Tax Developments

Contents

Provisions that will come into effect soon

Most of the amendments that were promulgated as part of the Taxation Laws Amendment Act (Act 43 of 2014), which have effective dates in 2015, have already taken effect. It is expected that the draft amendment bill, which would propose amendments for 2015, will be released for comment during July. Limited amendments relating to the transition of hedge funds into the collective investment scheme tax regime, provisions aimed at preventing corporate migrations and outright transfers of shares that serve as collateral have been made available for public comment. These proposals can be found on the National Treasury's website.

The following amendment made in the Tax Administration Laws Amendment Act (Act 44 of 2014) takes effect next month:

- The deletion of the Category F from section 27 of the VAT Act takes effect from 1 July 2015. This category allowed certain VAT vendors to have four-monthly VAT periods ending in February, June and October. Vendors affected by this amendment are likely to fall back into being a Category A or Category B vendor.

New regulations relating to voluntary VAT registration

The requirements of section 23 of the VAT Act that deal with voluntary registration of persons as vendors were amended at the end of 2013. These amendments, which took effect from 1 April 2014, require certain guidelines to be issued by the Minister of Finance. These regulations were finally issued on 29 May 2015. Each of the amended sections, as well as the relevant regulation, is set out below.

Section 23(3)(b)(ii)

This section allows a person who already carries on an enterprise to voluntarily register as a VAT vendor where the total value of taxable supplies has not yet exceeded R50 000 but can reasonably be expected to do so within 12 months of registration. This registration is subject to the conditions set out in the regulation (below) *and* that the person is registered on the payment basis until the total value of taxable supplies has exceeded R50 000.

Section 23(3)(b)(ii) regulations:

In order to satisfy the Commissioner that the person will reasonably make taxable supplies exceeding R50 000 in the following 12 months, one of the following must exist:

- Taxable supplies for between 2 and 11 months showing an average monthly value exceeding R4 200; or
- If person has only made taxable supplies for one month, value exceeding R4 200; or
- Written contracts with an obligation to make supplies exceeding R50 000 in the next 12 months; or
- Finance agreements with certain counterparties (including banks and credit providers) where the counterparty agrees to fund expenditure to be incurred within the 12 months following registration exceeding R50 000; or
- Proof of expenditure incurred in connection with the commencement of an enterprise and proof payment or extended payment terms showing that *payment* in respect of this expenditure has exceeded R50 000 or will exceed R50 000.

Download the regulation
http://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-Reg-2015-11%20-%20Regulation%20R447%20GG%20388836%2029%20May%202015.pdf

Section 23(3)(d)

This section allows a person who is continuously or regularly carrying on an activity, as specified by regulation (below), to register as a vendor. Unlike section 23(3)(b)(ii), this provision does not contain a R50 000 threshold and is therefore aimed at activities that may require a significant capital outlay but will not necessarily generate income in the next 12 months.

Activities covered by section 23(3)(d):

A person may register under s 23(3)(d) at the time that such person acquires goods or services directly in respect of the commencement of:

- Specified agricultural, farming, forestry or fishery activities;
- Exploration for any mineral, metal, oil, gas or natural gas
- Ship and aircraft building activities
- Manufacturing or assembly of plant, machinery, motor vehicles or locomotives;
- Property development (provided that the property will not be used to make exempt supplies – i.e. residential rentals)
- Development of infrastructure in the form of buildings, permanent installations or structures for purposes of the taxpayer's own enterprise where contractual obligations exceed R1 million and completion is expected to take more than 12 months
- Beneficiation of goods extracted from mining processes

Where required, the person must have already applied for or possess the relevant license, permit or similar document to conduct such activity.

