INTERPRETATION NOTE: NO. 59

DATE: 10 December 2010

ACT : INCOME TAX ACT, NO. 58 OF 1962 (the Act)

SECTIONS : SECTION 1 – DEFINITION OF "GROSS INCOME", SECTIONS 10 AND 23(*n*)

SUBJECT : TAX IMPLICATIONS OF THE RECEIPT OR ACCRUAL OF GOVERNMENT GRANTS AND GOVERNMENT SCRAPPING PAYMENTS

CONTENTS

PAGE

Preamble 2

1. Purpose 2

2. Background 2

3. Application of the law 3

3.1 Section 1 – Definition of "gross income" 3

3.2 Receipt or accrual of a capital or revenue nature 3

3.2.1 General remarks 3

3.2.2 Government grants calculated with reference to accounting profits or loss of future income 4

3.2.3 Trading receipts 4

3.2.4 Compensatory receipts 7

3.2.5 Government grants to assist or compensate a person in meeting costs of a capital nature 8

3.3 Conditional receipt 9

3.4 Section 8(4)(*a*) recoupment 10

3.5 Specific inclusion: Farming – Subsidies 11

3.6 Specific exemptions 11

3.6.1 Exemption under section 10(1)(*y*) – Programmes approved under the national budget process 11

3.6.2 Exemption under section 10(1)(*y*A) – Official development assistance 12

3.6.3 Exemption under section 10(1)(*z*A) – Export incentives 13

3.6.4 Exemption under section 10(1)(*z*E) – Small Business Development Corporation Limited 15

3.6.5 Exemption under section 10(1)(*z*G) – Films 15

3.6.6 Exemption under section 10(1)(*z*H) – Specific programmes 15

ARCHIVED

3.6.7 Exemption under section 10(1)(*z*I) – Public Private Partnership (PPP) 16
3.7 Government grants received for research and development expenses..... 16
3.8 Anti-double-dipping rules [section 23(*n*)]..... 17
4. Conclusion 17

Preamble

In this Note –

- unless the context otherwise indicates, any word or expression in this Note bears the meaning ascribed to it in the Act;
- references to sections are to sections of the Act;
- **"Eighth Schedule"** means the Eighth Schedule to the Act; and
- **"government"** refers to any "organ of state" as defined in section 239 of the Constitution of the Republic of South Africa, 1996 ("the Constitution").

1. Purpose

This Note provides guidance on the tax consequences resulting from the receipt or accrual of government grants and government scrapping payments.

2. Background

The term "government grant" is defined in section 1 to mean –

> "an appropriation, grant in aid, subsidy or contribution, in cash or kind, paid by a department listed in Schedule 1 to the Public Service Act, 1994 (Proclamation No. 103 of 1994), (other than a provincial administration), but does not include any amount paid in respect of the supply of any goods or services to that department".

The term "government scrapping payment" is defined in section 1 to mean –

> "any amount, in cash or otherwise, paid to any person by any department listed in Schedule 1 to the Public Service Act, 1994 (Proclamation No. 103 of 1994) (other than a provincial administration), or any such amount paid by any entity listed in the Schedules to the Public Finance Management Act, 1999 (Act No. 1 of 1999), in respect of an asset of that person supplied to that department or that entity solely for purposes of the scrapping, demolition or destruction of those assets for the purposes of public health and safety".

In the context of income exempt from normal tax, the term "government grant" is only used in section 10(1)(*y*). In other instances, however, the term "grant" is used, and in such event it becomes necessary to consider the ordinary dictionary meaning of the term.

In the *Oxford Dictionary Thesaurus, and Wordpower Guide*[1] the term "grant" is defined as –

> "a sum of money given by a government or public body for a particular purpose".

[1] 2 ed (2001) Oxford University Press Inc., New York.

ARCHIVED

3. Application of the law

3.1 Section 1 – Definition of "gross income"

The term **"gross income"** is defined in section 1 and means in relation to any year or period of assessment –

- in the case of a resident (as defined in section 1), the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of the definition, such amounts (whether of a capital nature or not) so received or accrued as are described in paragraphs (*a*) to (*n*) of the definition; or
- in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of the definition, such amounts (whether of a capital nature or not) so received or accrued as are described in paragraphs (*a*) to (*n*) of the definition.

