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PUBLIC BENEFIT ORGANISATIONS – THE TAX TREATMENT OF INCOME DERIVED FROM TRADING ACTIVITIES

Public benefit organisations (PBOs) play an important role in society as they relieve the financial burden on the state to undertake public benefit activities. Tax exemptions and deductions are available to assist PBOs achieve their objectives.

The sole or main object of a PBO must be to conduct a public benefit activity. The PBO's public benefit activity must, in accordance with s30 of the Income Tax Act, No 58 of 1962 (Act), be carried out in a non-profit manner and with an altruistic or philanthropic intent. Consequently, a PBO which carries on a public benefit activity with the sole purpose of making a profit will act contrary to the fundamental objective of a PBO. However, in a situation where a PBO, as part of undertaking a public benefit activity carries on a business undertaking or trading activity and earns income, is the PBO contravening the provisions of s30 of the Act? Put differently, what will the tax consequences be where a PBO carries on undertakings and activities for a profit, while the sole or main object remains the conducting of a public benefit activity?

As a point of departure, s10(1)(cN) of the Act permits a PBO to carry on business undertakings or trading activities, provided that the sole or main object of the PBO remains the carrying on of a public benefit activity as listed in Part I of the Ninth Schedule to the Act. Prior to April 2006, the law regulating the extent to which a PBO may conduct business undertakings or trading activities was contained in s30(3)(b)(iv) of the Act. In terms of this old rule, a so-called 'all or nothing' approach was followed as PBOs were prohibited from carrying on business undertakings or trading activities outside certain restricted limits. A PBO which failed to comply with these provisions forfeited its status as a tax exempt entity.

Currently, s10(1)(cN) of the Act provides that the receipts and accruals of a PBO that arise i) otherwise than from any business undertaking or trading activity or ii) from a business undertaking or trading activity which falls within one of the four exemption categories listed in the section, will be exempt from normal tax. The exemption categories under which the business undertaking or trading activity must fall in order to render any receipts or accruals exempt from tax, are the following:

- activities or undertakings which are integral and directly related to the PBO's sole or principal objective;
- activities which are occasional in nature and are undertaken substantially with assistance on a voluntary basis without compensation;
- activities approved by the Minister of Finance (Minister) by way of notice in the Government Gazette (GG) having regard to certain criteria; or
- any activities that are not integral and directly related to the sole object of the PBO, not of an occasional nature or not approved by the Minister, to the extent that the receipts and accruals do not exceed the greater of 5% of the total receipts and accruals of the PBO for the tax year or R200 000.

Each category has its own set of requirements, all of which must be met before the particular exemption will apply. Each category will be discussed in more detail below.

Integral and directly related trade

Section 10(1)(cN)(ii)(aa) of the Act provides that in order to qualify for this exemption:

- the undertaking or activity must be integral and directly related to the sole or principal object which is the approved public benefit activity carried on by the PBO;
- substantially the whole of the undertaking or activity must be conducted on a cost-recovery basis; and
- the undertaking or activity should not result in unfair competition with other taxable entities.

Interpretation Note No. 24 (issue 3) published by the South African Revenue Service (SARS) on 4 February 2014 (IN 24), dealing with the partial taxation of trading receipts of a PBO, provides that a business undertaking or trading activity will be regarded as having been carried out on a basis substantially the whole, if at least 85% or more of the undertaking or activity is directed towards the recovery of costs (such as the costs of hiring venues, transport, equipment etc) and not the maximising of profits.

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In addition, a PBO should not be in a more favourable position than a taxable entity conducting the same business undertaking or trading activity. In this regard, it is important for a PBO to determine whether there are other taxable entities carrying on the same or similar business undertakings or trading activities so as to not fall foul of this requirement. SARS will consider each case on its own merits in order to determine whether a PBO has such an unfair advantage.

Occasional trade

In order to qualify for exemption as an occasional trade, s10(1)(cN)(ii)(bb) of the Act provides that the business undertaking or trading activity must:

- take place on an occasional or an infrequent basis; and
- be undertaken substantially with assistance on a voluntary basis without compensation.

IN 24 provides that an undertaking or activity of an occasional nature is "one conducted on an irregular, infrequent basis or as a special event." Annual sales at which donated second-hand clothing are sold, charity golf days involving donated or sponsored prizes or a gala dinner to raise funds are examples of an activity of an occasional nature.

Further, any assistance in the business undertaking or trading activity must be predominantly undertaken on a voluntary basis without compensation. However, the costs incurred in the bona fide reimbursement of reasonable and necessary out-of-pocket expenditure will be allowed.

Ministerial approval

According to s10(1)(cN)(ii)(cc) of the Act, a business undertaking or trading activity may be approved by the Minister by notice in the GG by taking into account the following factors:

- the scope and benevolent nature of the undertaking or activity;
- the direct connection and interrelationship of the undertaking or activity with the sole or principal object of the PBO;
- profitability of the undertaking or activity; and
- level of economic distortion that will be caused by the tax exempt status of the PBO carrying on the undertaking or activity.

