Tax & Exchange Control

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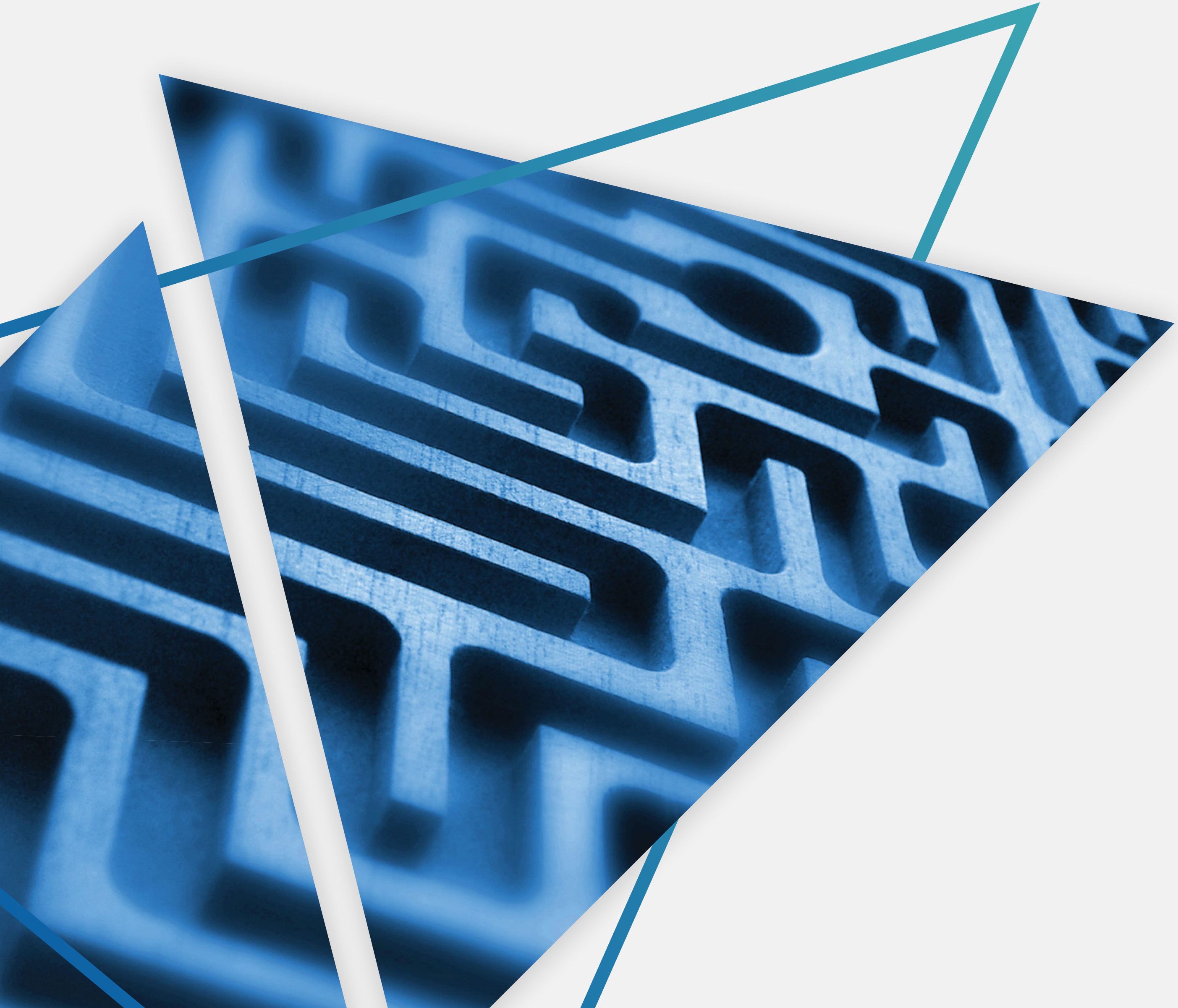

In this issue

SOUTH AFRICA

When a grant isn't 'free': Understanding the tax treatment of government grants under section 12P

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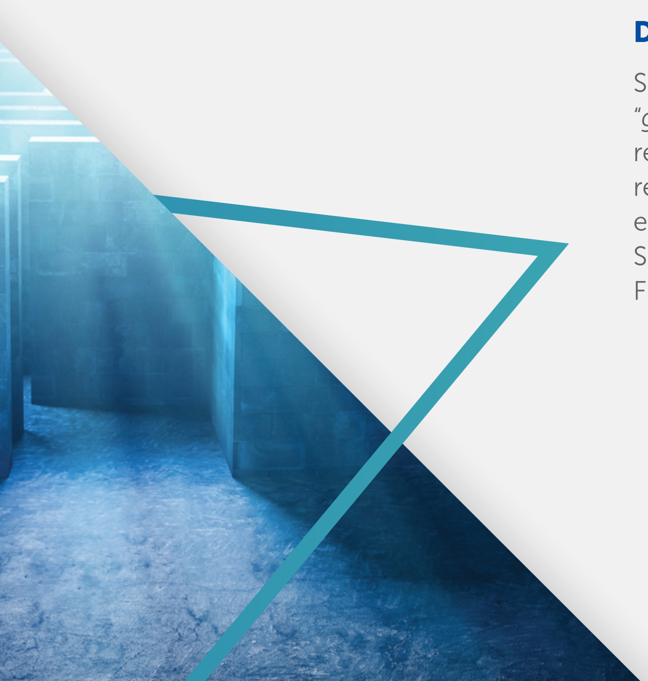
When a grant isn't 'free': Understanding the tax treatment of government grants under section 12P



Government grants play an important role in supporting South African businesses, particularly in sectors targeted for development or transformation. However, the assumption that such grants are automatically tax free is incorrect. In terms of the Income Tax Act 58 of 1962 (Act), government grants could be included in gross income unless a specific exemption applies or they are of a capital nature.