The computation of the gross income of a resident and the gross income of a person that is not a resident differs as follows:

- The receipts or accruals of a resident from all sources are brought to account.
- Only the receipts or accruals from a source within or deemed to be within the Republic are brought to account by a person that is not a resident.

The term **"income"** is defined in section 1 and means –

> "the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II".

The exemptions from normal tax are contained in section 10, which falls under Part I of Chapter II of the Act.

The first step in determining whether a grant is subject to normal tax is to determine whether or not it forms part of a person's gross income. Any receipts or accruals of a capital nature are as a general rule excluded from a person's gross income. However, certain grants are specifically included in gross income regardless of whether or not they are of a capital nature. If the first test results in the grant being included in gross income, the next step is to determine whether the particular grant qualifies for an exemption from normal tax under section 10.

3.2 Receipt or accrual of a capital or revenue nature

3.2.1 General remarks

Receipts or accruals of government grants only form part of a person's gross income if they are of a revenue nature. Receipts and accruals of government grants of a capital nature are by definition excluded from a person's gross income. The term "of a capital nature" is not defined in the Act. Whether an amount received or accrued is of a capital or revenue nature depends on its character in the hands of the recipient.

ARCHIVED

3.2.2 Government grants calculated with reference to accounting profits or loss of future income

The mere fact that a grant which is received by or accrues to a person is calculated with reference to accounting profits does not necessarily imply that it is income in nature. For example, in *DCT (Vic) v. Phillips*, Dixon & Evatt JJ[2] held that it is true that to treat a sum of money as income because it is computed or measured by reference to loss of future income is an erroneous method of reasoning.

In addition the court held that the right to future income may be an asset of a capital nature and the sum measured by reference to the loss of future income may be a capital payment made to replace that right.

3.2.3 Trading receipts

A government grant will be of a revenue nature in the hands of a person carrying on trading operations if it is a trading receipt. A grant is a trading receipt if its receipt is a normal incident of a person's trading operations. The nature of the grant received and the relationship which exists between the grant received and the recipient's activities needs to be examined.

A government grant will be a trading receipt when it is paid in order to assist in meeting a person's trading obligations or in order to assist in carrying on trading operations. A grant of this nature results in trading receipts being supplemented and accordingly is itself a trading receipt.

By contrast, any amount received or accrued for the purpose of –

- establishing an income-earning structure, or
- as compensation for the surrender of such a structure,

is of a capital nature.

A payment received as compensation for discontinuing a distinct part of a person's business operations is likewise of a capital nature. The above-mentioned receipts are not normal incidents of a person's trading operations.

The test whether a receipt or an accrual is of a capital or revenue nature is a factual inquiry. The following foreign case law provides guidance.

In *Seaham Harbour Dock Co v Crook (H.M. Inspector of Taxes)*[3] a harbour dock company had applied for and obtained grants from the unemployment grant committee. These grants were paid as the work progressed and were equivalent to half the interest on approved expenditure met out of loans. The payments were made several times a year for several years. In finding that the amounts were not trading receipts, Lord Buckmaster said the following:[4]

> "It was a grant … by a government department with the idea that by its use men might be kept in employment … I find myself quite unable to see that it was a trade receipt or that it bore any resemblance to a trade receipt."

It was said by Lord Atkin that the amounts –

[2] (1936) 55 CLR 144 at 156.
[3] (1931) 16 TC 333.
[4] At 353.

ARCHIVED

> "were received by the appropriate body not as part of their profits or gains or as a sum which went to make up the profits or gains of their trade."

In *Ryan (H.M. Inspector of Taxes) v Crabtree Denims Ltd*[5] a grant was likewise paid to the taxpayer company in order to enable it to retain persons in employment. The amount of the grant was calculated with reference to the interest which would have been payable on a £200 000 loan taken out by the taxpayer company. The court distinguished this case from the *Seaham* case cited above based on the fact that in the last-mentioned case the purpose of the payment was to add to the capital sum available to the company for carrying on certain works while in the *Ryan* case cited above the payment, under the grant, was neither of a revenue nor of a capital nature. According to the court the taxpayer company was free to do with the grant what it liked.

