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CAPITAL GAINS TAX

2621. Reduction of proceeds

30 min CPD VERIFIABLE ARTICLE

It is a general principle of South African income tax that a taxpayer is taxed on the receipt or accrual of an amount. However, it is often necessary and equitable to take into account certain events arising subsequent to the accrual of an amount in pursuance of the disposal of an asset for capital gains tax (CGT) purposes.

One such example is where two parties who enter into a contract for the purchase and sale of an asset at a certain price, subsequently amend the terms, resulting in a variation of the proceeds received on the disposal of the subject asset, notwithstanding the fact that such amount has already accrued to the disposing party.

Logic dictates that there must be a mechanism in order to cater for such a scenario, so that the taxpayer is not subject to tax on amounts that are never actually received. Paragraph 35(3)(*c*) of the Eighth Schedule to the Income Tax Act, 1962 (the Act) attempts to provide for such a scenario. The Tax Court recently handed down an interesting judgment on this issue (Case no. 13935, 14 December 2016, as yet unreported).

Facts, issues and judgment of the Tax Court

In short, the following facts were before the court:

- on 10 August 2010, the taxpayer disposed of shares it held in D Ltd on the open market in terms of a sale agreement;
- the proceeds derived from the sale were paid in full by the relevant purchasers in the market and received by the taxpayer's stockbrokers on its behalf;
- on 7 December 2010, the money held on the taxpayer's behalf was transferred to a certain entity located in the United Arab Emirates (UAE);
- this transfer was undertaken against the taxpayer's will, in what appeared to be a misappropriation of the funds.

Under the circumstances, the taxpayer argued that paragraph 35(3)(*c*) of the Eighth Schedule to the Act should apply, with the result that the proceeds derived from the sale of the shares should be reduced by the amount allegedly embezzled. In short paragraph 35(3)(*c*) sets out certain circumstances in which proceeds may be reduced.

It provides as follows:

The proceeds from the disposal, during a year of assessment, of an asset by a person, as contemplated in subparagraph (1) must be reduced by "(– "(*c*) any reduction, as the result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event during that year, of an accrued amount forming part of the proceeds of that disposal."

The main issue before the court was the meaning and ambit of the words "or any other event" as it was common cause that there was no cancellation, termination or variation of the sale agreement nor was there prescription or the waiver of a claim or a release of an obligation.

The court first referred to a previous case, namely ITC 1880 [2016] 78 SATC 103 which also dealt with the application of paragraph 35(3)(*c*), in which Wepener J held that a narrow interpretation should be given to the words "or any other event" to denote similar categories as those expressed by the preceding words in the paragraph.

In particular, Wepener J relied upon the *eiusdem generis* rule which is sometimes expressed as the latin maxim *noscitur a sociis*, which in essence means that the meaning of a word may be ascertained by reference to those associated with it.

In other words, the all-encompassing general words take their meaning and colour from the other specific words associated or linked to it. On this approach, the court held that while "any" may indicate a broad and unlimited term, in the specific instance it was limited to two broad categories, namely the changing of terms to the sale agreement, or where a person is released from an obligation.

The court in the Case agreed with the narrow interpretation given the words "any other event" in ITC 1880 and accordingly held:

"Having regard to the context in which the words are used and their clear purpose, it is sufficient to establish that the words apply to situations where the purchaser of an asset is partially or wholly released from the obligation to pay for the asset disposed of. Ultimately, the words were not intended to apply to an embezzlement of the nature alleged in this case, for the reasons stated herein. The set–off or deduction contemplated is one which flows as a consequence of extinguishing the taxpayer's right to receive payment and the payee's obligation to pay. The relevant nexus is to the event that causes such extinguishing, not to a subsequent unrelated event caused by a person who held no obligation to pay for the asset disposed of and who acted outside the agreement to dispose of the asset. The nexus cannot be a broad and vague one between the accrual and the deduction's event, irrespective of how remotely it is connected to the failure to actually retain/receive the funds. If the legislature intended a deduction to be available for any unrelated reason that would have the consequence of a reduced payment, it would have expressed itself in words conveying that meaning."

