there are instances in which policy (and legislative design) have been formulated to ensure simplicity.

A case in point is section 24JB of the Income Tax Act, 1962 ('the Act'), which deals with the taxation of certain financial instruments of 'covered persons' (i.e. generally banks). Section 24JB was introduced to allow such covered persons to simplify the process of determining their tax liabilities (and compliance obligations) in relation to financial instruments, which are generally taxed on a 'mark-to-market' basis that is regulated by extremely complicated provisions of the Act, including sections 24J and 22. As stated in the 2013 Explanatory Memorandum on the introduction of section 24JB:

> '**In order to simplify compliance and enforcement**, certain companies and trusts that operate under IFRS will be required to determine their income for tax purposes in respect of certain financial instruments in accordance with financial reporting required by IFRS.' (our emphasis)

Has the simplicity test always been applied when tax legislations or amendments thereto are enacted? We explore the simplicity test in the context of the recent amendment to the doubtful debt allowance regime which, among other things, expanded the scope of the allowance to include impairment ('expected credit loss (ECL) provision') relating to lease receivables. We also share some insight for taxpayers in the leasing business on the practicality of claiming any doubtful debt allowance on lease receivables.

As mentioned in the June edition of our Synopsis, although from a tax perspective an ECL provision relating to loans and receivables is generally not deductible, paragraphs *(j)* and *(jA)* of section 11 of the Act mention special deductions which entitle a taxpayer to claim the deduction of certain allowances calculated with reference to such ECL provision ('the doubtful debt allowances').

When paragraph *(jA)* was introduced in 2018 and paragraph *(j)* was amended in 2019, ECL provisions relating to lease receivables were specifically excluded from the scope of the doubtful debt allowance. This meant that ECL provisions relating to lease receivables did not qualify for the doubtful debt allowance. The reason for the exclusion is that ECL provisions calculated in terms of IFRS 9 for lease receivables include both accrued and future lease receivables.

In this regard, an anomaly resulted where taxpayers that have accrued lease payments that are in arrears are unable to claim doubtful debt allowances on these in terms of paragraphs 11*(j)* and 11*(jA)*, even though these amounts would qualify for a deduction upon becoming bad (currently, this is a qualifying criterium for claiming a doubtful debt allowance under both paragraphs). In order to address this anomaly, the Taxation Laws Amendment Act, 2020 (Act No. 23 of 2020) amended paragraphs *(j)* and *(jA)* to allow taxpayers that are applying IFRS 9 to claim a doubtful debt allowance on an ECL provision in respect of lease receivables that have been included in income. Specifically, the wording insofar as it is relevant to this article states 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—if IFRS 9 is applied to that debt by that person for financial reporting purposes, **other than in respect of lease receivables as defined in IFRS 9 that have not been included in income**, the sum of…' (our emphasis)

The question that immediately arises is whether ECL provisions as contemplated in IFRS 9 are split between those relating to lease receivables included in income and those relating to lease receivables not included in income?

To answer this question, it is appropriate to highlight the accounting considerations for the measurement and disclosure of the ECL provision relating to lease receivables.

Accounting considerations: Measurement and disclosure of ECL provision relating to lease receivables

Under IFRS 16 – *Leases*, lessors account for leases as either operating or finance leases, depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee.

Recognition of the underlying leased asset

Operating lease: The lessor continues to recognise the underlying leased asset as in the balance sheet (i.e. statement of financial position).

Finance lease: The lessor is required to derecognise the underlying asset and record a receivable equal to the net investment in the lease in the balance sheet, with a gain or loss on sale.

Recognition of income

With regard to the recognition of income, it is worth briefly mentioning the income tax treatment to contrast it with the accounting treatment, as follows.

Operating lease: For accounting, lease income is recognised on a straight-line basis over the lease term, while for tax it is the lessor's unconditional entitlement to the lease payment in terms of the underlying lease agreement.

Finance lease: For accounting, the lessor recognises assets sold under a finance lease as finance lease receivables. Income on finance receivables arises from interest earned (finance charges) on the outstanding lease receivable balances. For tax, it is not the interest that constitutes income but rather the unconditional entitlement to the instalment payments per the lease agreement.

