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TAX & EXCHANGE CONTROL **ALERT**

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Tax and exchange control considerations for South African tax residents taking up employment in the UAE

Because South Africa (SA) follows a residence-based tax system, SA residents are taxed on their worldwide income, irrespective of the jurisdictional source of their income. This means that a SA tax resident who becomes entitled to remuneration in respect of his employment services performed in the United Arab Emirates (UAE) will, as a rule, be subject to income tax in SA.

Standing the test of time: Updates to the wear and tear or depreciation allowance regime

A business' operational assets - such as computers, machinery, and vehicles - are crucial parts of any commercial enterprise. The consistent and sustained use of these assets in generating value for a business, leads to wear and tear over their useful lives. Recognising that the costs of these capital assets would not ordinarily be deductible under the general deductions formula, section 11(e) of the Income Tax Act 58 of 1962 was enacted to grant taxpayers a deduction for the wear and tear and/or depreciation of certain qualifying capital assets, used in that taxpayer's trade.

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Because South Africa (SA) follows a residence-based tax system, SA residents are taxed on their worldwide income, irrespective of the jurisdictional source of their income. This means that a SA tax resident who becomes entitled to remuneration in respect of his employment services performed in the United Arab Emirates (UAE) will, as a rule, be subject to income tax in SA.

However, relief is given under section 10(1)(o)(ii) of the SA Income Tax Act 58 of 1962 (ITA), which exempts from SA income tax, in a year of assessment, a maximum amount of R1.25 million, which is calculated on a proportionate basis (see Interpretation Note 16 (Issue 3) published by the South African Revenue Service (SARS) on 31 January 2020). This exemption may be helpful to tax residents entitled to a remuneration equal to that maximum amount (or lower) in respect of their employment exercised in a foreign country, such as the UAE, provided that all other requirements of section 10(1)(o)(ii) are satisfied (i.e. the individual is physically outside SA for 183 days in total during any twelve-month period of which at least 60 days must be continuously spent outside SA).

In light of the limited application of the section 10(1)(o)(ii) exemption, it is frequently asked whether SA individuals (who will retain their SA tax residency – see below), can obtain complete relief from SA income tax under the double tax agreement concluded between SA and the UAE (DTA). By way of example, let us say there is Mr X, a SA resident individual who accepts an offer to work on a full-time basis for a UAE-based employer for two years (receiving remuneration in excess of R1,25 million per annum), after which he will return to SA. Mr X will retain his SA tax residency and would like for his remuneration during this period to be fully exempt from SA income tax.

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Interestingly, some commentators have interpreted the words *"unless the employment is exercised in the other Contracting State"* in Article 14(1), as removing SA's taxing right completely and diverting the taxing right to the UAE, exclusively.

The SA/UAE DTA

Article 14 of the DTA gives taxing jurisdiction over the remuneration derived by a SA resident employee, between the State where the employment is exercised (i.e. the UAE) and where the employee is tax resident (i.e. SA). In this regard the general rule of Article 14 is contained in paragraph 1, which states as follows:

> *"... salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State".*

In applying Article 14(1) to Mr X's case, it means that the remuneration derived by him will be taxed by SA as the State of residence, and may also be taxed by the UAE, being the State where the employment is exercised, but only to the extent derived from employment exercised in the UAE. Thus, even though the UAE obtains a right to tax employment income under Article 14(1), it may not necessarily have the right to tax that income under the DTA if the income is not taxable in the UAE (which would likely be the case, as the UAE does not currently have an income tax regime on employment income).

Interestingly, some commentators have interpreted the words "*unless the employment is exercised in the other Contracting State*" in Article 14(1), as removing SA's taxing right completely and diverting the taxing right to the UAE, exclusively. However, this approach is likely incorrect, as confirmed in international case law such as the recent United Kingdom Supreme Court case of *Fowler (Respondent) v Commissioners for Her Majesty's Revenue and Customs (Appellant)*, where the court expressly held that "*... Article 14(1) does not prohibit the state in which an employee is resident from taxing him on his income earned abroad, but it merely permits (but does not require) the state where he is physically working to tax him*".