IN 24 provides that any submission to the Minister must "demonstrate and motivate the benefits of the business undertaking or trading activity for the general public, together with reasons why it will not result in unfair competition with other taxable entities, or erode the tax base." To date, no such undertakings or activities have been approved by the Minister.

Basic exemption

To the extent that the business undertaking or trading activity of the PBO does not fall within the first three categories listed above, the receipts and accruals of such undertaking or activity will, subject to a basic exemption, be subject to normal tax (s10(1)(cN)(ii)(dd) of the Act).

The basic exemption is the greater of 5% or R200 000 of the total receipts and accruals of the PBO. In other words, the total receipts and accruals of any business undertaking or trading activity which do not fall under the exemption categories in s10(1)(cN) of the Act, will be subject to tax. However, the PBO will be entitled to a deduction which is equal to an amount of 5% or R200 000 of the total receipts and accruals (whichever is greater). It is important to note that the total receipt and accruals from all undertakings and activities must be added together before the deduction of the basic exemption.

In light of the above, to the extent that a business undertaking or trading activity of a PBO falls under one of the categories listed above, the receipts and accruals from such undertaking or activity will be exempt from normal tax. However, in the event that the undertaking or activity does not fall under any exemption category, the PBO will be entitled to the basic exemption, while the remaining receipts and accruals from undertakings or activities will be taxed at 28%.

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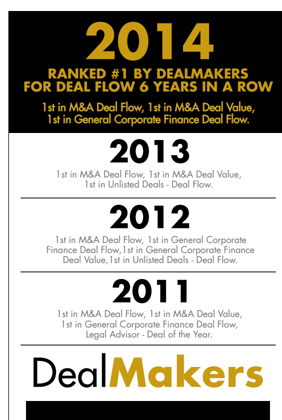

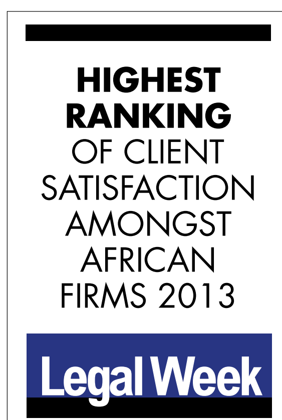

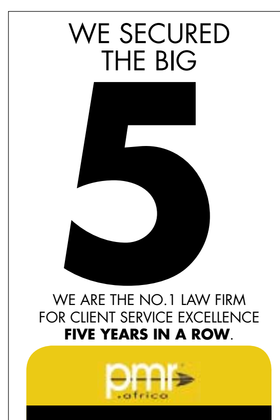

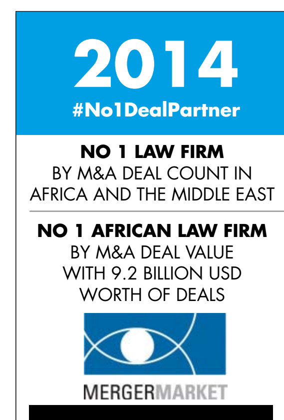

COURT ADDRESSES THE DEDUCTIBILITY OF RESEARCH AND DEVELOPMENT TAX INCENTIVES

In an attempt to encourage research and development in South Africa, s11D of the Income Tax Act, No 58 of 1962 (Act) was introduced to provide a research and development tax incentive which seeks to encourage and incentivise private sector investment in the research and development of scientific or technological activities. This particular tax incentive ensures that research and development activities are conducted within South Africa with the ultimate goal of indirectly stimulating the economy.

Under the provisions of s11D of the Act, two types of tax deductions are allowable. First, the 150% deduction of expenditure incurred directly for research and development purposes and secondly, an accelerated depreciation deduction for capital expenditure incurred on any building or part thereof, machinery, plant, implement, utensil or article used for research and development purposes.

However, in order to qualify for the tax incentive, a taxpayer must meet various stringent requirements relating to the taxpayer, the particular expenditure, and the research and development activities.

An interesting judgement, in relation to the deductibility of the research and development incentive, was handed down by the Tax Court, Cape Town (Court) on 20 April 2015, in the matter of *ABC (Pty) Ltd v Commissioner for the South African Revenue Service* IT13541.

The facts of the case are that ABC (Pty) Ltd (Appellant), a wholly-owned operating subsidiary of ABC Ltd, has been in the business of conducting software research and development for 27 years. The Appellant develops software programs for its customers that are designed to meet the specific customer's particular needs.

The nature of the Appellant's business is such that research and development is an integral part of its activities and a major source of its income is earned through licence fees calculated on the number of transactions the software utilises.

