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TAX & EXCHANGE CONTROL ALERT

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TAXATION OF SUBSISTENCE ALLOWANCES – SARS ISSUES NEW RULING

On 24 January 2018, the South African Revenue Service issued Binding Private Ruling 291, which deals with the taxation of subsistence allowances paid by an employer to its employees under certain circumstances. BPR 291 specifically related to the interpretation of s8(1)(a)(i)(bb) read with s8(1)(c) of the Income Tax Act, No 58 of 1962.

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With reference to the evidence led, the Tax Court held that although social development expenditure may be claimed as a deduction, the Taxpayer could not prove that the R2 million was deductible in terms of s11(a) under the circumstances.

Facts

- XYZ CC (Taxpayer), who is in the business of supplying "agricultural" inputs, such as lime and gypsum, to farmers, disputed being taxed on an additional amount of R2 million by the South African Revenue Service (SARS), in respect of the 2013 year of assessment.
- The Taxpayer initially claimed that the amount of R2 million constituted social development expenditure incurred in respect of Entity E, an entity that also operates in the agricultural sector, and therefore constituted a permissible deduction, in terms of s11(a) of the Income Tax Act No 58 of 1962 (IT Act).
- SARS disallowed the deduction and imposed a 100% understatement penalty. The Taxpayer objected against these decisions and then appealed when its objection was disallowed.
- While giving evidence before the Tax Court, however, the Taxpayer's accountant testified that the R2 million was not part of the Taxpayer's gross income, based on a credit note the Taxpayer issued to Entity E, which allegedly reflected an agreed price reduction. Therefore, it was unnecessary to prove that the requirements of s11(a) of the IT Act had been met.
- Mr B, the sole member of the Taxpayer, gave evidence that he wanted to make a donation to the V Trust. The V Trust served a community in Kwazulu-Natal of which Mr A, who worked for Entity E, was the leader.
- When Mr B found out that he could not make a deductible donation to the V Trust in terms of s18A of the IT Act, he suggested an alternative arrangement. In terms of the arrangement, the Taxpayer would credit Entity E's account with R2 million. Entity E would then pass this gift to the community and the community would be told through the V Trust that the Taxpayer had made this donation.
- Mr B indicated that he wanted to get "some BEE points" out of this arrangement for the 2013 year. In order to prove that the money went to the community, Mr A's accountant wrote a letter addressed to the Taxpayer in which the V Trust thanked the Taxpayer for the donation.

Finding regarding the deduction claimed

With reference to the evidence led, the Tax Court held that although social development expenditure may be claimed as a deduction, the Taxpayer could not prove that the R2 million was deductible in terms of s11(a) under the circumstances. Furthermore, it also held that the Taxpayer could not prove that the sum of R2 million did not form part of its gross income, as suggested by the Taxpayer's accountant.

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In terms of s223(1) of the TA Act, where one is dealing with a so-called "standard case", a 100% understatement penalty will be imposed where it is alleged that the Taxpayer's conduct constituted "gross negligence".

Understatement penalties

After finding that the amount of R2 million formed part of the Taxpayer's taxable income for the 2013 year of assessment, the Tax Court had to consider whether SARS correctly imposed a 100% understatement penalty. In terms of s223(1) of the TA Act, containing the understatement penalty percentage table, where one is dealing with a so-called "standard case", a 100% understatement penalty will be imposed where it is alleged that the Taxpayer's conduct constituted "gross negligence".

The Tax Court made reference to the fact that in terms of the table in s223(1), a 50% understatement penalty applies when there are "reasonable grounds for the 'tax position' taken" and that a 25% understatement penalty applies when reasonable care was not taken in completing the return. The Tax Court held that in terms of s223(1), the circumstances in which the 25% and 100% penalties are to be applied, are therefore defined in terms of fault. However, the circumstances which give rise to a penalty of 50% are not defined in terms of fault, but rather with respect to the existence of a certain state of affairs, namely the absence of reasonable grounds for the tax position taken by the taxpayer.

In terms of s129(3) of the TA Act, where an appeal is brought against an understatement penalty, the "tax court must decide the matter on the basis that the burden of proof is upon SARS and may reduce, confirm or increase the understatement penalty". With reference to case law on this issue, the Tax Court found that in cases involving the exercise of a discretion by SARS, a tax court must exercise its own, original discretion. Thus here, the Tax Court itself had to consider whether or not the present case involved gross negligence on the part of the Taxpayer.

The Tax Court referred to the judgment in *MV Stella Tingas: Transnet Limited t/a Portnet v Owners of the MV Stella Tingas and Another* 2003 (2) SA 473 (SCA) where it was held that in order for there to be gross negligence, there must be a departure from the standard of the reasonable person to such an extent that it is extreme. It also referred to *Lewis Group v Woollam* 2017 (2) SA 547 (WCC), where it was held that so called "ordinary" negligence, poor business decision-making or misguided reliance by a company's director on incorrect professional advice, will not constitute gross negligence.

Based on the evidence given by Mr B, who was the sole member and therefore the directing mind of the Taxpayer, and the evidence given by the Taxpayer's

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This constituted a case of misguided reliance by a member of a close corporation on incorrect professional advice, which could not constitute gross negligence.

accountant, which were contradictory, the Tax Court held that both the objection and the appeal procedures were followed on advice given by the Taxpayer's accountant, which Mr B did not fully understand. Where there were contradictions between the evidence of these parties, Mr B's evidence was preferable. SARS tried to argue that the Taxpayer could not argue that it was the victim of poor advice from its accountants, but the Tax Court rejected this argument as the evidence showed that the "tax position" adopted by the Taxpayer was the result of advice given by the Taxpayer's accountant. In other words, this constituted a case of misguided reliance by a member of a close corporation on incorrect professional advice, which could not constitute gross negligence. As such, the Tax Court held that the understatement penalty must be reduced to 50% as there was an absence of reasonable grounds for the Taxpayer's tax position.