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Where SA tax residents retain their tax residency and receive employment income in the UAE, they will remain taxable in SA and will, at most, be entitled to the R1.25 million exemption (provided that all of the requirements of section 10(1)(o)(ii) are met).

A similar view was held in the First-Tier Tribunal's case of *Russell Fryett v The Commissioners for Her Majesty's Revenue and Customs*, in relation to Article 14(1) of the tax treaty concluded between the United Kingdom (UK) and Hong Kong (which is worded similarly to the SA/UAE DTA). The Tribunal stated that "*the second part of paragraph 1 (the words following "unless…") provide an exception to the rule set out in the first part where the employment is exercised in Hong Kong. The exception enables both the UK [i.e. State of residence] and Hong Kong to have taxing rights when the employment is exercised in Hong Kong*" (own emphasis).

This, of course, allows for the incidence of double tax. In such an instance, Article 22 of the SA/UAE DTA comes into operation to avoid double taxation, by requiring the State of residence (i.e. SA) to give credit for any tax paid in the State where the employment was exercised (i.e. the UAE). In the absence of any taxes in the UAE, of course, no credits will be given in SA.

It is worth noting that other Articles in the DTA are more specific in relation to which country has an exclusive taxing right, such as those dealing with directors' fees, pensions, social security, students, trainees, teachers and researchers, and any income must, at all times, be tested against these specific provisions.

In summary, where SA tax residents retain their tax residency and receive employment income in the UAE, they will remain taxable in SA and will, at most, be entitled to the R1,25 million exemption (provided that all of the requirements of section 10(1)(o)(ii) are met).

Whilst there is an exception in Article 14(2), it only prohibits the State where the employment is exercised to tax the income from the employment. As the employment is exercised in the UAE (and in the absence of income tax in the UAE, at least for the time being) this provision likely does not assist in the dilemma faced by SA tax residents, such as Mr X in our earlier example.

What if income tax is payable in the foreign state?

If the UAE does in future impose tax on employment income, it appears that SA tax residents will potentially not be liable for income tax in the UAE if all three of the following conditions are satisfied:

1. the individual is present in the UAE for a period or periods not exceeding the aggregate 183 days in any 12-month period that begins or ends during the taxable year concerned (i.e. the taxable year in which the services are performed);
2. the remuneration is paid by, or on behalf of an employer who is not a resident of the UAE; and
3. the remuneration is not borne by a permanent establishment or fixed base that the employer has in the UAE.

In the meantime, the above exception will be helpful in source States (i.e. States in which the employment is exercised) with a higher individual tax rate than SA, assuming that SA has a tax treaty with them. An example of such a state would be Austria, with a maximum marginal tax rate of 55% for individuals with income in excess of €1 million. Therefore, should a SA

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tax resident derive remuneration in respect of his employment exercised in Austria and satisfy the three conditions above (see Article 15(2) of the SA/Austria DTA), that person would likely be taxed in SA only regardless of the fact that his employment services would have physically been performed in Austria.

As illustrated above, South Africans will not be able to escape their SA income tax liability, on any structuring, whilst retaining their SA tax residency. Relinquishing tax residency in SA (commonly referred to as tax emigration) is an option, however, such a decision is entirely fact-dependent and may, in addition, trigger an *"exit tax"* in SA as a result of the deemed disposal rules under the ITA. Tax emigration is usually worthy of consideration in instances where an individual intends to permanently move to another jurisdiction and take up employment there. However, for individuals intending to return to SA at some point (therefore working outside of SA for a short-term period), this may not be the best option considering the potential tax triggered. More importantly for tax emigration, an individual is also required to convince SARS that his residency status has, in fact, changed. This process has become quite formal and requires more administration to place it on record with SARS, considering the additional forms required to be completed upon exiting SA, the requirement to apply for a tax compliance status letter (TCS Letter) and submit various supporting documentation to SARS.

