South African Institute of Tax Professionals

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The South African Revenue Service

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RE: DRAFT INTERPRETATION NOTE: NO. 9 (Issue 6)

Provided below are SAIT's comments relating to the Draft Interpretation Note: No. 9 (Issue 6).

The comments are presented in the order of the paragraphs used in the Draft Interpretation Note. When reference is made to the 'Draft Interpretation Note' we used the abbreviation 'Draft Note'. References to a section will be to a section in the Income Tax Act, unless stated otherwise.

The use of the words 'proposed' and 'bill' in the footnotes

The last sentence in footnote 10 reads as follows:

> "The examples in this Note assume this proposed amendment is promulgated."

The issue here is the effective date of the R20 million amount. Apart from the fact that none of the examples in the Draft Note, where the year of assessment ended before this effective date, refers to the R20 million, the assumption is not appropriate. This is because the Act was actually promulgated.

The footnote should really just state that the fact regarding the effective date and may refer to the relevant amendment Act.

There are a number of other footnotes that also refer to a "Bill" and use the word "proposed". They are footnotes 10, 29, 62 and 64.

It is accepted that these footnotes were inserted in the previous version of this Interpretation Note. As all these Bills were promulgated it is suggested that the footnotes rather refer to the relevant Amendment Acts. The use of the word 'proposed' must similarly be dropped from the footnotes. If not, it would leave the reader wondering whether or not the proposal was in fact legislated.

Paragraph 4.1.1 - Legal entity requirement [section 12E(4)(a)]

(c) Private company

We agree that section 12E(4)(a) requires that a "small business corporation' must be any private company as defined in section 1 of the Companies Act. Before the promulgation of the Taxation Laws Amendment Act, 2013, the requirement referred to a "private company as defined in section 1 of the Companies Act 1973 (Act 61 of 1973). The Companies Act, Act 71 of 2008, became effective on 1 May 2011, and the Income Tax Act was accordingly amended and since then section 12E refers to the 2008 Act.

The old Companies Act defined (in section 20) a 'private company' as a company having, amongst others, a share capital and which by its articles restricts the right to transfer its shares, limits the number of its members to 50, etc. The relevant principal was that the company must have a share capital. Certain companies did not have a share capital and had the liability of its members limited by the memorandum of association (in the Act they were termed 'a company limited by guarantee'). They would then not have qualified as a small business corporation.

SARS didn't deal with this issue in the previous versions of Interpretation note 9.

In the past incorporated practices were treated as private companies for purposes of section 12E, presumably because they had a share capital. It seems unfair that, with the advent of the new Companies Act, these practices no longer qualified as a small business corporation. We accept that this may be policy issue and the matter should be raised not as a comment on the Draft Note.

Paragraph 4.1.3 - (a) Gross income

The Draft Note states that the "term "accrued to" was held by Watermeyer J (as he then was) in WH Lategan v CIR to mean – "to which he has become entitled"."

The general accepted view is that it must be an unconditional right (or entitlement) – see for instance Judge Hefer comments in Cactus Investments v CIR. The Judge confirmed the view expressed in CIR v People's Stores (Walvis Bay) (Pty) Ltd – which the note confirms in footnote 13.

It is suggested that the word accrued is explained by including the unconditional element.

Example 2 – Determination of gross income limitation

The following fact is given in this example:

> "The qualifying entity acquired a machine contemplated in section 12E(1A) on 1 August 2014 and commenced using it on 15 August 2014".

It is not clear what the relevance of this fact is as it was already stated that the entity "started trading activities on 15 August 2014." It is therefore suggested that the sentence copied above be removed from the facts in the example, or alternatively it must be stated in the facts that it has no bearing on the grossing-up of the gross income amount where the period is less than 12 months.

Paragraph 4.1.4

Example 3 – Determination of investment income

In the suggested solution to the facts of the example the following interpretation is stated:

> "The provision of serviced accommodation at the guesthouse gives rise to rental income from immoveable property which is "investment income" as defined. The room rate is a daily fixed periodical return, the guest is a tenant or occupier of the room and the guesthouse owner is a landlord."

At issue are the words, in the definition of 'investment income', "any income in the form of … rental derived in respect of immovable property".

The first important point is that the Act uses the word 'rental'. It doesn't use the word 'lease' or 'dwelling' (which includes a room), as for instance is used in the Rental Housing Act, 1999. As the word rental is not defined it is generally accepted that one must "apply ordinary rules of grammar and syntax" – see Judge Chacalia's view in Chetty v Hart.

The Oxford dictionary (http://www.oxforddictionaries.com/definition/english/rent) provides the following meaning:

> "A tenant's regular payment to a landlord for the use of property or land".

According to the Legal dictionary, at http://legal-dictionary.thefreedictionary.com/rent, it means:

> 1) v. to hire an object or real property for a period of time (or for an open-ended term) for specified payments. 2) n. the amount paid by the renter and received by the owner.

It is submitted that the meaning of the word 'rental' is therefore limited to the amount derived from the use of the property. In a sense we are saying that rental is the amount derived from the immovable property itself. On that basis the provision of 'serviced accommodation' is not 'rental'.