Comment

The judgment is helpful in that it explains how the types of conduct described in s223(1) of the TA Act should be interpreted. Most importantly, this judgment shows that SARS will only be entitled to impose a 100% understatement penalty for gross negligence, where it is clear that a taxpayer's conduct constituted either an extreme departure from the standard of conduct of the reasonable person or where the taxpayer's conduct constituted more than misguided reliance on incorrect tax advice. If SARS cannot prove this, a lower penalty must be imposed, which must be determined with reference to the facts of the matter.

Taxpayers should also take note that SARS has recently released a Draft Guide to Understatement Penalties, which could give an indication of SARS's interpretation of the understatement penalty provisions.

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TAXATION OF SUBSISTENCE ALLOWANCES – SARS ISSUES NEW RULING

In terms of s8(1)(a)(i)(bb) of the Act, where an amount has been paid or granted to a person by his principal as an allowance or advance during a year of assessment, that amount must be included in the person's taxable income.

On 24 January 2018, the South African Revenue Service (SARS) issued Binding Private Ruling 291 (BPR 291), which deals with the taxation of subsistence allowances paid by an employer to its employees under certain circumstances. BPR 291 specifically related to the interpretation of s8(1)(a)(i)(bb) read with s8(1)(c) of the Income Tax Act, No 58 of 1962 (Act).

Section 8(1)(c)(i) states that for the purposes of s8(1)(a)(i)(bb), the recipient will be deemed to have actually expended the amount of the expenses incurred by him in respect of accommodation, meals or incidental costs that he can prove.

Description of the proposed transaction

The applicant in BPR 291 is a South African resident employer (Applicant). In terms of the Applicant's subsistence and travel policy (Policy), employees who are required to spend at least one night away from their usual places of residence on local travel for business purposes receive an amount from the Applicant in respect of meals and incidental subsistence expenditure. The amount paid to them is equal to 80% per night of the prescribed maximum daily amount determined and gazetted (by SARS in the Government Gazette) in respect of meals and incidental costs under s8(1)(c)(ii) of the Act. The Applicant arranges and pays for the accommodation separately and in some cases the price of accommodation includes meals while in other cases it does not. The Applicant pays 80% of the gazetted amount, regardless of whether or not the price of accommodation includes a meal.

The legislative framework

Before discussing what SARS ruled in BPR 291, it is useful to consider the contents of the relevant legislative provisions.

In terms of s8(1)(a)(i)(bb) of the Act, where an amount has been paid or granted to a person by his principal as an allowance or advance during a year of assessment, that amount must be included in the person's taxable income, excluding the following: Any portion actually expended by the recipient on any accommodation, meals and other incidental costs, as contemplated in s8(1)(c), while such recipient is obliged because of the duties of his office or employment to spend at least one night away from his usual place of residence in South Africa.

Section 8(1)(c)(i) states that for the purposes of s8(1)(a)(i)(bb), the recipient will be deemed to have actually expended the amount of the expenses incurred by him in respect of accommodation, meals or incidental costs that he can prove. This amount is limited to the amount paid or granted to him to cover those expenses.

Section 8(1)(c)(ii) states that for the purposes of s8(1)(a)(i)(bb), a recipient shall be deemed to have actually expended for each day or part of a day while he is absent from his usual place of residence, such amount as SARS may determine by way of notice in the Government Gazette, in respect of meals and other incidental costs, or incidental costs only. The recipient's expenditure is limited to the amount paid or granted to meet those expenses. The proviso to s8(1)(c)(ii) states that the section does not apply to the extent that the employer has borne the expenses in respect of which the allowance was granted or where the recipient has proved to SARS any amount of actual expenditure in respect of meals or incidental costs for that day or part of that day, as contemplated in s8(1)(c)(i).

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An amount paid by way of an allowance in terms of the Policy which is less than the gazetted amount contemplated in s8(1)(c)(ii) will fall within the deeming provisions of s8(1)(c)(ii) only when the Applicant has not borne any of the expenses in respect of which the allowance is paid.

Ruling

Based on the abovementioned facts and legal provisions, SARS ruled as follows:

- An amount paid by way of an allowance in terms of the Policy which is less than the gazetted amount contemplated in s8(1)(c)(ii) will fall within the deeming provisions of s8(1)(c)(ii) only when the Applicant has not borne any of the expenses in respect of which the allowance is paid.
- If the Applicant bears any of the expenses in respect of which the allowance is paid, the maximum amount deemed to be expended under s8(1)(c)(ii) will be the gazetted amount, reduced by the amount of expenses borne by the Applicant. For example, in determining the maximum amount that will be deemed to be expended under s8(1)(c)(ii), the gazetted amount must be reduced by the breakfast charge when the accommodation paid for by the Applicant charges breakfast separately.
- The Applicant must retain documentary proof in the form of invoices of the expenditure incurred by the Applicant in order to establish the reduced deemed amounts as contemplated in s8(1)(c)(ii).
- BPR 291 does not apply to employees who have accepted permanent assignments for extended periods, due to the nature of the business of the Applicant, such as employees at the Applicant's offsite facilities and also does not apply to subsistence allowances paid in respect of travel outside South Africa.

Comment

BPR 291 appears to provide some guidance regarding the application of the provisions in s8 of the Act. It also seems to suggest that there might be some leeway for employers in structuring the subsistence allowances that they provide to their employees within the context of s8, although it is important to note that BPR 291 is only binding on the employer and employees referred to therein.

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