In the *Ryan* case cited above the court found that the grant was undifferentiated, that is, the grant was not expressly appropriated either to a capital or a revenue purpose and, therefore, the grant was a revenue receipt.

In *Poulter (H.M. Inspector of Taxes) v Gayjon Processes Ltd*[6] the court had to consider whether payments received from the Department of Employment in order to enable a company to retain persons in employment were to be treated as capital or revenue. Walton J held that it did not matter whether the payment was expressly earmarked for a revenue purpose or whether it was to be paid to the taxpayer company for use in its business as an undifferentiated receipt; in either case it fell to be treated as a revenue payment.

In *Pontypridd and Rhondda Joint Water Board v Ostime (H.M. Inspector of Taxes)*[7] the salient facts were as follows:

- A water board was authorised by a local Act to supply water direct to consumers in the districts of its two constituent authorities and to sell water in bulk to water undertakings in two more districts.
- In the event of an estimated deficit in its net revenue for any year the board was authorised to issue instructions to its two constituent authorities calling for lump sums to be contributed to them, which they might pay either from their respective district funds or by levying rates.
- If either authority defaulted in payment the board was empowered, by instruction, to raise the necessary amount by levying a rate in place of the defaulting authority.

The issue was whether the sums received under the instructions to meet an estimated deficiency were trading receipts.

The court held that the amounts received by the Pontypridd and Rhondda Joint Water Board in terms of the instructions were paid in order to assist the board in meeting its trading obligations and, therefore, the amounts were trading receipts.

Viscount Simon summarised the question at issue in the *Pontypridd* case in two propositions. First, payments in the nature of a subsidy from public funds to an

[5] (1987) STC 402.
[6] (1985) STC 174.
[7] (1946) 1 ALL ER 668.

ARCHIVED

undertaker to assist in carrying on its trade are trading receipts. Secondly, this is subject to the exception that if the undertaker is a rating authority, and the subsidy is the proceeds of rates levied by the undertaker itself, there is no question of profits arising from trade, because there is no identity of source with the recipient.

The court found that the amounts received in terms of the instructions supplemented the board's business trading receipts so that it could maintain its trading solvency.

Example of a government grant that is revenue in nature

The Skills Development Act, No. 97 of 1998 makes provision for refunds to employers that have provided training for their employees, through a registered provider. Employers can claim back a portion of their skills development levy paid to SARS. Regulations to the Skills Development Act, 1998 indicate that a company may claim back two grants, namely –

- 15% of its levy by submitting a training plan to its Sector Education Training Authority (SETA); and
- 45% if it submits a training implementation report to its SETA.

Examples of whether the receipt of a government grant is a trading receipt or a capital receipt

Example 1 – Government grant paid to small business enterprises as incentives to incorporate

Facts:

Government grants are paid to small business enterprises operating as partnerships as incentives to incorporate, in order to increase the range and quality of services offered to the public. In terms of the programme the partnerships are encouraged to amalgamate and incorporate into a number of large private companies.

The purpose is to fund only those expenses that relate directly to –

- investigations undertaken to explore the benefits and disadvantages of amalgamation and incorporation;
- feasibility studies on amalgamation and incorporation; and
- actual amalgamation of the enterprises.

Result:

The grant received is not a receipt that relates to the carrying on of a business, but rather to the termination of one business and the start of another. The grant received is a capital receipt.

Example 2 – Receipt of a government grant as a reward for services rendered

Facts:

A contractor tenders for a specific contract with the Government of South Africa. The tender is successful and as a result the contractor receives a government grant, paid in advance of performance of the contract. Under the terms of this contract the

ARCHIVED

person must provide written recommendations to the government on ways that government departments can reduce their energy consumption.

Result:

An amount was granted to the contractor for purposes of undertaking a specific project. The grant is not a severable part of the contract. It is subject to the contractor meeting the performance terms provided for in the contract. The grant is money to which the contractor is entitled in terms of the contract as a reward for services rendered and is of a revenue nature.

