DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

DEDUCTIBILITY OF EMPOWERMENT COSTS

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In the context of black economic empowerment transactions (BEE transactions), a question that has been the subject matter of much debate over the last few years is whether advisory fees can be deducted for income tax purposes. In this context, the argument is that empowerment is a cost of obtaining a licence to operate and on this basis it should thus be seen as part of the income earning operations of the company.

In *Warner Lambert SA Pty Ltd v CSARS 65 SATC 346*, the court had to deal with the deductibility of social responsibility expenditure that was incurred by a company that was, at the time, a subsidiary of a US company that adhered to the Sullivan Code. The Sullivan Code provided for the non-segregation of races in the workplace, equal and fair employment for all employees, equal pay, development of training programmes, increasing the number of disadvantaged persons in management and supervisory positions and improving the quality of employees' lives outside the work environment. The principles of the Sullivan Code were very similar to the current principles governing empowerment in South Africa.

It was held by the court that the relevant expenses incurred by the subsidiary company were deductible, specifically that it reduced the risk that the taxpayer could lose its subsidiary status. The court used the analogy of paying insurance premiums and remarked that the expenditure was to "insure against the risk of losing its treasured subsidiary status". It was argued that the loss of the subsidiary status could have resulted in the loss of all kinds of trade advantages and that these expenses were thus *bona fide* incurred for the performance of the taxpayer's income earning operations. It was also indicated that the expenses were not of a capital nature as no capital asset was created or improved in the hands of the subsidiary. The income earning structure of the taxpayer had been erected some time before the expenses were incurred and it was merely a question of protecting the relevant earnings. On that basis there was thus no creation of a capital asset.

SARS has issued two Rulings dealing with similar types of expenditure. In Binding Class Ruling BCR 2 it was indicated that expenditure incurred in respect of Corporate Social Investment (CSI) programmes is deductible. However, it should

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be appreciated that the expenditure incurred related to bursary payments made by the taxpayer and was not aimed at increasing shareholding in the taxpayer from an empowerment perspective.

In Binding Private Ruling BPR 113, SARS equally indicated that expenditure associated with Broad Based Black Economic Empowerment would be deductible. However, once again the taxpayer implemented a so-called Equity Equivalent Programme given the fact that it was a subsidiary of a foreign company and that there could not be any change in shareholding in the applicant. The so-called Equity Equivalent Programme entailed the investment of 4% of the applicant's annual turnover, over a period of seven years, into selected qualifying small black owned independent vendors. Such course of conduct would have enabled the applicant to receive the full 20 empowerment points per annum for the ownership component of the BEE Scorecard. One of the issues was that the applicant would not subscribe for any shares in the companies in which investments were made. It was indicated by SARS that the equity equivalent expenditure was deductible, even though it was apportioned over a seven year period in terms of s23H of the Income Tax Act, No 58 of 1962 (Act) given the fact that the benefit was to be enjoyed over a seven year period.

One should appreciate that as BEE transactions are designed to improve the ownership component of the BEE scorecard, the transaction generally involves the acquisition of shares in a company which is to be empowered. In many of these BEE transactions, SARS has refused the deduction of this type of expenditure. Even though many of these matters were subsequently settled between SARS and the taxpayer, one of the issues that generally arises is whether the expenditure is on capital account, given the fact that it relates to shareholding and that the transaction would thus have related to the income earning structure as opposed to the income earning operations of the company. The counter argument is that the costs are incurred to retain or protect the taxpayer's income earning structure akin to insurance premiums. It may be that the taxpayer implementing the BEE transaction has a mining license which it wishes to retain. However, for example, where the costs are incurred to obtain (rather than retain) a mining license the argument is that the costs are incurred to create a capital asset and are therefore not deductible for income tax purposes.

Overall, there is a good argument in favour of the deductibility of the relevant BEE transaction costs but one should expect some resistance from SARS. Even though it has been indicated by SARS that expenditure qualifies for a deduction if it is incurred in attaining the requisite points per the ownership scorecard pertaining to broad-based black economic empowerment, one of the critical issues is whether the costs incurred are of a capital nature.