Allie J thereafter expressed that the purpose behind paragraph 35(3)(*c*) was to provide relief in the form of a deduction from the proceeds of a disposal of an asset in certain circumscribed instances. The particular instance she had in mind was where proceeds had not been paid but had already accrued to the taxpayer, but the provision for payment of the funds was cancelled. In summation, the facts did not fall within the ambit of paragraph 35(3)(*c*) due to the fact that the funds were already received by the taxpayer and furthermore, the alleged embezzlement was committed by a party that was unrelated to the transaction for the disposal of shares.

Comment

It is clear that the courts have thus far been loath to extend the meaning of the words "any other event" as an all-encompassing phrase. Importantly, "any other event" not only envisages an event which falls within the two broad categories first introduced in *ITC 1880*, but there must also be a link or *causal nexus* between the reduction of the proceeds and the taxpayer's right to receive payment (or conversely the purchaser's obligation to make payment).

What is interesting to note is that the judgment is silent on whether the taxpayer could claim an ordinary capital loss which would have placed him in a similar tax position, notwithstanding the non-application of paragraph 35(3)(*c*). Perhaps, the hurdle in that regard was that there was in essence a loss of cash which does not fall within the meaning of "asset" in the Eighth Schedule thereby prohibiting the taxpayer from claiming a capital loss.

Having said that, Interpretation Note No. 80 issued by the South African Revenue Service (SARS) in November 2014 states as follows in respect of the potential loss of a capital nature:

"In contrast [to cash/currency], a bank account is an asset for Capital Gains Tax (CGT) purposes, being a debt claim against the bank. It follows that embezzlement, fraud or theft involving a bank account may give rise to a capital loss assuming that it does not represent a loss of floating capital allowable under s11(*a*). To the extent that the expenditure on the bank account is allowable under s11(*a*) it will result in the reduction in the base cost of the bank account under paragraph 20(3)(*a*) of the Eighth Schedule. Similarly, the expenditure on the bank account must be reduced under paragraph 20(3)(*b*) of the Eighth Schedule by any portion of that expenditure that has been recovered or has become recoverable from any other person (for example, the thief or an insurer)".

Ultimately, however, it appears the taxpayer in this Case not only paid tax on the disposal of his shares, but also suffered a loss of his after-tax profit which could not have been compensated for by allowing a reduction of proceeds or the claiming of a capital loss. Nevertheless, issues often arise subsequent to entering into transactions, which require the technical application of certain tax rules.

In particular, the cancellation of contracts may result in certain unintended consequences. The Taxation Laws Amendment Act, 2015 (TLAA 2015) introduced several new rules in respect of the cancellation of contracts in an attempt to deal with some of the anomalies arising in practice. In particular, the TLAA 2015 introduced the following:

- A new non-disposal event was introduced in the form of paragraph 11(2)(*o*) of the Eighth Schedule which applies when a sale is cancelled in the same year of assessment.
- Paragraph 20(4) was introduced in the Eighth Schedule to reinstate the base cost when the sale is cancelled in a subsequent year of assessment. In addition, to reflect actual economic value/expenses incurred post entering into the contract, the base cost of the asset reacquired will take into account any subsequent expenditure incurred by the new owner as allowed under paragraph 20 of the Eighth Schedule.
- Further additional paragraphs 3(*c*) and 4(*c*) were included in the Eighth Schedule to reverse the original capital gain or loss in the year of cancellation.

It is therefore vital to carefully consider the specific facts and circumstances in each case in order to ensure that no unintended consequences arise in the hands of taxpayers while undertaking sale transactions.