Consideration may also be given to relinquishing exchange control status (commonly referred to as financial emigration), and the short and long-term benefits of such a decision (both tax and exchange control emigrations must be distinguished from relinquishing SA citizenship, and thus an individual's SA passport). The process for exchange control emigration requires approval from the South African Reserve Bank (SARB), and it must be noted that for an individual seeking to relinquish their tax residency, it is not a requirement to emigrate from an exchange control perspective. Conversely, exchange control emigration does not impact an individual's tax residency but may be a factor worthy of consideration in determining whether an individual broke his tax residency. Therefore, tax emigration and exchange control emigration are two separate processes that run independently of each other, however, may overlap as the fiscal authorities are bound to exchange information pertaining to an individual's emigration. In practice, exchange control emigration can only be obtained once a person has obtained a TCS Letter from SARS and to this extent, there is some interaction between the two processes.

In practice, proof of citizenship in the new country of residence would assist an SA taxpayer to prove tax (or exchange control) emigration. However, this may be quite difficult to obtain in other jurisdictions, especially the UAE, as individuals with

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work permits in the UAE are usually not permitted to obtain citizenship by mere reason of working there (and an individual's ownership of property or a business in the UAE does not necessarily entitle him to citizenship). Article 8 of the UAE's Federal Law No. 17 of 1972 (Federal Law 17) provides that citizenship may be granted to a person if that person has, *inter alia*, continuously resided in the UAE for a period not less than 30 years and is proficient in the Arabic language. There are instances in which certain individuals may be granted UAE citizenship earlier than the 30-year requirement (i.e. Article 9 of Federal Law 17 provides that those who render "*marvellous deeds for the country may be granted citizenship regardless of their period of residence*"), however, what constitutes a "*marvellous deed*" for purposes of Federal Law 17 is beyond the scope of this article, and will ultimately, depend on the circumstances of each case.

Conclusion

Where SA tax residents receive employment income in a foreign country, they will remain taxable in SA and will, at most, be entitled to the R1,25 million exemption, provided that all other requirements of section 10(1)(o)(ii) are met. When considering the (rather drastic) decision to emigrate, it is clear that an all-round approach cannot be adopted for every individual taking up an opportunity to work abroad, and the circumstances of each case, i.e. legal, tax, commercial and personal factors, must all be carefully considered in order to achieve the best outcome for each individual.

Moreover, those individuals already permanently living and working abroad (with no intention to return to SA) must ensure that they have emigrated compliantly and that they have settled their tax affairs prior to leaving the country, as their permanent residence in a foreign country will not prevent SARS from holding them to account for non-compliance.

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Standing the test of time: Updates to the wear and tear or depreciation allowance regime

These two SARS guidance documents contain the updated considerations and write-off periods for determining the useful life of a qualifying asset and therefore annual value of the allowance available to a taxpayer.

A business' operational assets - such as computers, machinery, and vehicles - are crucial parts of any commercial enterprise. The consistent and sustained use of these assets in generating value for a business, leads to wear and tear over their useful lives. Recognising that the costs of these capital assets would not ordinarily be deductible under the general deductions formula, section 11(e) of the Income Tax Act 58 of 1962 was enacted to grant taxpayers a deduction for the wear and tear and/or depreciation of certain qualifying capital assets, used in that taxpayer's trade.

Since 2015, section 11(e) (Wear and Tear Allowance) has been subject to several amendments. Some of these amendments have only recently taken effect and these amendments have led to the publication of new issues of SARS' Interpretation Note 47 and Binding General Ruling 7 (BGR 7). These two SARS guidance documents contain the updated considerations and write-off periods for determining the useful life of a qualifying asset and therefore annual value of the allowance available to a taxpayer.

The amendments have removed the Commissioner's discretion to determine the just and reasonable amount by which qualifying assets have depreciated in a given year and therefore the amount of the allowance. This amount is now to be determined on the basis of the periods of use listed for this purpose in a public notice issued by the Commissioner, or a shorter period of use approved by the Commissioner on application in the prescribed form and manner by the taxpayer.