Download the regulation:
http://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-Reg-2015-10%20-%20Regulation%20R446%20GG%20388836%2029%20May%202015.pdf

Tax court judgment on the application of section 11D before its amendment in 2012

Judgment was delivered in the Cape Town Tax Court in April in a case relating to the application of section 11D of the Income Tax Act (the Act) to a taxpayer's 2010 year of assessment. An overview of the judgment, in the context of the 2010 legislation, is provided in this article. The implications of this judgment in the context of the current wording of section 11D are also considered.

Facts considered

In brief, the facts considered by the court were as follows:

- The taxpayer was in the business of developing software solutions for its clients, which included SARS. The software was licensed to the clients on a monthly basis and used by them in processes of freight forwarding, customs clearing and cargo transport from the point of origin until the goods reached its ultimate destination.
- Based on requests from clients, the taxpayer undertook development work on the software.
- It initially deducted the development cost under section 11*(a)* of the Act, but subsequently reopened the assessments to deduct an additional 50% allowance under section 11D.

SARS disallowed the additional 50% deduction on the grounds that the software was used by the taxpayer's clients in managing their business processes. It argued that this fell within the prohibition in section 11D(5)(b), which read:

> "Notwithstanding any other provision of this section, no deduction shall be allowed in terms of subsection (1) or (2) in respect of expenditure or costs relating to – ...
>
> (b) management or internal business processes..."

The taxpayer argued that this prohibition only applied to the expenditure incurred in developing software to be used by the taxpayer itself in its manage or internal business processes.

Judgment

The judgment was essentially based on the view that:

(a) the interpretation of legislation requires that the language of the law must be read in light of the ordinary rules of grammar and syntax, the context of the provision, its apparent purpose and the material known to those who produced the law. This does however not entail a judge substituting the wording that they regard as reasonable, sensible or business-like for the words actually used.

(b) When interpreting legislation that create class privileges, such as favourable provisions available to farming and mining operations, a strict construction of the empowering legislation must be followed.

In this context, it was held that the prohibition did not only apply to expenditure relating to development of software to be used in the management and internal business processes of the taxpayer, but by any person, including the clients of the developer.

Analysis

SARS holds a similar view in paragraph 4.2.4. of Interpretation Note 50 (issued in 2009) where it is stated that, in determining whether the computer program falls under section 11D(5), "it is irrelevant whether such software is developed for use in-house or is developed for the purpose of sale to end-users". The purpose of section 11D(5) is to prevent misuse of the provision. In light of this, a reason for the SARS view to extend the use-test to the ultimate end-user may have been to prevent a scenario where a subsidiary is set up to develop software to be used in its internal business processes by another group entity, but where such software can be viewed as being the external product of the development subsidiary.

From this judgment and SARS' view one can deduce that the 2010 version of the incentive in section 11D would then only have been aimed at, and applied to, the development of software that was not related to management or internal business processes. This implies that the software had to be used in external business processes. It is submitted that this distinction may become extremely fine, as the licensing of software to its customers would arguably have constituted the external business process of the taxpayer. It may also be quite an onerous and possibly difficult task to follow the use of the software through the value chain by all entities involved to judge whether the usage relates to internal business processes or not.

Practically, this approach arguably requires in-depth knowledge about the client's business and may well involve some judgement about the use of the software.

Post-1 October 2012 legislation

One of the most important changes to section 11D is the fact that it now requires approval by the Department of Science and Technology to take advantage of the incentive. The incentive is available if, amongst other, such expenditure is approved, as contemplated in section 11D(9) by the Minister of Science and Technology, and the expenditure was incurred on or after the date of the application for such approval. In the 2015 Budget Review it was acknowledged that a backlog in considering applications exists and that measures may be required to ensure that taxpayers are not prejudiced. In essence, the above should result in the debate about the nature of computer programmes being developed being considered at a different point in the process (upfront, as opposed to as the time of assessment), but it is unlikely to eliminate this discussion.

The development of software may still fall within the scope of the revised definition of research and development, as given in section 11D(1). A further requirement added to the 2010 legislation in respect of a computer program is that it should be of an *innovative* nature. A similar requirement exists in respect of improvements to computer programs. This term is not defined further and is a factual question left to the evaluation committee to consider.