Cliffe Dekker Hofmeyr
ITA: Section 11(*a*) and paragraphs 3(*c*), 4(*c*), 11(2)(*o*), 20(3), 20(4) and 35(3)(*c*) of the Eighth Schedule
SARS Interpretation Note 80
Taxation Laws Amendment Act, 2015

EXCHANGE CONTROL

2622. Intellectual property relaxations

Introduction

In the 2017 Budget Review, the National Treasury (Treasury) proposed the relaxation of the exchange control restrictions surrounding certain intellectual property ("IP") transactions as follows:

"*Government proposes that companies and individuals no longer need the Reserve Bank's approval for standard intellectual property transactions. It is also proposed that the "loop structure" restriction for all intellectual property transactions be lifted, provided they are at arm's length and at a fair market price. Loop structure restrictions prohibit residents from holding any South African asset indirectly through a non-resident entity*."

To give effect to the above proposals, the Financial Surveillance Department of the South African Reserve Bank ("FinSurv") released Exchange Control Circulars No. 7 of 2017 and No. 8 of 2017.

Sale, transfer, assignment and licensing of IP

South African residents are currently prevented from selling, transferring or assigning IP to a non-resident without having obtained prior approval from FinSurv. Circular No. 7 of 2017 is aimed at providing relief from this rule to the following extent:

"*Authorised Dealers may, however approve the outright* ***sale, transfer*** *and* ***assignment*** *of intellectual property by South African residents, excluding mandated state-owned companies as defined in Schedule 2 of the Public Finance Management Act, 1999 (Act No. 1 of 1999), to* ***unrelated*** *non-resident parties at an* ***arm's length and a fair and market related price****, provided that Authorised Dealers view the sale, transfer or assignment agreement and the provision of an auditor's letter or intellectual property valuation certificate confirming the basis for calculating the sale price. The above-mentioned dispensation excludes sale and lease back agreements*." (Emphasis added)

This circular requires all inward funds emanating from such transactions to be repatriated to South Africa within a period of 30 days from the date of the recipient becoming entitled thereto.

This represents a significant policy shift by Treasury and FinSurv, as previously it was not easy to obtain approval to export IP.

The same circular proceeds to provide for relief in relation to the licensing of IP to non-residents, irrespective of whether or not such non-residents are related to the resident, in the following manner:

"*Authorised Dealers may approve the licensing of intellectual property by South African residents to non-resident parties at an* ***arm's length and a fair and market related price*** *for the term of the agreement, provided Authorised Dealers view the licence agreement and an auditor's letter confirming the basis for calculating the royalty or licence fee*." (Emphasis added)

The circular also requires that all royalties and/or fees emanating from such transactions must be repatriated to South Africa within a period of 30 days from the date of the licensor becoming entitled thereto.

Permissible loop structures

Unlisted technology, media, telecommunications, exploration and other research and development companies are currently allowed, with prior FinSurv approval, to obtain a primary listing offshore in order to raise foreign capital and loans for their operations. FinSurv approval in this regard will, however, be subject to the following conditions:

- The company must register with FinSurv;
- The company must be incorporated in and have its place of effective management (as the term is contemplated for tax purposes) in South Africa;

- The company’s IP must remain registered in South Africa and may be assigned offshore subject to appropriate tax treatment;

- The offshore listed entity must obtain a secondary listing in South Africa within two years after obtaining its primary listing offshore, with a report on the status of its primary listing having to be submitted to FinSurv; and

- An annual report on the operations and offshore funds raised must be submitted to the FinSurv.

Circular No. 8 of 2017 expands on the above dispensation by allowing such unlisted companies to establish offshore companies without the need to obtain a primary listing offshore. In this regard, Circular No. 8 of 2017 states that:
“*(ii) Authorised Dealers are advised that unlisted South African technology, media, telecommunications, exploration and other research and development companies may establish an offshore company to raise foreign funding for their operations, subject to the following conditions:*

a) registration with the Financial Surveillance Department;
b) the established offshore company must be a tax resident in South Africa;
c) full details of the percentage shareholding in the offshore company including the group structure must be provided; and
d) an annual report must be submitted to the Financial Surveillance Department on the operations, including details of funds raised offshore.”