At best one can say that the amount derived from 'serviced accommodation' may include a portion attributable to the rent of the property concerned, but that would then also include, in addition to the room itself, the other articles (such as furniture therein). It is unlikely that a lay person would equate the amount charged by a hotel, for a furnished room, as rent. It would commonly be referred to as the provision of lodging or accommodation and not as rental. This is particularly true where the accommodation is provided for short periods of time, such as on a daily basis.

It is submitted that it is not correct to interpreted 'in the form of … rental derived in respect of immovable property' as including amounts derived from serviced accommodation. It is also suggested that the interpretation if rental not be done in the example, but rather in the text preceding the example.

(b) Definition of "personal service" [section 12E(4)(d)]

It is clear from the previous issues of Interpretation Note 9 that SARS's interpretation in this regard changed over the years. Most notably, the view changed after Tax Court case 12680 where the interpretation of the term "personal service" as used in section 12E was considered by Judge Mbha.

We start with some general observations first.

The relevant words in the legislation are found in section 12E(4)(a)(ii) and reads as follows:

> "where … not more than 20 per cent of the total of all receipts and accruals (other than those of a capital nature) and all the capital gains of the company, close corporation or co-operative consists collectively of investment income and income from the rendering of a personal service…"

It is therefore the receipts or accruals from the rendering of a personal service.

We agree with the general statement that "a personal service refers to a service rendered for which the income derived is mainly a reward for the personal efforts or skills of an individual." The definition, of personal service, limits this (with reference to the words 'an individual') to a service performed any person who holds an interest in the entity. This the person referred to the 'holder of shares … or member" in section 12E(4)(a)(ii). (The Draft Note makes this point as well). The principle is that if the services are rendered by employees of

the entity or other persons who are not holders of shares or members, the service would not be a personal service.

The Draft Note makes the point that "only the portion of the income from the rendering of the service by the person holding the interest is regarded as income from the rendering of a personal service." This of course is only relevant with reference to the requirement that the service must be rendered by the holder of shares or member. It brings us to the comment that "a Rand-value apportionment of the income which is attributable to that person's involvement". This point was not raised in any of the previous versions of Interpretation Note 9. It does create a practice generally prevailing by stating that it is not required.

We agree that the phrase "income from the rendering of a personal service" would require such an apportionment, but don't agree that it is relevant to the definition of 'personal service' itself. Clearly, where the services rendered by the individual concerned include the use of employees of the entity, apportionment is necessary and we agree that the apportionment would be a complicated matter.

The words "any service in the field of" preceding the categories of services listed in the definition suggest that a wide interpretation must be applied to these categories. Therefore, the list must be interpreted to include every service in the specified field irrespective of whether it is of a professional nature.

This brings us to the requirement that an employee must be 'engaged in the business of' the entity 'of rendering that service'. We welcome the fact that the principle is being dealt with on this Draft Note. We agree that "the persons considered in the employee count need not necessarily be involved in an activity that directly generates the income from the potential personal service." From the meaning of the word, according to the Oxford Dictionary, it is clear that engage (or engaged) has the wide meaning of 'participate or … involved in". On that basis all employees that are indirectly involved in r part of rendering the service are engaged in the business of rendering that service.

The statement that "if one of these requirements for a personal service is not met, the qualifying entity will not be rendering a personal service for purposes of section 12E" is a bit confusing. It may be because of the

two times the word “not” appears in it. The principle is that both requirements must be met for the service to be a personal service. So if only one of them applies, the service would not be a personal service.

Example 7

We agree that the employees of Compzone CC are not engaged in the rendering of the computer software development service.

We suggest that an example where they were involved would have been useful. It would deal with the principle of apportionment mentioned earlier and would add value to understanding the practice prevailing.

Paragraph 4.2.2 - Other assets [section 12E(1A)]

The Draft Note states that:
“Assets used by a person carrying on farming activities which qualify for a deduction under paragraph 12(1) or 12(1A) of the First Schedule.51

- Assets for which a deduction may be granted under sections 12B, 12C, 12DA,12E(1) or 37B…”

It must be remembered that section 12B(1)(f) also refers to farming operations.

(d) Election of the small business corporation in the year the asset is brought into use

It is stated that “one of the ongoing requirements of section 11(e) is that the asset must be used for the purposes of the taxpayer’s trade. This requirement means that a taxpayer that fails to use the asset in a year of assessment will not be entitled to the allowance for that year of assessment.”

In example 15 it is also mentioned that ‘if the asset was not used during the third year the taxpayer will not be allowed to claim the 20% allowance.”

The relevant requirement in section 12E(1A) is that it must be an asset 'in respect of which a deduction is allowable under section 11(e)'. Its purpose is therefore to define the asset and not to provide a deduction. One must only look to section 12B(1A) to determine when and how the deduction is allowed. It doesn't, as for instance section 12C(3)(c) that refers to an asset disposed of in a previous year, deal with the deduction in the first and second succeeding year where the asset is not used.

As the taxpayer is still carrying on a trade one would expect that the deduction would still be available.

Please don't hesitate to contact us if you have any questions with regard to our comments.

Sincerely

PJ Nel