Recognition of ECL provision

Operating lease: The lessor will recognise a debtor in respect of any outstanding lease receivable. IFRS 9 – *Financial Instruments* requires a 12-month ECL provision to be recognised in respect of leases receivable, unless the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime ECL provision. In the event of a significant increase in credit risk, the 12-month ECL provision will move to a lifetime ECL provision. As a general proposition, the ECL provision recognised in this instance will relate to leases receivable which have already accrued to the lessor. In that instance, there should be no ECL provision relating to future leases receivable. This should, however, be distinguished from an ECL provision on leases receivable that result from applying the straight-lining principles of IFRS 16.

Finance lease: The lessor will recognise a lease receivable (net investment in the lease) which is assessed for impairment in terms of IFRS 9. The net investment in the lease is subject to derecognition and impairment requirements set out in IFRS 9 (this is described in IFRS 16.77). Upon recognition, IFRS 9 requires a 12-month ECL provision to be recognised, unless the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime ECL. In the event of a significant increase in credit risk, finance lease receivables move from stage 1 to stage 2 impairment risk. When this occurs, IFRS 9 requires the ECL provision to be increased to a lifetime ECL provision.

Disclosure of finance and operating lease receivables

ECL provisions on lease receivables (either finance lease or operating lease) follow the IFRS 9 impairment process and are therefore included in the Stage 1, 2 and 3 ECL provisions disclosure. The ECL provision is offset against the lease receivable asset in the balance sheet. This means that a net asset is presented in the balance sheet comprising the gross lease receivable minus the ECL provision.

There is no particular requirement upon recognition of the ECL provision in the instance of a finance lease receivable for it to be split between lease receivables already accrued to the lessor (i.e. included income) and those relating to lease receivables yet to accrue (i.e. future lease receivables not included in income).

Income tax considerations

On the basis that there is no requirement for the ECL provision to be split between lease receivables accrued to the lessor and those which are yet to accrue, the question arises how qualifying taxpayers will take advantage of the amendment to paragraphs *(j)* and *(jA)* of section 11 of the Act when the required data is not readily disclosed in the accounting records.

For operating leases, this should ideally not be of much concern, as it is ordinarily expected that the majority of the ECL provision would relate to lease receivables that the lessor has become unconditionally entitled to. That said, taxpayers would be required to ensure that this is indeed the case, especially if the entity has significant lease receivables resulting from applying the straight-lining principles under IFRS 16.

Turning to finance leases, this would be of particular concern as the ECL provision is recognised on both lease receivables that the lessor has become unconditionally entitled to and future lease receivables that the lessor has yet to become unconditionally entitled to.

Credit lending institutions like the banks, vehicle asset finance companies etc. would have ECL provisions relating to finance lease receivables recognised in their financial records. Depending on the quality and granularity of the ECL provision data, taxpayers with in-house quants teams (actuaries) can split the ECL provision between those relating to lease receivables included in income (for tax purposes) and those that are not – this will obviously not be efficient, as additional time will be required. On the other hand, taxpayers without an in-house quants team would have to engage the services of specialists who can assist with performing this split – this would obviously come at a price, which defeats the simplicity test.

The takeaway

With regard to the ECL provision relating to finance lease receivables, it appears that the amendments failed the simplicity test, as taxpayers may have to incur additional costs in order to split ECL provisions on lease receivables between those relating to lease receivables included in income and those relating to future lease receivables not included income.

What is of concern is that in terms of section 102(1)(b) of the Tax Administration Act No. 28 of 2011, a taxpayer bears the burden of proving that an amount or item is deductible or may be set off. Therefore, taxpayers would have to keep the relevant documentation in support of this split for purposes of calculating the allowance, as this information is not disclosed in the annual financial statements which are submitted together with the underlying income tax return. This begs the question of whether SARS has the in-house specialism to perform a review of the split supplied by the taxpayer? To the extent that SARS does, this will require effort on the part of SARS, which again defeats the simplicity test.

For taxpayers who require assistance with splitting the ECL provisions between the two categories or reviewing the split, our PwC Actuarial, Risk and Quants (ARQ) team often perform reviews of ECL provisions and are uniquely placed to assist them.