Notably, the circular explicitly allows such offshore companies to create so-called “loop transactions” by holding investments in and making loans into South Africa, irrespective of any of the prohibitions on the creation of loop structures.

Conclusion

The above changes are welcomed, as they remove some of the red tape associated with international IP transactions. It should however, be noted that there are still various nuances and administrative requirements that must be adhered to in order prevent a breach of the exchange control rules. In this regard, it is advised that you contact your tax and exchange control advisor when dealing with international IP transactions.

Werksmans Attorneys
Exchange Control Circulars No. 7 and 8 of 2017
Public Finance Management Act, 1999

2623. Authorised dealers manual

The Currency and Exchanges Manual for Authorised Dealers (Authorised Dealer Manual), was published on 29 July 2016 and came into effect on 1 August 2016. It replaced the Exchange Control Rulings that had been in place up until that point. The Authorised Dealer Manual contains, amongst other things, the permissions and conditions applicable to transactions in foreign exchange that may be undertaken by Authorised Dealers (ADs) and/or on behalf of their clients in terms of Regulation 2(2) of the Exchange Control Regulations (Regulations).

The Authorised Dealer Manual must be read in conjunction with the Regulations. Following the announcement in the 2017 Budget Speech that certain requirements pertaining to exchange control would be relaxed, the South African Reserve Bank's FinSurv released Exchange Control Circulars Nos. 7 and 8/2017, in terms of which the Authorised Dealers Manual was amended to give effect to these changes.

On 19 April 2017, FinSurv released Exchange Control Circular No. 9/2017 (Circular 9/2017), in which it announced further amendments to the Authorised

Dealer Manual and other guideline documents. We discuss some of these amendments below.

Foreign bank accounts

In terms of section E.D of the Authorised Dealer Manual, Authorised Dealers (ADs) may approve requests by South African companies to open and operate foreign bank accounts, subject to certain conditions set out in section E.D(i). Circular 9/2017 points out that a new paragraph E.D(iv) has now been added to the Authorised Dealers Manual, which states that ADs may, where applicable, approve the extension of the authorities previously granted by FinSurv provided the conditions stipulated in section E.D(i) are strictly adhered to.

Licence agreements involving the local manufacture of goods

In terms of section B.3(E) of the Authorised Dealer Manual, royalties and fees payable to non-residents (related and unrelated parties) in respect of licence agreements involving the local manufacture of goods can only take place if certain criteria have been met. Previously, it was required, inter alia, that the Department of Trade and Industry (DTI) had to assess the licence agreement and forward its assessment to FinSurv for final consideration. An AD would then have to be satisfied that the payments fall within the terms of the relative agreement, and where applicable, that it complies with any conditions laid down in the authority granted by DTI and FinSurv.

Prior to effecting payments, ADs would also need to view a copy of the approval letter from FinSurv. Following the amendment to the Authorised Dealer Manual, it is now no longer a requirement for FinSurv to approve the agreement. Only the DTI needs to approve the agreement.

Miscellaneous transfers – Refunds

Prior to the amendment of the Authorised Dealer Manual, section B.14(J) of the Authorised Dealer Manual provided that Authorised Dealers (ADs) could only approve the payment of refunds, where it involved the following:

- payment by the South African Revenue Service (SARS) to non-residents;
- where a pension payment has been received from outside the Common Monetary Area (South Africa, Namibia, Lesotho and Swaziland) after the demise of a resident beneficiary; and
- where the refund was in respect of orders, tour reservations, registration fees, erroneous payments and overpayments by non-residents.

Paragraph B.14(J)(iv) has now been added and states that ADs may also approve the payment of refunds not exceeding a total value of R100,000 per calendar year due to non-residents involving related parties. However, the AD must be satisfied that the relevant transaction complies with the transfer pricing guidelines and that suitable documentary evidence is viewed in this regard.