3.2.4 Compensatory receipts

A compensatory receipt generally takes the form of the item it replaces. Accordingly, a payment made to reimburse or compensate a person for a revenue expense or loss will ordinarily be of a revenue nature and must be included in gross income.

The following are examples found in case law:

- In ITC 1557[8] the issue was whether compensation received by a taxpayer from the Department of Transport as a result of the introduction of a railway service that resulted in the closure of a particular bus route of the taxpayer was of a capital or revenue nature.

  The taxpayer's main business was "the conveyance of persons or goods on a public road by means of a motor vehicle for reward". A claim for compensation was made by the taxpayer under section 26A of the Road Transportation Act.[9] The taxpayer's income-producing structure or machinery consisted among others of the routes along which it was authorised by permit to convey passengers for profit.

  It had relinquished the route in issue – part of its income-producing machinery – due to the introduction of a rail service on the route which had the effect of destroying the economic value of the said route. The court held that the compensation received by the taxpayer filled a hole in its capital assets and was of a capital nature and hence fell outside the definition of the term "gross income" in section 1.

- In *Reckitt & Colman Pty Ltd v FC of T*[10] the taxpayer manufactured a wide range of household, toiletry, pharmaceutical and food products and also maintained a laboratory to conduct programmes of research into and development of existing and new products to be produced by the company. The taxpayer received a grant under the Industrial Research and Development Grants Act, 1967 in order to assist it with the increased costs it had incurred in undertaking its research and development.

  The Supreme Court of New South Wales held that the payments were income according to ordinary usages and concepts as they represented the reimbursement of expenditures of a revenue nature that were derived in the ordinary course of business.

[8] (1992) 55 SATC 218 (T).
[9] Act No. 74 of 1977.
[10] (1974) ATC 4185; 1974 (4) ATR 501.

ARCHIVED

- In *KBI v Transvaalse Suikerkorporasie Bpk*[11] the taxpayer received from buyers of sugar railway charges in excess of the actual expenditure on railage (railway advantage moneys) in terms of a prevailing industry-wide agreement.

  Following a dispute with the SA Sugar Association, amongst other things, as to which body was entitled to the railway advantage money, an agreement was entered into in which the taxpayer –

  (a) waived its right to the retention in perpetuity of the railway advantage money generated in terms of the Industrial Agreement,

  (b) agreed to the amendment of the Sugar Industry Agreement by which this right was surrendered; and

  (c) in consideration accepted R3,5 million.

  The court held that the amount paid to the taxpayer was intended to compensate it for the permanent relinquishment of its ability to generate additional income by way of railage advantage money and was accordingly of a capital nature.

3.2.5 Government grants to assist or compensate a person in meeting costs of a capital nature

A government grant which is designated as being made towards the cost of specified capital expenditure is capital in nature because it is made in order to assist or compensate a person in meeting costs of a capital nature. The same principle will apply to a compensatory receipt for the loss of a capital asset. In certain circumstances the recoupment provisions of section 8(4)(*a*) may apply. These provisions are discussed in **3.4**.

If a person uses the proceeds of a grant designated for capital purposes for other purposes, such as to fund its working capital, the grant would be regarded as revenue in nature, irrespective of whether the person is subsequently obliged to refund the grant because the conditions of the grant were not satisfied.

A government grant received for the purpose of acquiring land will be of a revenue nature in the hands of a person speculating in land but in the hands of a farmer it will be of a capital nature.

Further examples of compensatory grants of a capital or revenue nature

Example 3 – Compensatory receipt for a farmer's pastoral lands

Facts:

A farmer's pastoral lands suffer damage as a result of floods. The farmer receives a government grant to rehabilitate the property. For the purposes of this example it is assumed that the grant does not fall within paragraph (*l*) of the definition of "gross income".

Result:

The receipt is of a capital nature because the asset being reinstated is a capital asset in the hands of the recipient.

[11] (1987) (2) SA 213 (A), 49 SATC 11.

ARCHIVED

Example 4 – Receipt of a government grant by a public transport operator

Facts:

Government grants are paid to public transport operators to assist them with the purchase of new buses. The project is a result of public concern over the safety of buses. Operators are required to use the funds to purchase new buses for their bus routes.