Section 12P of the Act sets out a narrowly defined exemption framework, supported by anti-avoidance rules designed to preserve tax neutrality. This article outlines the key principles governing the taxation of government grants, with reference to section 12P, its interaction with sections 24C and 8(4), and the South African Revenue Service's (SARS) latest guidance contained in Interpretation Note 59 (Issue 3), published on 25 March 2025.

Default position and scope of the exemption

Since the inclusion of paragraph (lC) in the definition of *"gross income,"* SARS has taken the view that amounts received by way of government grants, whether capital or revenue in nature, are taxable unless exempted. Section 12P exempts only those grants that are listed in the Eleventh Schedule or designated as exempt by the Minister of Finance in the Government Gazette.

Interpretation Note 59 (Issue 3) confirms that a grant's exemption status must be determined strictly with reference to these sources. Notably, only grants made by a department or sphere of government qualify and they must be listed in the Eleventh Schedule to the Act or be specifically identified by notice. Notably, the Supreme Court of Appeal (SCA) has confirmed that municipal-owned entities, such as City Power SOC Ltd, are not themselves *"government"* for purposes of section 12P as they are separate juristic entities and do not form part of the local sphere of Government as defined in section 40 of the Constitution.

Anti-avoidance rules: Deduction limits and asset cost reductions

Where a grant is exempt, section 12P(3) to (6) ensures the taxpayer does not receive a double benefit. If used to fund deductible expenditure or trading stock, the deduction must be reduced by the grant amount. If applied to acquire an asset that qualifies for wear-and-tear or capital allowances, the base for such allowances must be reduced accordingly. For non-allowance assets, such as land, the capital gains base cost must be reduced.

Section 12P(6) serves as a catch-all rule. Any portion of an exempt grant not already offset must reduce other deductible expenditure. If the grant exceeds expenditure in a given year, the excess is carried forward and reduces deductions in subsequent years.

When a grant isn't 'free': Understanding the tax treatment of government grants under section 12p

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To illustrate: if a taxpayer receives a R1 million exempt grant and incurs R600,000 in deductible expenses (which expenses were funded by the grant), then no deduction is allowed in that year. The remaining R400,000 is carried forward in terms of section 12P(6)(b) and will reduce deductions in the following year, provided they are also not limited. In contrast, if the grant is not exempt, the full R1 million is included in income, and the R600,000 may be deducted under normal principles.

Timing mismatches and section 24C relief

Grants may be received before the related expenditure is incurred, creating timing mismatches. In such cases, section 24C may provide relief, allowing a deduction for future expenditure where the grant is received under a binding agreement that obligates the taxpayer to perform in a future year.

Importantly, the relief under section 24C is only available where both the income and the future expenditure arise from the same agreement. This principle was confirmed by the Constitutional Court in *Big G Restaurants (Pty) Ltd v CSARS* [2020] (6) SA 1 (CC), which held that the future obligation must be enforceable under the same agreement that gives rise to the income.

It was held that under section 24C of the Act, the contract in terms of which income is received or accrues (income-earning contract) must be the same contract that imposes the obligations, the performance of which is to be financed with that income (obligation-imposing contract). To the Constitutional Court this demonstrated a requirement of "*sameness*". However, the Constitutional Court did not read the sameness requirement in the section to connote that there must be one single contract stipulating for the earning of income and the imposition of future expenditure. Two or more contracts may be so inextricably linked that they may satisfy this requirement.

Taxpayers must therefore preferably ensure that the terms of the grant agreement itself give rise to a binding obligation to incur future expenditure in order to rely on section 24C. Alternatively, if there are two or more contracts, one should comply with the guiding principles in the *Big G* case and others such as *Clicks Retailers (Pty) Ltd v CSARS* 84 SATC 71.

Recoupment risks and special rules for energy assets

If a grant reimburses prior expenditure, or if an asset funded by a grant is disposed of, a recoupment may arise. While section 8(4)(a) governs general recoupments, section 12P typically neutralises this by reducing initial deductions or base cost, thereby limiting the scope of recoupment. This prevents the need for recoupment under section 8(4)(a), avoiding double taxation.

When a grant isn't 'free': Understanding the tax treatment of government grants under section 12p

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A more specific recoupment rule applies in terms of section 8(4)(nA), introduced alongside the renewable energy incentive under section 12BA. If a taxpayer claims the 125% allowance and disposes of the qualifying asset prematurely, a portion of the proceeds (i.e. the 25%) must be brought into income (over and above the normal recoupment under section 8(4)(a)). Interpretation Note 59 explains how this interacts with section 12P's asset-related limits.

Conclusion

While government grants can provide meaningful financial support, their tax treatment is subject to strict rules. Section 12P provides exemption only in limited cases and imposes reductions to deductions or base cost to prevent double benefits. Interpretation Note 59 (Issue 3) offers essential guidance and should be consulted when assessing the appropriate treatment of any grant, especially with reference to understanding SARS' position.

Taxpayers must verify whether a grant is exempt and maintain clear records of how funds were applied. Missteps, whether through incorrect classification, premature deductions, or failure to apply the anti-avoidance provisions, may result in tax adjustments, penalties, and interest. As SARS continues to monitor grant-funded expenditure closely, early and accurate treatment is critical. Where uncertainty exists, particularly in complex, multi-year projects, professional advice should be sought.

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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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