Comment

From the perspective of businesses, the granting of additional powers to ADs and the reduced need for FinSurv approval under the circumstances referred to above, might be a positive development as it could make it easier to do business locally and abroad.

Cliffe Dekker Hofmeyr
Currency and Exchanges Manual for Authorised Dealers
Exchange Control Regulations, 1961
Exchange Control Circulars Nos. 7, 8 and 9 of 2017

FRINGE BENEFITS

2624. Free transport for employees

In many businesses, it is common for employers to provide their employees with free or low-cost transport services, from their homes to their place of employment. However, in terms of the Income Tax Act, 1962 (the Act), such arrangements could constitute a taxable fringe benefit in the hands of the employees, depending on the circumstances and facts of the case.

The South African Revenue Service (SARS) released Binding Private Ruling 262 (BPR 262) on 30 January 2017 and Binding General Ruling (Income Tax) 42 (BGR 42) on 22 March 2017, both of which deal with this very issue.

Facts of BPR 262

In BPR 262, the relevant facts were as follows:

- The Applicant, a South African resident company, proposes to implement a transport scheme (Scheme) to assist its employees to travel to and from work safely and more efficiently. The nature of the Applicant's business requires its employees to commence and end their normal working days at times when public transport is either unavailable or very limited.

- The Applicant proposes two transport service types to implement the Scheme namely, the Shuttle Service Concept (Shuttle Service) and the Direct Service Concept (Direct Service).

- The Shuttle Service entails that a shuttle service will connect each of the Applicant's business units to a public transport interchange nearest to the relevant business unit and will serve employees who work shifts during normal working hours.

- The Shuttle Service will be available where the nearest interchange is situated more than 500 metres walking distance from the business unit where the employee works and the employees will use the Shuttle Service between the transport interchange and the relevant business unit. However, the employees will make use of public transport services to travel from their homes to this nearest transport interchange.

- In terms of the Direct Service, a dedicated transport service will be provided between a specifically identified central point (collection points) in a residential area where an employee resides and the business unit where the employee works. The Direct Service will only be available to employees whose work is core to the Applicant’s operations and who work shifts that are difficult to align with existing transport services.

- The Direct Service will only be available where the nearest available public transport is situated more than 500 metres walking distance from the business unit where the employee works. Employees will be required to organise their own transport from their homes to the collection points and back.

- It should also be noted that the Applicant will fairly distribute the collection points in its discretion and design the routes in a circular format to allow maximum coverage of the particular area, taking into account its size and density.

- From a cost perspective, the Applicant will engage with independent shuttle transport service providers (Service Providers) to pick up and drop off the employees in implementing the Shuttle Service and the Direct Service.

- The Service Providers will invoice the Applicant directly, while the Applicant will bear the cost of providing the shuttle services and the employees will not be required to pay anything for these services.

SARS's Ruling in BPR 262

In light of the abovementioned facts, SARS ruled that no value will be placed on the taxable benefit to be granted to the Applicant's employees in providing them with the Direct Service and the Shuttle Service.

Analysis of BPR 262 in light of the Act and BGR 42

To determine whether the provision of a free transportation service by an employer to its employees constitutes a taxable benefit, one must consider paragraphs 2 and 10 of the Seventh Schedule to the Act (the Seventh Schedule).

Paragraph 2(*e*) of the Seventh Schedule states that a taxable benefit (i.e. a fringe benefit) is deemed to have been granted by an employer to an employee if any service has, at the expense of the employer, been rendered to the employee for his or her private or domestic purposes. In terms of South African tax law, expenses incurred in travelling between one's home and place of employment are considered to be expenses of a domestic and personal nature. To determine the cash equivalent of the value of this fringe benefit, one must apply paragraphs 10(1) and (2) of the Seventh Schedule.