A further notable consequence of the removal of the Commissioner's discretion applies to the determination of the value of a qualifying asset acquired by way of donation, inheritance, or distribution *in specie*. With the removal of the discretion, qualifying assets acquired in these ways will be valued at an arm's-length, market value price only.

The Previous Dispensation

Prior to the amendments coming into force, the general guardrails for the exercise of the Commissioner's discretion to quantify the Wear and Tear Allowance were contained in the previous issues of Interpretation Note 47 and BGR 7.

BGR 7, which reproduces certain parts of Interpretation Note 47, contains SARS' binding interpretation of how the Wear and Tear Allowance ought to apply. It deals with *inter alia*:

- The valuation of qualifying assets,
- The methods available to depreciate qualifying assets over time, and
- The ordinary useful lives of various types of assets over which the allowance will apply, also known as write-off periods.

BGR 7 previously bound SARS to the methods for calculating depreciation and the write-off periods it sets out. However, this was subject to alteration by exercise of the Commissioner's discretion, in circumstances where applying BGR 7 would not result in a just and reasonable depreciation value. Similarly, the valuation of a qualifying asset received through a donation, inheritance or distribution *in specie* could be discretionarily altered

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The amended section 11(e) does not contain a discretion for the Commissioner to determine a just and reasonable value for depreciation. Now, the value of the qualifying asset will be determined solely under the acquisition cost provision in 11(e)(vii).

by the Commissioner. These discretionary alterations would, according to BGR 7, be exercised upon audit or assessment by SARS.

The updated section 11(e) and new SARS guidance

Following the coming into effect of the amendments to section 11(e), the guidance issued by SARS was similarly amended to reflect the changes to the legislation. The SARS guidance takes the same form as it did previously with new issues of Interpretation Note 47 and BGR 7 being published on 9 February 2021.

As noted above, the amended section 11(e) does not contain a discretion for the Commissioner to determine a just and reasonable value for depreciation. Now, the value of the qualifying asset will be determined solely under the acquisition cost provision in 11(e)(vii). This provision deems the cost of the qualifying asset to be the market value in an arm's length transaction.

Further, SARS is now bound to publish the lists of write-off periods for qualifying assets, as has been and is currently contained in BGR 7. These write-off periods are used for disaggregating the depreciation over the useful life of the qualifying asset. Another new aspect of the Wear and Tear allowance is a formalised process for applying to the Commissioner for a shortened write-off period.

The new issue of BGR 7 deals with two further notable aspects which are not addressed in the previous issue, being: the implications of section 24M, dealing with unquantifiable acquisition costs; and personal use assets becoming used in a taxpayer's trading activities.

Section 24M(2) regulates the consequences of a taxpayer disposing of or acquiring an asset where part of the consideration is unquantifiable. Section 24M(4) deals with circumstances where a taxpayer would have received a greater amount of Wear and Tear Allowance, but for the unquantifiable part of the acquisition cost of such asset. It provides that in such a circumstance, where the amount becomes quantifiable, then a "*catch-up*" allowance will be granted in that year of assessment.

BGR 7 also details SARS' position where personal use assets later become used in the taxpayer's trade. SARS takes the view that it is unacceptable that the original acquisition cost be used as the basis for depreciation. Therefore, BGR 7 takes the stance that the value of the qualifying asset must be determined at the date when the asset is brought into use for trade, as the lower of the original market value or the market value at the date when it is brought into trade. The write-off period must similarly be determined at the date the asset is brought into trade, considering its condition at that point.

Comment

The amendments to section 11(e), while not fundamentally changing the way the Wear and Tear Allowance operates, do provide more certainty and clarity for taxpayers. SARS had previously attempted to provide taxpayers with this certainty in the form of published and binding guidance. Now with a formal requirement for this guidance in the Income Tax Act, taxpayers engaged in trades are assured of having a means to better understand the Wear and Tear Allowances available regarding various qualifying assets.

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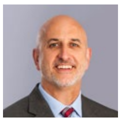

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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