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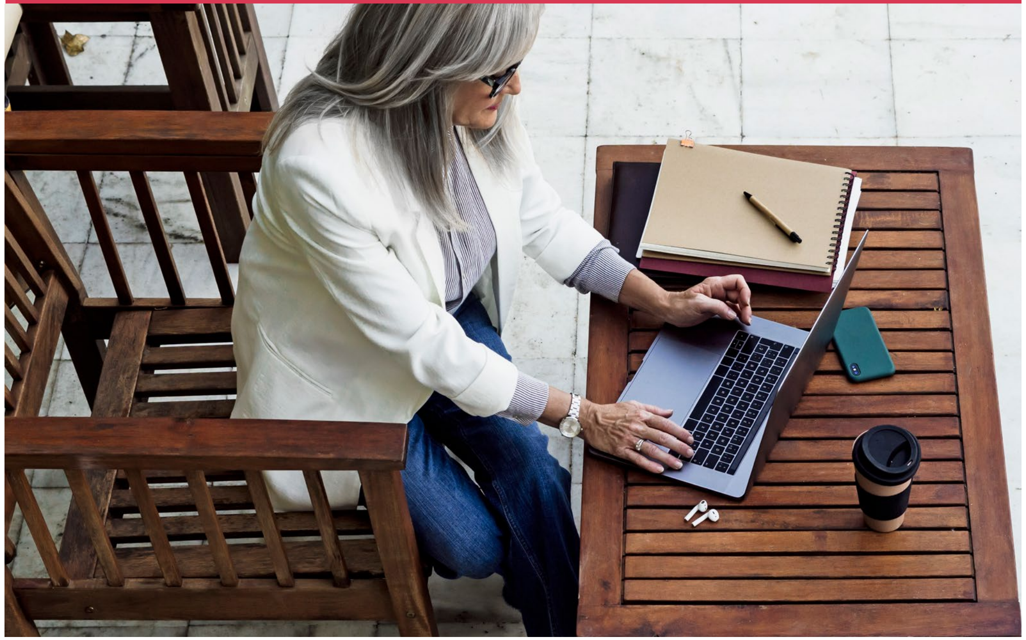
Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests

Introduction

National Treasury is concerned with the situation in which a South African resident with an interest in a South African retirement fund ceases to be a resident but retains their interest in the fund. Having ceased to be a resident, they subsequently withdraw a lump sum from the fund (either when they die or when they retire from employment), and/or receive periodic payments from the fund in the form of annuity or pension payments.

In such a situation, a question arises regarding the allocation of the taxing rights of the respective countries. Does South Africa still have the right to tax amounts payable by the fund to the (now) non-resident? To what extent?



As per section 9(2)*(i)* of the Income Tax Act, 1962 ('the Act'):

> 'An amount is received by or accrues to a person from a source within the Republic if that amount … constitutes a lump sum, a pension or an annuity payable by a pension fund, pension preservation fund, provident fund or provident preservation fund and the services in respect of which that amount is so received or accrues were rendered within the Republic ...'.

Consequently, despite the fact that the individual may have ceased to be a South African resident, lump sums, pensions and annuities payable to the individual by a South African retirement fund are still, in terms of section 9(2)*(i)*, regarded as being from a South African source (the only requirement being that the services in respect of the amount must have been rendered within South Africa).

However, on the basis that the individual is now (invariably) a resident of the other country, it is likely that country ('the country of residence') will seek to tax the individual on amounts paid to that individual on the basis of their residence in that country.

In this situation, the relevant provisions of an applicable double tax treaty ('DTT') between South Africa and the country of residence need to be considered.

The OECD Model Tax Convention, 2017 ('the MTC')

The relevant provision in the MTC is Article 18 (Pensions). Insofar as is relevant, that Article provides as follows:

> ' … pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.'

Where the applicable DTT contains an article that is modelled on the MTC, South Africa will lose its taxing rights in respect of lump sums, pensions and annuities (referred to from here on as 'pension benefits') paid by South African retirement funds to non-resident individuals, despite the fact that such pension benefits are paid in respect of services that were rendered in South Africa by the individual while the individual was a resident of South Africa.