Paragraph 10 of the Seventh Schedule deals with the provision of free or cheap services. In terms of paragraph 10(1)(*b*), the cash equivalent of the value to be placed on the fringe benefit, including services such as the Direct Service and the Shuttle Service, will be the employer's expense in rendering the service less any amount paid by the employee as consideration. However, paragraph 10(2)(*b*) of the Seventh Schedule states that "no value shall be placed…on any transport service rendered by an employer to his employees in general for the conveyance of such employees from their homes to the place of their employment and vice versa."

In BGR 42, SARS acknowledges that there is uncertainty as to the application of the no-value provision contained in paragraph 10(2)(*b*). In BGR 42, SARS states that the word "homes" need not be restricted to the exact position of an employee's specific dwelling as an employee could, for example, live in a block of flats, on a farm, or in a rural area with little or no accessible roads. Under certain circumstances, an employee would, therefore, be required to walk to the nearest accessible road to obtain the transport service which, could be a few kilometres away from the employee's dwelling.

In light of these circumstances, SARS states in BGR 42 that an employer may arrange for employees living within a certain radius to be collected from or dropped off at a common area or central point between the employees' homes and place of employment. An employer may also provide transport services for only part of the trip between the employees' homes and place of employment.

SARS now provides clarity on the interpretation of paragraph 10(2)(*b*) and has ruled in BGR 42 that "transport services provided to employees to and from any collection or drop-off point en route to or from the employees' homes and place of employment is accepted to fall within the provisions of paragraph 10(2)(*b*). No value will, therefore, be placed on these transport services."

The clarity provided by BGR 42 is welcomed. From a practical perspective, the fact that no value is placed on these transport services means that no tax will be payable by these employees in receiving such transport services, even though it still constitutes a fringe benefit.

Cliffe Dekker Hofmeyr
ITA: Paragraphs 2 and 10 of the Seventh Schedule

BGR 42

BPR 262

Editorial Comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear.

INDIVIDUALS

2625. Deductibility of interest expenses on home loans

Facts

Mr X, the taxpayer, is a qualified solicitor in England and Wales, currently in the employ of Y Attorneys, an incorporated firm of attorneys. Although he is not an equity partner with the law firm as he has not been admitted as an attorney in South Africa, he enjoys the same remuneration as an equity partner and therefore has to assist with on-going working capital requirements of the firm. He does this by maintaining a credit balance on his loan account (Firm Loan Account) for which he is then remunerated by his employer at the prime rate of interest.

The amount that must be kept in the Firm Loan Account is deducted proportionately from the taxpayer's monthly remuneration, meaning that the source of the funds paid towards the Firm Loan Account is his remuneration.

The interest on the Firm Loan Account accrues to him and therefore constitutes taxable income in his hands. Occasionally, the firm would make a distribution in the form of interest to loan account holders. However, the taxpayer is not entitled to withdraw the outstanding balance on the Firm Loan Account unless he resigns.

The other important fact is that the taxpayer purchased property, which he uses as his residence and is secured by a mortgage bond access facility (Home Loan) which he had drawn on to fund a variety of his expenses. The taxpayer claimed in his income tax returns for the 2010, 2011 and 2012 years of assessment that certain interest incurred on the mortgage bond was incurred in the production of interest income received from the law firm, but the South African Revenue Service (SARS) disallowed these deductions to which the taxpayer then objected.

Issue

The key issue was whether the taxpayer is entitled to deduct from the interest income earned on the Firm Loan Account, a portion of the interest incurred on the Home Loan. This would depend on whether the interest was incurred in the production of income, in terms of section 11(*a*) of the Income Tax Act, 1962 (the Act).

Judgment

One of the requirements to claim an expense as a deduction, is that the expense must be incurred in the production of income in terms of section 11(*a*) of the Act. The taxpayer's case largely relied on Practice Note 31 (PN 31), which states that, even if a person does not carry on a trade as a moneylender and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless SARS's practice to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income.