Result:

The grants will only be taxable if they are a trading receipt. For a bus operator the following items are trading receipts:

- The receipt of a fare in return for a bus trip.
- Ongoing payments made to subsidise fares based, for example, on the number of passengers or on a "per kilometre" basis.

A bus is a capital asset in the hands of a bus operator. As a result any amount received by a bus operator in order to replace a bus will be a capital receipt.

Example 5 – Receipt of grant under the Provision of Land and Assistance Act, No. 126 of 1993

Facts:

A person obtains a land redistribution grant for agricultural development from the Department of Land Affairs in order to fund –

- the acquisition of a farm situated in the district of Rustenburg in the North West province for agricultural production;
- the acquisition of certain capital assets for the development of the land; and
- expenditure for the improvement of the land.

Result:

The grant is a capital receipt because it is used to fund expenditure of a capital nature.

ARCHIVED

3.3 Conditional receipt

The mere fact that a grant has been received is not conclusive evidence that the conditions attached to the grant have been or will be fulfilled. Also, the possibility that in certain circumstances a government grant may have to be repaid does not warrant the classification of the grant as a loan.

The decisions in *Brookes Lemos Ltd v CIR*[12] and *Greases (SA) Ltd v CIR*[13] support the view that an amount received as a taxpayer's own must be included in gross income even if the contract provides that the amount is repayable under certain circumstances. However, if the terms of the grant stipulate that the funds must be held separately in a trust account until certain conditional requirements are fulfilled, no amount is included in gross income until the conditions have been met.

[12] 1947 (2) SA 976 (A), 14 SATC 295.
[13] 1951 (3) SA 518 (A), 17 SATC 358.

In *Lincolnshire Sugar Co Ltd (in Liquidation) v Smart (H.M. Inspector of Taxes)*[14] the court held that subsidies received by a taxpayer were supplementary trade receipts despite being repayable in certain circumstances and that the obligation to make repayment might be considered a contingent liability.

In ITC 1557 (discussed in **3.2.4**) the taxpayer received certain subsidies from the Department of Transport for season tickets sold to commuters on approved bus routes. The question was at what stage the subsidies accrued to the taxpayer. In terms of applicable legislation any payment of subsidies was discretionary and could be made subject to conditions and contingencies.

It was argued on behalf of the Commissioner that the subsidy accrued to the taxpayer the moment the passenger purchased a ticket to which the subsidy applied and that the auditor's certificate merely confirmed the accuracy of the claim for the subsidy and was not a precondition to establish a right to the subsidy.

However, the court held that the fact that all the conditions precedent were regarded as having been fulfilled, was signified by the approval and payment of the appellant's claim by the Department. For the amounts in question, this happened only in subsequent years of assessment and it was therefore in those years that the amounts fell to be taxed.

In most instances the unconditional receipt of a government grant in advance will have unfavourable tax consequences for the recipient who must use it in whole or in part to finance future expenses in performing the obligations associated with the grant. The money received in advance constitutes gross income upon receipt while the concomitant expenditure is only incurred in a subsequent year of assessment. Section 24C may provide relief in these circumstances.

Section 24C empowers the Commissioner to allow a taxpayer to deduct an allowance for future expenditure against the advance payment received. A deduction will be allowed of whatever allowance the Commissioner may determine for so much of the future expenditure as relates to the amount received in advance. The allowance may not exceed the amount received.[15]

3.4 Section 8(4)(*a*) recoupment

Under section 8(4)(*a*) there must be included in a taxpayer's income all amounts allowed to be deducted or set off in the current or any previous year of assessment under sections 11 to 20, and sections 24D, 24F, 24G, 24I, 24J, 27(2)(*b*) as well as 37B(2) but excluding sections 11(*k*), (*p*) and (*q*), 11D(1), 12(2) or 12(2) as applied by section 13(8) or 13*bis*(7) or 15(*a*) or 15A that have been recovered or recouped during the current year of assessment.