In this context, it is not difficult to understand the discomfort of the South African government, especially in light of the current emigration of South African residents in their numbers, many of whom have substantial retirement savings that have been built up in South Africa over many years. It is also important to bear in mind that, in building up these retirement savings, the individual would have benefitted from deductions of the amounts contributed to the retirement fund and investment income would have accrued tax free in the fund in line with the general policy relating to the taxation of retirement savings.

Government's proposal

In this year's Budget, it was announced that the above 'anomaly' would be addressed unilaterally by way of amendments to the Income Tax Act. In this regard, the Budget Review set out a proposal along the following lines:

- On the day before an individual ceases to be a South African resident, the individual will be deemed to have withdrawn from all South African retirement funds in which the individual holds a retirement interest. At the point of deemed withdrawal, the amount of the retirement interest in each fund will be determined and will be subject to South African income tax ('retirement withdrawal tax') as a retirement fund lump sum benefit or retirement fund lump sum withdrawal benefit.
- Should the individual elect not to make an actual withdrawal from a retirement fund (and only make an actual withdrawal when they die or retire from employment), the individual's liability to make payment of the retirement withdrawal tax (including 'associated interest') will be deferred until the retirement fund makes payment of any amount to the individual (or to the individual's estate in the event of the death of the individual) ('the date of payment').
- On the date of payment, the tax payable by the individual will be calculated based on the prevailing lump sum tables (in the case of the payment of a lump sum) or at the prevailing income tax rate applicable (in the case of an annuity). To the extent that there is a difference between the liability for the retirement withdrawal tax as determined on the deemed date of withdrawal and the date of payment, a tax credit mechanism will be used to compensate for this difference.

Following the above announcement in the Budget Review, the draft Taxation Laws Amendment Bill, 2021 ('the DTLAB'), was released for public comment on 28 July. The DTLAB proposes the insertion of a new section 9HC, which broadly gives effect to the above proposal, into the Act.

Some initial concerns with the proposal

On the whole, South Africa's DTTs with other countries generally follow the OECD MTC approach in respect of the tax treatment of pension benefits paid by South African retirement funds to non-resident individuals.

Contrary to the statement in the Budget Review (as well as in the Explanatory Memorandum to the DTLAB) to the effect that this treatment is an 'anomaly', there are valid and cogent reasons for this approach, many of which are explained in the Commentary on the OECD MTC ('the Commentary').

Policy and administrative considerations

As stated in the Commentary, various policy and administrative considerations support the principle that the state of residence should have exclusive taxing rights.

The state of residence is in a better position to take into account the recipient's overall ability to pay tax. In addition, giving the state of residence the exclusive right to tax pension benefits avoids imposing on the recipient the administrative burden of having to comply with tax obligations in States other than the recipient's State of residence.

While, as stated above, it is not difficult to appreciate government's discomfort with the existing treatment of pension benefits in light of the current wave of emigration from South Africa, the proposal seems to ignore the above policy and administrative considerations.

DTTs are negotiated in light of the context of the regulatory and tax regimes of the contracting states

Aside from the recent slowdown in this regard as a result of the COVID-19 pandemic, the international mobility of individuals has increased substantially in the past few decades.

Pension regimes have, however, been primarily designed on the basis of purely domestic policy considerations. As pointed out in the Commentary, treaties are therefore extremely important to assist in removing obstacles to the international movement of persons (and especially employees) by ensuring that the domestic regimes of the respective countries can 'talk to each other' and eliminate the potential for double taxation (or double non-taxation) arising from differences and mismatches between the tax and regulatory regimes of the contracting states.

In this regard, it is important to remember that, where two contracting states are party to the negotiation of a DTT between them, they must (of necessity) have taken cognisance of the differences and mismatches between their respective regulatory and tax regimes. The knowledge of these differences and mismatches will have informed the negotiations, as well as the particular treatment of pension benefits in terms of the treaty.

The effect of the proposal, if it is adopted, would be to override the negotiated terms of existing DTTs between South Africa and other countries, terms that were negotiated in light of the respective tax and regulatory regimes of the contracting states. This could have a significant adverse impact: by effectively undoing these negotiated terms, the certainty afforded by existing DTTs could be removed, and the potential for double taxation again arises. In this regard, it is interesting to note that the Netherlands introduced a similar 'exit tax' for pensions which was ultimately ruled by the Netherlands Supreme Court to be in contravention of DTTs formulated in accordance with the MTC.

