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TAX AND EXCHANGE CONTROL ALERT

IN THIS ISSUE

SARS LOOKS TO CLEAR UP MISCONCEPTIONS RELATING TO TAX EXEMPTION FOR FOREIGN EMPLOYMENT INCOME

The South African Revenue Service (SARS) issued Draft Interpretation Note 16 (Issue 2) (Draft IN) for public comment recently. When compared to the current Interpretation Note 16 (IN16), the Draft IN indicates a marked shift, on certain aspects, in SARS's interpretation of the tax exemption that applies to foreign employment income, under s10(1)(o)(ii) of the Income Tax Act, No 58 of 1962 (Act).

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Before going into detail on the more important points of the Draft IN, it is useful to deal with the basic principles of s10(1)(o)(ii) of the Act. The exemption has been utilised, quite successfully over the years, by individuals rendering services in a foreign jurisdiction and earning income in respect of those foreign services. The effect of complying with s10(1)(o)(ii) of the Act is that a certain portion of the remuneration earned in respect of those foreign services is exempt from normal tax in South Africa. Certain 'practices' developed over the years in applying the exemption, read with SARS's views as set out in IN16.

The general rule is that income earned by a resident from the rendering of services anywhere in the world will be included in "gross income", as defined in s1 of the Act. Notwithstanding the general residency based rule, certain exemptions apply, in particular, s10(1)(o)(ii) of the Act in respect of remuneration which would ordinarily have been subject to normal tax. The exemption provided under s10(1)(o)(ii) of the Act applies in respect of services rendered outside South Africa for or on behalf of any employer, as long as the individual is outside South Africa for a period or periods exceeding 183 full days (calendar, not working days) in aggregate, during any 12 month period commencing or ending during a tax year.

In addition, the exemption will only apply if, during the 183-day period, there was at least a 60-day continuous period of absence from South Africa. The Draft IN and IN16 confirm that any 12 month period could be taken for the purposes of this provision (ie a backward and forward looking approach). Furthermore, the services referred to in s10(1)(o)(ii) of the Act should in fact be the services performed that led to the generation of income that is now considered for exemption.

Those employers who are brave enough and of the view that the provisions of s10(1)(o)(ii) of the Act apply to a given employee's scenario, can elect not to deduct employees' tax (confirmed in the Draft IN and IN16). Given the inherent employees' tax late payment penalty, understatement penalty and interest risks associated with not complying with the provisions of s10(1)(o)(ii) of the Act, most employers in practice choose the route of least resistance and continue to deduct employees' tax, thereby passing the baton over to the employee to claim a refund on assessment. The relative size of those refund claims would, in most cases, trigger a SARS review in the hands of the affected employee.

In respect of calculating the 183/60 day periods, as required under s10(1)(o)(ii) of the Act, the Draft IN essentially continues SARS's previous

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practice (under IN16) whereby weekends, public holidays, annual leave days, sick leave days and rest periods spent outside South Africa are taken into account in determining any potential exemption. IN16 contains examples indicating the practical application of the '183/60 day approach' and it could reasonably be accepted, based on that practice, that the determination of an amount qualifying for exemption is relatively straightforward. That straightforward approach is set for a rethink under the Draft IN and employers need to carefully evaluate the impact on its employees that render services offshore.

The Draft IN states that a "common misconception is that all remuneration received or accrued during the qualifying 12 month period of 12 months is exempt". The Draft IN goes further to state that only "the remuneration received or accrued in respect of services rendered outside the Republic during the qualifying period of 12 months is exempt". SARS is correct in its approach, in my view, however, the practical application of the aforementioned statement may be based on an approach not considered by many employers (at least not in practice). Essentially, the Draft IN brings in an apportionment calculation, which seems to act as a 'second step' in determining the actual remuneration exempt from normal tax, once the 183/60 day tests have been complied with.

Stated differently, in any given situation, the first test would be to apply the normal 183/60 day rules, which take into account weekends, public holidays, annual leave days, sick leave days and rest periods, and, as a second test, apply SARS's apportionment methodology which excludes any day not regarded as a 'work day'. A 'work day', as contemplated in the Draft IN does not include "weekends, public holidays or leave days. Only days of actual services rendered are taken into account". The effect is that remuneration received for 'work days' in South Africa, would be subject to normal tax, whereas jetting in and out of South Africa could have slipped into the exemption potentially under IN16 (where no apportionment is contemplated).

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Clarity by way of a practical example is probably required in the final version of the Draft IN.

In determining the tax exempt portion under s10(1)(o)(ii) of the Act, the following apportionment formula is contemplated under the Draft IN:

> Exempt portion = (Work days outside South Africa for the period/Total work days for the period) x Remuneration received during the period.

The Draft IN provides various examples of the practical application of the apportionment approach and it would be in a taxpayer's best interest to fully understand how it applies to a given set of facts.

The Draft IN also deals with a common scenario where employees are required to take mandatory rest periods that are enforced by their home or host country's health and safety regulations and states that no "actual services are rendered during the rest periods, even though the employees remain in continuous employment during these periods. The services that are rendered to earn the remuneration are the services that are rendered during the work shifts". SARS concludes their view on the aforementioned scenario by stating that if "those services are rendered offshore and during a qualifying period, all remuneration attributable to those offshore services will qualify for exemption and no apportionment must be done". This approach is uncertain as it may be that the 183/60 day rules are complied with, but it is not clear whether compulsory health and safety rest periods (which are not annual leave) are then regarded as 'work days' outside South Africa. What if those compulsory rest periods are spent in South Africa – does it affect the 'work day' driver in the apportionment approach? Clarity by way of a practical example is probably required in the final version of the Draft IN.

Although not covered in this article, the Draft IN also expands on the approach to take in respect of share incentive scheme gains made under s8C of the Act. The apportionment approach contemplated for purposes of s8C of the Act follows on similar approaches already dealt with under Binding Private Rulings issued previously.

Employers and individuals rendering services offshore need to take account of SARS's contemplated approach under the Draft IN and ensure compliance with s10(1)(o)(ii) of the Act. SARS is going to tighten the requirements for being able to access the foreign employment tax exemption without necessarily changing the wording of the Act itself.

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