PN 31 states that the "…practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed…"

In the court's view, interest earned on capital or surplus funds invested, as contemplated in paragraph 2 of PN 31, contemplates interest earned on capital or surplus funds which would have accrued to the investor. However, once such capital or surplus funds are received, and the investor, of his own volition, invests such capital or surplus funds on interest, and then any interest incurred as a consequence of investment of such capital or surplus funds is incurred in the production of interest income from the capital or surplus funds so invested. The court referred to the judgment in *PE Electric Tramway Company Limited v CIR* [1936] 8 SATC 13, where it was held that expenditure has been incurred in the production of income if the expenditure is so closely related to the trade that it can be said that it is part of the costs of running the business.

It also referred to the judgment in *CIR v Genn & Company (Pty) Ltd* [1955] 20 SATC 113, where it was held that one must look at the purpose of the expenditure and to what it actually effects to determine whether the expense was incurred in the production of income. Lastly, the court referred to the judgment in *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd* [1985] 47 SATC 179, which the taxpayer relied on to argue that a portion of the interest on the Home Loan was deductible. In the latter case, the court found in favour of Standard Bank, but also stated that to determine whether interest was deductible, "…a distinction may in certain instances have to be drawn between the case where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his (or its) business."

On the facts of the current matter, the court held that the taxpayer acquired the Home Loan for purposes of purchasing his residence and that this was an instance where the money was borrowed for an identifiable purpose, as stated in the Standard Bank judgment. The proceeds of the Home Loan were utilised for the payment of the purchase price. That was the taxpayer's intention in acquiring the Home Loan and there is no indication on the record of evidence of a change of intention or, if his initial intention had changed at some point, at what point was there a change of intention.

Therefore, the interest paid on the Home Loan was incurred in the acquisition of a capital asset and, as such, the expenditure thus incurred was expenditure of a capital nature as it was not borrowed for the purpose of earning interest income. The expenditure also did not have the effect of earning interest income. The court pointed out that although the taxpayer changed the Home Loan from a bond account into an access facility over time, he could not prove that the purpose of the Home Loan was to earn interest from the Firm Loan Account.

Editorial comment: The question as to whether expenditure in the form of interest to acquire capital assets is expenditure of a capital nature, is a controversial matter.

Cliffe Dekker Hofmeyr
ITA: Section 11(*a*)
SARS Practice Note 31

2626. Foreign pensions exemption

Foreign sourced pensions are usually exempt from South African income tax where such pensions constitute consideration for past employment outside South Africa. Taxpayers earning foreign pensions should, however, take note that the application of this exemption has recently been narrowed.

Until 28 February 2017 the exemption of foreign pensions under section 10(1)(*g*C) of the Income Tax Act, 1962 (the Act) applied to exempt from normal tax any:

"(i) amount received by or accrued to any resident under the social security system of any other country; or

(ii) lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for past employment outside the Republic".

This sometimes resulted in the unintended consequence that South African tax residents working outside South Africa could make tax deductible retirement contributions to their local South African retirement funds for the relevant years of assessment, while receiving tax exempt pensions upon retirement.

Effective 1 March 2017, subparagraph (ii) of section 10(1)(g*C*) was amended to exclude amounts received or accrued from local retirement funds from the application of the exemption. While subparagraph (i) remained intact, subparagraph (ii) now only applies to exempt from normal tax any:

"(ii) lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for past employment outside the Republic other than from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund as defined in section 1(1) excluding any amount transferred to that fund from a source outside the Republic in respect of that member".

Binding General Ruling 25 (issue 2), issued on 16 March 2017, deals with the source of income in relation to the foreign pension exemption. The Ruling states that an amount of pension income will be regarded as sourced outside South Africa for purposes of section 10(1)(g*C*)(ii) if the originating cause giving rise to that amount is located outside South Africa (in other words, if the services that gave rise to the pension were rendered outside South Africa). Only the portion of a pension that relates to services rendered outside South Africa is exempt from South African income tax. The Ruling further confirms that local retirement funds are now excluded from the exemption, irrespective of where those services may have been rendered.