Conclusion

The above are just some of the potential issues and concerns with the proposal. It can be expected that this controversial matter will be the subject of much deliberation and debate as the legislative process unfolds.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SARS Watch

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Legislation		
30 July 2021	Amendment to rules under sections 59A and 76 to facilitate the implementation of export duty on scrap metal (DAR220)	Notice R656 published in Government Gazette 44907 with effect from 1 August 2021.
28 July 2021	2021 Draft Tax Administration Laws Amendment Bill (TALAB)	Comments must be submitted to SARS and National Treasury by Friday, 27 August 2021.
28 July 2021	2021 Draft Memorandum on the objects of the 2020 Draft Tax Administration Laws Amendment Bill	Comments must be submitted to SARS and National Treasury by Friday, 27 August 2021.
28 July 2021	2021 Draft Taxation Laws Amendment Bill (TLAB)	Comments must be submitted to SARS and National Treasury by Friday, 27 August 2021.
28 July 2021	2021 Draft Explanatory Memorandum on the 2020 Draft Taxation Laws Amendment Bill	Comments must be submitted to SARS and National Treasury by Friday, 27 August 2021.
28 July 2021	Draft Explanatory Notes on Emergency Tax Measures in response to the continuing Covid-19 pandemic and recent unrest in the country	Comments must be submitted to National Treasury by Friday, 27 August 2021.
28 July 2021	Tax Administration Act, 2011: Draft revised public notice in terms of section 210(2), relating to incidences of non-compliance by individuals to file returns that are subject to a fixed-amount penalty in accordance with section 210(1)	Comments must be submitted to SARS by Tuesday, 11 August 2021.
23 July 2021l	Customs & Excise Act, 1964: Amendment rules to section 18 to provide for a process for obtaining permission for the interruption of transit through the Republic for purposes of carrying out activities contemplated in section 18(13)(b)(i) (DAR218)	Notice R649 published in Government Gazette 44884 with an implementation date of 23 July 2021.
23 July 2021	Customs & Excise Act, 1964: Amendment to rules under section 60, 64E and 120 – accreditation of clients (DAR219)	Notice R648 published in Government Gazette 44884 with an implementation date of 23 July 2021.
20 July 2021	Amendments to Carbon Offset Regulations	Notice No. 595 published in Government Gazette No. 44818 with an effective date of 1 June 2019.
20 July 2021	Summary and Responses on Carbon Offset Regs Amendments	This document summarises the comments received by National Treasury on the Carbon Offset Regulations and provides responses to the issues raised by stakeholders.
9 July 2021	Customs & Excise Act, 1964: Amendment to Part 1 of Schedule No. 1, by the substitution of notes 9 and 10 in Chapter 99 in order to include the use of the consolidated tariff subheadings to be used for other rebate items that allow for duty relief on personal and household effects	Notice No. 598 published in Government Gazette No. 44820 with an effective date of 1 July 2021.
9 July 2021	Customs & Excise Act, 1964: Amendment to Part 1 of Schedule No. 2, by the deletion of anti-dumping items 204.05/2004.10.2/01.07; 204.05/2004.10.2/02.07; 204.05/2004.10.2/03.07; 204.05/2004.10.2/04.07; 204.05/2004.10.2/05.07; and 204.05/2004.10.2/06.07 in order to terminate the anti-dumping duties on frozen potato chips originating in or imported from Belgium and the Netherlands – ITAC Report 657	Notice No. 597 published in Government Gazette No. 44820 with retrospective effect from 26 January 2021.
9 July 2021	Customs & Excise Act, 1964: Amendment to Part 6 of Schedule No. 1, by the removal of the Statistical unit column to ensure that there is no duplication of the statistical unit in Part 6 of Schedule No. 1, as the statistical unit in Part 1 of Schedule No. 1 will be utilised for declaration processing	Notice No. 596 published in Government Gazette No. 44820 with effect from 1 August 2021.
3 July 2021	Customs & Excise Act, 1964: Amendment to rules under sections 59A, 60 and 120 – Electronic submission of applications for registration and licensing (DAR217)	Notice R572 published in Government Gazette No. 44798 with retrospective effect from 25 June 2021.