Exclusions similar to those previously found in section 11D(5) are now contained in the proviso to the definition of research and development in section 11D(1) and reads:

> "Provided that for the purposes of this definition, research and development does not include activities for the purpose of—...
>
> (b) development of internal business processes **unless those internal business processes are mainly intended for sale or for granting the use or right of use or permission to use thereof to persons who are not connected persons in relation to the person carrying on that research and development**..." (own emphasis)

It is submitted that activities (development of a computer program) undertaken for the development of internal business processes may already refer to something different from "expenditure or costs relating to ... management or internal business processes" (as it was in the previous version of section 11D). Even though the legislation still does not limit the exclusion to internal business processes of the taxpayer, the exception to the exclusion (in bold above) may go a long way to overcoming the concerns raised in the analysis. This is likely to result in the finding of the judgment not finding direct application to expenditure incurred post-1 October 2012 in respect of computer program development.

The utilisation and carry-forward of assessed losses and the burden of proof (*Medox Limited v C:SARS*)

The SCA heard the Medox case during May 2015. The case deals with the administrative process relating to the carrying forward of assessed losses, rather than some of the technical aspects of section 20 of the Income Tax Act (Act).

Facts

Medox Limited (hereafter the taxpayer) traded since 1976. It was provisionally wound-up in 1995 but continued trading. In 1997, the high court set aside the winding-up order as it sanctioned a scheme of arrangement between the taxpayer and its creditors. The taxpayer submitted a return for the 1996 year of assessment that reflected an assessed loss of approximately R46 million. It failed to submit a return for the 1997 year of assessment, but did submit returns for all subsequent years from 1998 until 2010 (excluding 2003). The taxpayer however did not carry forward its 1996 assessed loss into the 1998 and subsequent returns. SARS assessed the taxpayer accordingly without considering the assessed loss. The taxpayer did not object to these assessments. During 2009, the taxpayer allegedly realised the failure to submit the 1997 return and to make use of the 1996 balance of assessed loss. At that stage it approached the court for an order to declare the 1998 and subsequent assessments invalid on the grounds that SARS did not apply section 20(1)*(a)*.

Judgment

In order to obtain declaratory relief from the SCA, the taxpayer had to show that it had an existing, future or contingent right to have the assessments declared void. In this case, such right would stem from section 81 of the Act, which dealt with the right to object to an assessment (from 1 October 2012 onwards, section 104 of the Tax Administration Act (TAA)).

Section 81(5) determined that an assessment became final if no objection was made to it under section 81 (section 100(1)*(b)* of the TAA has a similar effect). Counsel for Medox argued that section 81(5) only applies to valid assessments, which would appear to refer to an assessment where SARS applied the law correctly. Fourie AJA was of the view that this interpretation would be contrary to the purpose of section 81, which is precisely to deal with assessments where the taxpayer is of the view that SARS applied the law incorrectly. It was therefore held that any order after the period for objecting has lapsed to declare an assessment that became final under section 81(5) would be contrary to the role section 81.

It was further stated that both the wording of section 20(2A)(b) as well as the burden of proof in section 82(b) (now in section 102(1)(b) of the TAA), makes it clear that the taxpayer, as opposed to SARS, should prove entitlement to such an assessed loss.

Analysis

The provisions of the TAA relating to dispute resolution are unlikely to have rendered a different result if the case had to be decided under the TAA.

This case illustrates the effect of the burden of proof and its interaction with section 20 of the Act well. It is submitted that the taxpayer may have been in a difficult position had it attempted to object to the non-utilisation of the 1996 balance of the assessed loss in 1998 and onwards, without having determined or being able to prove the impact of the 1997 assessment on such balance.

