DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

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IN THIS ISSUE

CONCERNS RAISED ON INTEREST DEDUCTION LIMITATION RULES

Interest deduction limitation provisions have been enacted in terms of s23N of the Income Tax Act, No 58 of 1962 (Act), which apply to so called 'reorganisation and acquisition transactions'. These provisions have been in effect since 1 April 2014. The purpose of these provisions (as the heading suggests) is to limit interest deductions in respect of certain debt arrangements that National Treasury consider as being susceptible to excessive gearing.

In addition, a new s23M of the Act will have effect from 1 January 2015, which will essentially apply to debts owed by a debtor to a creditor in a 'controlling relationship' and the amount of interest incurred by the debtor is not subject to tax in the hands of the creditor (eg a non-resident creditor). National Treasury contends that these interest deduction limitation provisions are necessary to avoid the erosion of the South African tax base.

The provisions of s23M and s23N of the Act are complex and require careful analysis to fully understand the tax consequences thereof. Recent amendments have been proposed to these sections in the draft Taxation Laws Amendment Bill 2014 (Bill) and some interesting comments have been made in respect of these sections.

For example, some of the important comments that were made by various stakeholders at the parliamentary public hearing on the draft Bill (held on 26 August 2014) and at a recent workshop hosted by National Treasury and the South African Revenue Service (SARS), include the following:

- It is possible that an arrangement could be subject to: i) the transfer pricing and thin capitalisation provisions in s31 of the Act; ii) section 23N of the Act; and iii) section 23M of the Act. While s23N is subject to s23M of the Act, it is not clear which section should take precedence (eg s23M or s31 of the Act) and, if an adjustment is made to an interest deduction in terms of s31 of the Act, is s23M of the Act still applicable?

- The current proposal is for s23M of the Act to also apply to a debt that is guaranteed by a person that is in a controlling relationship with the debtor. It was contended by a number of stakeholders that this amendment is too wide and includes arrangements which should not fall within s23M of the Act. The following basic example was cited by a number of stakeholders:

"An operating company borrows from an unrelated third-party financier which is exempt from tax (eg a pension fund). Section 23M of the Act should not apply to the interest expenses as there is no 'controlling relationship'. If a third-party financier requires security in the form of a guarantee from the borrower's parent, the loan would then be subject to s23M of the Act (if the proposed amendment is enacted)."

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In the workshop it was indicated that the proposed amendment to include guarantees from persons in a controlling relationship will be reconsidered. It does not necessarily mean that this proposed amendment to s23M will be deleted and taxpayers should pay careful attention to this provision in the final Bill, 2014.

- Section 23N of the Act should only apply to new debt used to finance a 'reorganisation transaction' or 'acquisition transaction' and should not apply to debt assumed as part of the settlement of the purchase consideration (ie 'existing debt'). Unless amendments are made to s23N, taxpayers should therefore be aware of this issue when implementing any 'reorganisation or acquisition transactions';

- No policy decision appears to have been given for allowing a taxpayer to roll forward any interest deductions disallowed in terms of s23M of the Act but any interest deduction disallowed in s23N of the Act may only be carried forward for the five years following the 'acquisition transaction' or 'reorganisation transaction'; and

- From a practical perspective, the application of s23M and s23N of the Act could have adverse provisional tax consequences as a taxpayer will not necessarily be able to calculate its 'adjustable taxable income' until the year-end audit has been completed, which will obviously impact the determination of a taxpayers' second provisional tax payment.

It was difficult to establish from the workshop whether these (and other) comments by the various stakeholders will be incorporated in the final Bill 2014, other than the request for s23M(2)(b)(ii) to be deleted (ie the request for expansion of s23M to guarantees furnished by persons in a controlling relationship to be deleted).

It is anticipated that taxpayers can expect to see a number of amendments to both s23M and s23N in the future as they have a significant impact on business transactions in South Africa. There has also been indication from National Treasury that an interest deduction limitation of 40% of the 'adjusted taxable income' may in fact be lenient if one has regard to international data. The business community will no doubt raise a number of concerns if the interest deduction limitation rate is reduced from the current 40% of the 'adjusted taxable income'.

Andrew Lewis

SALARY SACRIFICES

In the recent case of *ABC Limited v The Commissioner for the South African Revenue Service* (case number 12984, as yet unreported), the Tax Court had to determine whether the Appellant had entered into an effective salary sacrifice scheme with its employees in respect of motor vehicle benefits. If there truly was a salary sacrifice, only the taxable value of such benefit in accordance with the provisions of the Seventh Schedule to the Income Tax Act, No 58 of 1962 (Act) will have accrued to the employee, otherwise the amount expended by the Appellant to provide the benefit will have accrued.