2 July 2021	Draft Excise Forms: Automotive Production and Development Programme (APDP)	Comments must be submitted to SARS by Friday, 23 July 2021.
2 July 2021	Customs & Excise Act, 1964: Amendment to Part 1 of Schedule No. 1, by the substitution of tariff subheadings 1001.91 and 1001.99 as well as 1101.00.10, 1101.00.20, 1101.00.30 and 1101.00.90, to reduce the rate of customs duty on wheat and wheaten flour from 19,17c/kg and 28,76c/kg to free of duty respectively, in terms of the existing variable tariff formula – Minute M02/2021	Tariff amendment notice R570 published in Government Gazette No. 44792 with a date of implementation of 2 July 2021.
Interpretation Note		
28 July 2021	IN 20 (Issue 8) – Additional Deduction Learnership Allowance	This Note provides clarity on the interpretation and application of section 12H, which provides deductions for registered learnership agreements and deals with learnership agreements entered into from 1 October 2016.
28 July 2021	IN 86 (Issue 2) – Additional Investment and Training Allowances for Industrial Policy Projects	This Note provides guidance on the interpretation and application of section 12I, which provides for the deduction of additional investment and training allowances from the income of a company carrying on an 'industrial project' which qualifies as an 'industrial policy project'.
Rulings		
6 July 2021	BPR 367 – Employment tax incentive	This ruling determines that students in the proposed training programme are not 'employees' as contemplated in the ETI Act and that the applicant will not be entitled to claim an employment tax incentive in respect of any of them.
Guides		
28 July 2021	Guide on Valuation of Assets for Capital Gains Tax Purposes (Issue 5)	This guide provides general guidance on determining the market value of assets for capital gains tax purposes.
28 July 2021	Guide to the Urban Development Zone Allowance (Issue 8)	This guide is a general guide about the urban development zone allowance provided for in section 13quat of the Income Tax Act 58 of 1962.
28 July 2021	VAT Quick Reference Guide for Non-executive Directors	This quick reference guide provides information and guidelines regarding the VAT treatment of non-executive directors (NEDs) and should be read in conjunction with Binding General Ruling (BGR) 40 'Remuneration Paid to Non-Executive Directors' and BGR 41 (Issue 2) 'VAT Treatment of Non-Executive Directors'.
9 July 2021	Guide to the SARS MobiApp	The guide has been updated to include the new Lwazi Chat Bot services.
9 July 2021	Guide to the Tax Compliance Status functionality on eFiling	The guide now includes the updated Pin information for Foreign Investment Allowance and Emigration.
7 July 2021	How to submit a Dispute via eFiling	This guide has been updated with PAYE administrative penalty information.
1 July 2021	ABC of Capital Gains Tax for Individuals (Issue 12)	This guide provides a simple introduction to capital gains tax (CGT) at its most basic level and contains insufficient detail to accurately determine CGT in most practical situations. It should accordingly not be used as a legal reference. It applies to the 2021 year of assessment which covers the period 1 March 2020 to 28 February 2021.
1 July 2021	ABC of Capital Gains Tax for Companies (Issue 10)	This guide provides a basic introduction to capital gains tax for companies as defined in section 1(1) of the Income Tax Act 58 of 1962.
Other Publications		
29 July 2021	OECD Corporate Tax Statistics: Third Edition	The data, released in the OECD's annual Corporate Tax Statistics publication, shows the importance of corporate tax as a source of government revenues, while also pointing to evidence of continuing base erosion and profit-shifting behaviours.
26 July 2021	OECD: Making Dispute Resolution More Effective – MAP Peer Review Report, South Africa (Stage 2)	This report reflects the outcome of the stage 2 peer monitoring of the implementation of the Action 14 Minimum Standard by South Africa.
26 July 2021	Tax Alert – Carbon Tax: looming deadline for Filing	The Alert discussed the carbon tax filing submission deadline, which ended on Thursday, 29 July 2021.
19 July 2021	OECD: Tax Administration: Towards Sustainable Remote Working in a Post-COVID-19 Environment	This note explores some of the key issues that tax administrations may wish to consider in designing remote working policies, processes and guidance to help ensure that longer-term remote working is sustainable for both the tax administration as well as individual employees.