Application of the zero-rating in section 11(2)(n) of the VAT Act (*Alan George Marshall NO and Others v C:SARS*)

The case relates to an application for an order to declare a VAT ruling issued by SARS in relation to a zero-rating of services invalid.

Facts

The SA Red Cross Air Mercy Service Trust (hereafter the taxpayer) contracts with various health departments and provincial governments to provide aero-medical services to it. During 2013 SARS issued a VAT ruling to the taxpayer to the effect that the services supplied are taxable supplies and attract VAT at a rate of 14%.

An important aspect of the ruling is the fact that the taxpayer was approved as a public benefit organisation for purposes of the Income Tax Act and conducted activities that constituted welfare activities, as per the relevant regulation issued under the VAT Act. As such, it met the requirements to be classified as a welfare organisation and was therefore a designated entity, for purposes of the VAT Act. This was not disputed.

The taxpayer relied on section 11(2)*(n)* for the zero-rating of the services supplied by it to the departments and governments. This section provides for a zero-rating in respect of:

> "the services comprise the carrying on by a welfare organisation of the activities referred to in the definition of "welfare organisation" in section 1 *and to the extent that any payment in respect of those services is made in terms of section 8 (5) those services shall be deemed to be supplied by that organisation to a public authority or municipality*" (own emphasis added)

Section 8(5) deems the following to be a service rendered:

> "For the purposes of this Act a designated entity shall be deemed to supply services to any public authority or municipality to the extent of any payment made by the public authority or municipality concerned to or on behalf of that designated entity in the course or furtherance of an enterprise carried on by that designated entity."

The dispute related to the question whether section 11(2)*(n)* only applies to deemed services, as was argued by SARS, or also to actual services rendered, as contended by the taxpayer. SARS contended that section 8(5) only applied when there was no actual supply of a service (otherwise the deeming provision would not have been necessary) and that section 11(2)*(n)* therefore only applied to such services. The dispute therefore centered on the interpretation of the italicized reference to section 8(5) in section 11(2)*(n)*.

Judgment

The judge found that the purpose of section 8(5) is to deem the supply made by the designated entity to the public authority to be a service, as opposed to goods, and that such supplies are deemed to be made in the course of carrying on an enterprise. It was held that the wording of section 11(2)*(n)* makes it clear reference to any service supplied by a welfare organisation to a public authority. Paragraph 37 of the judgment further goes on to state that the reference to section 8(5) merely deems the supply to be made to the public authority in the course of the welfare organisation's enterprise.

Analysis

The court considered instances in which the purposive approach to interpretation of legislation would be appropriate. In this case, the judge however held the view that the ordinary meaning of the words used in sections 8(5) and 11(2)*(n)* was sufficiently clear and not ambiguous. It was therefore not necessary to follow a purposive approach to the interpretation of the section.

It is submitted that the direct implications of the judgment is likely to be limited to zero-rating of supplies by welfare organisations dealing with public authorities. The judgment does however leave some food for thought and debate as to:

- The role of the deemed supply rules - in particular, the fact that it appears to suggest that in some instances, the deemed supply rule may fulfil the role of clarifying the nature of an actual supply (i.e. goods or services) rather than deemed something which would not otherwise constitute a supply;
- The reading of the second part of section 11(2)*(n)* by welfare organisations in light of the meaning and purpose attributed to it in paragraph 37 of the judgment, which appears to view this as a statement clarifying the treatment already deemed to exist under section 8(5); and
- The point where it becomes necessary to follow the purposive approach to interpretation. Section 11(2)*(n)*, especially the second part of the provision, is not an easy section to read. The views of authors, for example, de Koker and Kruger in the textbook VAT in South Africa, appear to be in line with those of SARS in relation to the second part of the section 11(2)*(n)*, that it only applies to payments which would, had it not been for the deeming provision in section 8(5), not have been treated as a supply of services. It is also suggested that the view held in the judgement may require the second part of section 11(2)*(n)* to be read as:

  > the services comprise the carrying on by a welfare organisation of the activities referred to in the definition of "welfare organisation" in section 1 and to the extent that any payment in respect of those services is made in terms of section 8 (5)**[,]** those services shall be deemed to be supplied by that organisation to a public authority or municipality

  Numerous reads of section 11(2)*(n)* leaves a reader with some doubt as to whether this provision is clear and unambiguous. This poses a question about when a provision would be open for more than one interpretation and may therefore require a purposive approach to interpretation thereof. The fact that the judge concluded that the wording of the provision is clear and unambiguous seems to suggest that an ambiguous provision needs to be distinguished from one where the ordinary meaning of the words is being misinterpreted by a party rather than there being ambiguity in the phrasing of the provision.

Concluding thoughts

Despite the judgment not being based on a purposive approach to interpretation of section 8(5) and section 11(2)*(n)*, it is submitted that when constructing a view on the application of any section of the VAT Act, especially one that is as difficult to read as section 11(2)*(n)*, it is a valuable check to consider what the intention and objective of the legislature was when it inserted that section. An analysis of the section in light of the VAT regime relating to welfare organisations and the concessions made for these entities as well as how this regime differs from non-designated entities, where the legislation makes specific reference to grants, may have shed some further light on the debate around the interpretation of section 11(2)*(n)* in the context of its application to actual services being rendered by such an organisation.

Binding private ruling on the interaction between the withholding tax on interest and interest-related tax adjustments (BPR 192)

BPR192 essentially deals with the question whether the withholding tax on interest applies to a notional interest adjustment that is made under section 31(2) of the Income Tax Act (the Act).

Facts provided in the ruling

A foreign company, which is not a resident of South Africa for tax purposes, advances an unsecured interest-free loan that is repayable on demand to a South African company. The two entities are connected persons in relation to each other. The parties to the loan foresee that a transfer pricing adjustment may be required under section 31.

Ruling

If an adjustment is made under section 31, the foreign lender company will not be liable for the withholding tax on interest and the resident borrower company is not obliged to withhold or pay withholding tax on interest in respect of such adjustment.

Analysis

Application of section 31

A transfer pricing adjustment under section 31 is required where a party obtains a tax benefit from the non-arm's length terms or conditions of a transaction. As the lack of interest payable results in no amount being deducted in the hands of the resident borrower company, it is unlikely that the tax benefit arises in its hands. It is therefore submitted that such tax benefit would be derived in the hands of the foreigner lender company from the lack of South African sourced interest income, which may otherwise have been subject to tax in South Africa.

As the definition of tax includes any tax imposed in terms of the Act, the avoidance of withholding tax on interest if no interest is charged may cause such a tax benefit, depending on the provisions of the relevant double tax agreement (if any). If such a tax benefit is derived as a result of the terms and conditions not being at arm's length, section 31(2) requires that the taxable income or *tax payable* be determined as if the terms and conditions were at arm's length.

Withholding tax on interest

Section 50B imposes the withholding tax on any interest *paid* to a foreign person to the extent that such interest is from a South African source. Interest is currently not defined in section 50A. One would assume from the fact that the question was asked in relation to the withholding tax, that the interest qualified for the exemption in section 10(1)*(h)*, given the interaction between this section and section 50D.

Grounds for the ruling

A few contrasting requirements exist between sections 31(2) and 50B and may well have been the cause of the ruling application. Firstly, a withholding tax by its nature requires an amount to be paid from which a portion can be withheld. Secondly, the question may arise whether a transfer pricing adjustment retains its nature as interest in this case or whether the wording of section 31(2) overrides the meaning of interest, as contemplated in section 50B.

The view in the ruling appears to favour the view that an actual payment of interest is required for the withholding tax to apply rather than just a notional interest adjustment. In the context of inbound cost-free funding into the South African economy this view would be well justified from a policy perspective

About PvdZ Consulting (Pty) Ltd

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