By way of background, the Appellant operated an employee remuneration arrangement in terms of which the Appellant expended certain amounts in providing employment benefits to its employees (employment costs). One of these employment benefits related to the provision of a company vehicle where the employee could elect either:

- to receive the right to use the company vehicle as a benefit of his or her employment and the amount expended by the Appellant in providing the benefit would be deducted from the employment costs (company car scheme). The balance would be used for the provision of other remuneration benefits; or
- to receive a motor vehicle allowance where the amount of the allowance paid by each employee would be deducted from the employment costs (car allowance). In this instance as well, the balance would be available for the provision of other remuneration benefits.

The Commissioner for the South African Revenue Service (Respondent) assessed the Appellant on the premise that the amounts allocated to the company car scheme constituted remuneration which accrued to the employees and were as such taxable in terms of Paragraph (c) of the definition of gross income in s1 of the Act. The Appellant objected to the Respondent's assessment, which objection

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was disallowed. The Appellant appealed the disallowance of the objection on the basis that a salary sacrifice agreement had been entered into between the Appellant and its employees and consequently there was no accrual of sacrificed amounts in respect of the employee's remuneration package.The Appellant further contended that the employment costs were subject to a contingency in that an employee first had to make an election before the employee would be entitled to anything. The employee would only be entitled to any benefit after an election had been made.

In respect of the company car scheme, the Appellant purchased the vehicle which was registered under the employee's name however ownership was retained by the Appellant.

Every employee who elected to participate in the company car scheme would be allocated a notional account where an amount would be credited towards the motor vehicle allocation. The employee was provided with a fleet card and any amount that was expended via the fleet card was debited against the credit allocated thereon. Further, any other costs incurred in respect of the vehicle such as insurance, fuel and interest were debited against the amount credited in the notional account. In the event of the employee spending more than was available in the notional account, such employee was obliged to make payment in the form of deductions from salary. In the event of the employee having underspent, such employee was entitled to reclaim the balance.

The Appellant contended that the benefits did not accrue to the employees, as the employment costs were contingent on the employees electing either of the options mentioned above. Only once the employee concerned had made an election, would he or she be entitled to the benefit chosen. Therefore, the Appellant's obligation towards the employees was contingent on such choice being made.

The Respondent contended that the benefits paid by the Appellant in terms of the company car scheme remain part of the accrued income and that the salary sacrifice was 'not a genuine dimunition in the remuneration package arising from the costs to company.' The Respondent further contended that the divestment in favour of the company car scheme was not an antecedent divestment of the right to the money making up the sacrificed portion and therefore this still accrued to the Appellant. As a result the employees were entitled to an amount equal to the sacrificed portion in that the credit balance in the notional account was not forfeited in favour of the Appellant, but accrued to the employee as a right to claim such amount.

The Court agreed with the Respondent and held that-

> *"…once the employee made a choice, he became entitled to the use of the car subject to the payment of an amount to be administered on his behalf towards defraying whatever expenses are incurred. Debits were made against his allocation and any credit balance remained he still had a right to claim payment thereof. The employer made no contribution at all. I agree with the submission made on behalf of the respondent that the employee is entitled to the monies he agreed to allocate to the motor vehicle scheme as part of his gross income. This right accrued to the employee. The employer on the other hand is entitled to set-off the expenses the employee incurred for the private use of the employer's motor vehicle. This is a debt owed to the employer, but does not affect or impact on the definition contained in s1 paragraph (c) of the Income Tax Act that any amount received or accrued in respect of services rendered or to be rendered is taxable."*

In other words, the employees became entitled to the income and did not antecedently divest themselves of the right to the money since entitlement on the company car scheme account credit balance was not forfeited but paid out to them on request. The Appellant did not dispute this and the court accepted this as factually correct.

Interestingly, the Appellant submitted that in the event of the appeal not being upheld, the interest and penalties imposed should be remitted as there was no ill intent but a misinterpretation on the applicability of the law to the facts and therefore a genuine error on the part of the Appellant. The court dismissed this contention on the basis that Paragraph 6(1) of the Fourth Schedule to the Act which provides that in the event of an employer failing to pay any amount of employees' tax for which he or she is liable, the South African Revenue Service (SARS) *must* impose a penalty equal to 10% of such an amount. The court held that this paragraph is peremptory and therefore SARS was compelled to impose the penalty. Further, the reasons advanced on behalf of the Appellant did not amount to exceptional circumstances and therefore the interest would not be remitted.

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Having regard to all of the above it should be noted that this judgment is important as it highlights the fact that in order for a salary sacrifice scheme to be effective, an employee must antecedently divest himself or herself of any right to the amount sacrificed.

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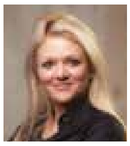

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