It is undisputed that during the 2010 year of assessment, the Appellant funded research and development in the course of its operations, and it incurred expenditure in the sum of R19,968 ,378. Initially, the Appellant claimed the actual expenditure incurred in respect of research and development as a deduction. The Commissioner for the South African Revenue Service (Respondent) allowed this deduction under the provisions of s11(a) of the Act. During the period between September and December 2011, the Appellant requested that the assessment be re-opened and claimed additional expenditure allowed for research and development in terms of s11D. The additional deduction amounted to R3,290,968.

The Respondent disallowed the additional 50% claimed for research and development expenditure in terms of the provisions of s11D of the Act and issued a revised additional assessment on 2 March 2012. The Appellant objected to the additional assessment and the Respondent disallowed the objection in its entirety. The Appellant then appealed against the Respondent's decision and the matter was referred to the Court.

The crucial issue in this appeal was whether the Appellant could claim 150% for the research and development expenditure incurred in respect of computer programs designed for its various customers, in terms of s11D of the Act, as it applied to its 2010 year of assessment. The Court therefore had to consider whether the expenditure incurred by the Appellant, as contemplated in s11D(1)(b)(iii) of the Act, is precluded by s11D(5)(b) because it related to 'management or internal business processes'.

Section 11D(1)(b)(iii) of the Act, as it applied to the Appellant's 2010 year of assessment, provides that:

"For the purposes of determining the taxable income derived by a taxpayer from carrying on any trade there shall be allowed as a deduction from the income of such taxpayer so derived, an amount equal to 150 per cent of so much of any expenditure actually incurred by that taxpayer directly in respect of activities undertaken in the Republic directly for purposes of…the devising, developing or creation of any…computer program as defined in section 1 of the Copyright Act, 1978 (Act, No 98 of 1978), if that information, invention, design, computer program or knowledge is of a scientific or technological nature, and is intended to be used by the taxpayer in the production of his or her income or is discovered, devised, developed or created by the taxpayer for purposes of deriving income"

Section 11D(5)(b) of the Act, as it applied to the Appellant's 2010 year of assessment, further provides that:

"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…management or internal business processes…"

The Appellant contended that it was entitled to the 150% deduction for research and development expenditure incurred, as the 'management or internal business processes', envisaged in s11D(5)(b), are limited to the 'management or internal business processes' of the Appellant and excludes the users for which the computer programs were developed. Accordingly, the Appellant contended that the limitations set out in s11D(5) of the Act, relate to expenditure incurred by a taxpayer in the course of its own business operations, which cannot be considered for the s11D deduction, where the expenditure was incurred by the taxpayer itself.

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The Respondent conceded on the point that the expenditure referred to in s11D(5) can only be the expenditure of the Appellant but disagreed with the Appellant that the 'management or internal business processes' can only be those of the Appellant. According to the Respondent, the ambit of s11D(5) is not limited in the way contended by the Appellant and may well include the users for which the programs were developed by the Appellant on a customised basis.

In light of the above, the Court held that based on statutory interpretation, it must be accepted that the intention of s11D is to incentivise the development of innovative computer programs but not where those relate to, among other things, 'management or internal business processes'.

Having regard to the statutory interpretation of the words 'management or internal business processes' and the provisions of the South African Revenue Service (SARS) Interpretation Note No. 50, published on 28 August 2009, the Court held that the Appellant's interpretation of the prohibition under s11D(5) of the Act was wrong for two reasons:

- The words 'of the taxpayer' after 'management and internal business processes' have specifically been excluded by the legislature and cannot be read into the prohibition; and
- The Appellant's interpretation of s11D(5) would render the prohibition so narrow that it would be nugatory.

The Court therefore concluded that the Respondent's interpretation of s11D(5) was correct to the effect that the internal business processes are not restricted to the Appellant's internal business processes but apply to the nature of the computer program.

The Court further held that "it must be accepted that s11D creates a class privilege for certain categories of research and development expenditure, by permitting the deduction of 150% thereof, whereas the norm is that only the actual amount of qualifying expenditure can be deducted". Accordingly, s11D(5) of the Act places a curb on the class privilege available to such categories of research and development.

The Respondent further argued that the Appellant was not entitled to entitled to a 150% deduction in terms of s11D as s23B(3) of the Act precluded the taxpayer from claiming a deduction under s11(1) of the Act and s11D of the Act. The Respondent contended that either s11D of the Act applies to justify a deduction of 150% of the expenditure in question or, if s11D does not apply, s11(a) applies. The Court held in this regard that the Respondent's contention was correct.

Accordingly, the appeal was dismissed.

This judgement is important as it proves that the process in claiming research and development tax incentives can become quite technical. The interpretation and implementation of s11D of the Act requires expert knowledge on the principles of tax law and taxpayers are therefore advised to seek legal advice to assist in documenting the relevant technical information required by SARS to support their research and development claim.

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