The exemption of foreign pensions from South African income tax will therefore only apply to amounts received or accrued from a foreign retirement fund or amounts that were transferred to a local retirement fund from a foreign retirement fund, provided those amounts take the form of a lump sum, pension or annuity and constitute consideration for services rendered outside South Africa in terms of past employment.

BDO
ITA: Section 1(l) and Section 10(1)(g*C*)
BGR 25

2627. Foreign earned income

Employees who work outside South Africa and employers that employ them should be aware of the proposed change to the application of the exemption relating to foreign-earned income. This change was announced in the 2017 Budget Review.

Under the exemption as it currently exists, South African-resident employees who render services outside South Africa will be exempt from income tax on amounts that accrue in respect of those services. In order to qualify for the exemption, the employee must be outside South Africa for a total of 183 days (which must include a continuous period of 60 days) during any 12-month period and the services must be rendered during the period or periods of absence. Recent changes to the interpretation note now also allow earnings for incidental days of presence in South Africa to be included in the exempt amount.

The proposed change announced in the Budget is that an amount will only be exempt in terms of the relevant provisions if the amount is subject to tax in a country outside South Africa.

The original purpose of the exemption was to prevent the unnecessary and often onerous administration involved in claiming tax credits, and not to provide a complete exemption from tax. In light of this, the proposed change is logical.
Whilst logical, the devil will be in the detail, and the proposal gives rise to many questions.

Generally speaking, "subject to tax" requires that tax is actually levied on the income. Will it therefore be necessary to identify certain elements of the remuneration that might be tax exempt in a particular country, and then subject those to tax in South Africa? Where the tax rate in the host country is lower than in South Africa, employees might prefer to receive a taxable benefit in the host country than a non-taxable one which would be subject to tax in South Africa.

It might therefore be necessary to review remuneration packages of expatriate employees to determine optimum tax efficiency from a total tax perspective.

Employees working in countries which have no personal income taxes (such as certain Middle East countries) will, if the proposal is accepted, now be taxable in South Africa. Part of the attraction of working in these countries is the tax benefit, and employers will likely have to compensate employees for the loss of this benefit (where there is no tax equalisation). Depending on how the proposal takes shape, employees could potentially be better off working in a low tax jurisdiction (as opposed to a no-tax jurisdiction).

SARS will no doubt require proof that the remuneration is subject to tax. It is likely that this will be in the form of an assessment showing the amounts subject to taxation. The usual issues with non-coterminous years of assessment will likely result in significant delays in the finalisation of the South African tax year for those that claim the exemption.

South African employers that currently apply the exemption through their payroll systems will, in order to avoid possible penalties and interest for under deduction of PAYE, now need to undertake extra due diligence around applying the exemption.

Where there is a double tax agreement between South Africa and the host country, many out-bound assignees from South Africa break South African residence by virtue of the application of residence “tie-breaker” clauses in the relevant double tax agreement. The foreign-earned income exemption generally would not apply in these circumstances (the assignee would, in terms of the treaty, only be subject to income that is sourced in South Africa).

In circumstances where the proposed change, if implemented, would be prejudicial (whether to the employee or to the employer), employees might consider organising their affairs in such a way that they are no longer resident in South Africa (provided that there would be no significant adverse implications arising from their ceasing to be resident, such as capital gains tax on deemed disposals of their assets as a result of cessation of residence). South Africa has double tax agreements with the United Arab Emirates, Qatar and Saudi Arabia, three countries with no personal income tax.

Conclusion

It is a misconception that the foreign-earned income exemption exists in order to absolve South African-resident employees from South African income tax when they work abroad. The primary aim of the exemption was to alleviate the administrative burdens associated with international secondments. The proposed change to the exemption will align the exemption more closely with its original purpose.

However, it is almost certain that the proposed change, if implemented, will require a fairly substantial revision of existing payroll and compliance procedures associated with the management of international secondments of South African resident employees.

PwC

ITA: Section 10(1)(*o*)(ii)

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