Other transaction costs, however, if not linked to the empowerment transaction, would not qualify for a deduction from an income tax perspective, including by way of way of example any other restructuring costs not directly related to the BEE Transaction.

To the extent that the costs are deductible from an income tax perspective, the costs may have to be apportioned in terms of s23H of the Act.

Andrew Seaber

TREATMENT OF EARLY SETTLEMENT DISCOUNTS FOR VAT PURPOSES

Every now and then the issue arises as to how one is to treat early settlement discounts in respect of Value-added Tax (VAT).

For example, a supplier who is a VAT vendor supplies goods to a customer on credit. The supplier and the customer agree upfront, or have a general agreement in place, to the effect that the customer will receive discount if the account is settled on or before a certain date.

Since a VAT vendor who makes a taxable supply has to issue a tax invoice to the recipient within 21 days of making the supply, in terms of section 20 of the VAT Act, No 89 1991 (VAT Act), and since the VAT vendor has to account for output VAT in respect of that supply with reference to its applicable tax period, certain practical problems may arise. For instance, there may be uncertainty as to what the value of the supply is, what amount should be reflected on the tax invoice and whether any credit or debit notes need to be issued.

There are various ways in which one can construe such a set of facts.

Firstly, one could view the transaction as a supply, the consideration for which is determined upfront as being a higher amount, but if payment is made before a certain date, the consideration will be reduced to a lower amount. In such a scenario it seems clear that a tax invoice has to be issued to the recipient for the higher amount, and if the recipient pays early and qualifies for the lower amount, a credit note needs to be issued to the recipient in terms of s21(1)(c) of the VAT Act indicating the decrease. This is a typical early settlement discount scenario.

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Secondly, one could view the transaction as a supply, the consideration for which is determined upfront as being a lower amount, but if payment is made after a certain date, the consideration will be increased to a higher amount. Here it seems that a tax invoice has to be issued to the recipient for the lower amount, and if the recipient pays late, a debit note needs to be issued to the recipient in terms of s21(1)(c) of the VAT Act indicating the increase.

In *GUD Holdings (Pty) Ltd v Commissioner for the South African Revenue Service 69 SATC 115*, the court characterised what would generally be termed a 'settlement discount' not as a discount but as a late payment penalty, in line with the second scenario above. From this judgment it is clear that it would depend on the facts, and specifically on the wording of any agreements, whether one is dealing with a discount or a penalty.

Thirdly, one could view the transaction as a supply, the consideration for which is either one of two amounts – a lower amount if payment is made on or before a certain date, or a higher amount if payment is made after that date. At the time of supply the consideration is completely uncertain and not determinable. The consideration will only be determinable on the date of payment or the cut-off date that qualifies the recipient for paying the lower amount, whichever arrives first.

In this scenario it may be completely unclear as to whether one should issue an invoice for the higher or lower amount. In practice, vendors may issue invoices stating both the higher and lower amounts and the conditions under which either will apply. However, this is not necessarily helpful as the vendor would still have to account for output VAT in respect of the applicable tax period, and if the consideration does not become certain by that time, the vendor may not know which amount to account for.

Recently the South African Revenue Service released Binding General Ruling 6, in which it rather briefly deals with the issue of early settlement discounts in the Fast Moving Consumable Goods industry. The ruling simply states that a vendor must issue a credit note for a discount if the discount:

- alters the original purchase price of a supply of goods or services in terms of an agreement with the recipient; and

- results in the tax charged on the tax invoice in relation to that supply being incorrect (that is, the amount of tax charged shown on the tax invoice exceeds the actual tax charged).

The ruling also indicates that where a "discount" is extended that does not actually alter the consideration for the supply, but in fact constitutes consideration by the vendor for a service or other supply by the recipient to the vendor, the recipient must account for VAT on that supply.

It seems that for the most part the proper treatment of an early settlement discount will depend on the facts. However, there will often be scenarios in which it is very difficult to determine the amount of the consideration that should be accounted for.

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