The appellant in ITC 1435[16] acquired a machine at a cost of R26 222 during the 1980 year of assessment and claimed wear-and-tear allowances of R3 496 (1980) and R5 244 (1981) on the machine. During the 1981 year of assessment the appellant received a grant-in-aid of R18 000 for the purchase of the machine. The Commissioner conceded that the grant-in-aid should not reduce the "value" on which the wear-and-tear allowances were to be calculated but included the amounts of

[14] (1937) 1 All ER 413.
[15] Section 24C(2) qualifies the allowance with the words "not exceeding the said amount".
[16] (1987) 50 SATC 117 (EC).

ARCHIVED

R3 496 and R5 244 in the appellant's income as a recoupment under section 8(4)(*a*). The court allowed the appeal, holding that –

- the grant-in-aid of R18 000 was a receipt of a capital nature that was not specifically included in the definition of the term "gross income" in section 1 (unlike certain farming subsidies included in paragraph (*l*) of the definition); and
- there could only be a recovery or recoupment under section 8(4)(*a*) if the asset on which the wear-and-tear allowances were claimed was lost, sold or disposed of, or if the amount received represented a cash substitution for the asset itself.

Example 6 – Receipt of a government grant in order to scrap machinery

Facts:

A manufacturing company receives a government grant of R100 000 as compensation for scrapping an air-polluting machine. The original cost of the machine was R80 000, which had been fully claimed by way of wear-and-tear allowances in previous years of assessment.

Result:

The grant is a capital receipt because it relates to the replacement of a capital asset. However, under section 8(4)(*a*) the total wear-and-tear allowances of R80 000 are recouped in full because the amount of the grant exceeds the original cost price of the machine. This amount is specifically included in the "gross income" of the company under paragraph (*n*) of the definition of that term. The remaining part of the grant (that is, R20 000) does not form part of gross income because it is a capital receipt. The amount of R20 000 will therefore comprise a capital gain under the Eighth Schedule as follows:

	R
Proceeds R100 000 less recoupment of R80 000 (paragraph 35(3)(*a*) of the Eighth Schedule)	20 000
Less: Base cost (cost of acquisition of R80 000 less wear-and-tear allowance of R80 000 (paragraph 20(3)(*a*) of the Eighth Schedule)	(Nil)
Capital gain	20 000

3.5 Specific inclusion: Farming – Subsidies

Paragraph (*l*) of the definition of the term "gross income" in section 1 specifically includes in the gross income of a farmer any amounts received or accrued by way of a grant or subsidy for any soil erosion works referred to in section 17A(1) or any expenditure incurred on farming development and improvements referred to in paragraph 12(1)(*a*) to (*i*) of the First Schedule to the Act.

3.6 Specific exemptions

3.6.1 Exemption under section 10(1)(*y*) – Programmes approved under the national budget process

Any government grant or government scrapping payment received or accrued under a programme or scheme which has been approved under the national annual budget process and identified by the Minister in the *Gazette*, is exempt from normal tax. The Minister is required to consider the designation of such a project having regard to a

ARCHIVED

variety of economic and socio-political government objectives set out in section 10(1)(*y*) as well as the financial implications for government of exempting the government grant or scrapping payment from normal tax and whether the tax implications were taken into account in determining the appropriation or payment in respect of the programme or scheme.

No scheme has been gazetted by the Minister under this provision up to the date of this Note. The approval of the above-mentioned programmes is the function of National Treasury.

3.6.2 Exemption under section 10(1)(*y*A) – Official development assistance

Any amount received by or accrued to a person for goods or services provided to beneficiaries in terms of an official development assistance agreement that is binding under section 231(3) of the Constitution, is exempt from normal tax, to the extent that –

- the amount is received or accrues in relation to projects that are approved by the Minister after consultation with the Minister of Foreign Affairs,
- the agreement provides that those receipts and accruals must be exempt, and
- the Minister announces that those receipts and accruals are exempt by notice in the *Gazette*.

These agreements are governed by the Department: International Relations and Cooperation.[17]

Section 231 of the Constitution of the Republic of South Africa, 1996 (the Constitution)

231. International agreements.—

(1) The negotiating and signing of all international agreements is the responsibility of the national executive.

(2) An international agreement binds the Republic only after it has been approved by resolution in both the National Assembly and the National Council of Provinces, unless it is an agreement referred to in subsection (3).

(3) An international agreement of a technical, administrative or executive nature, or an agreement which does not require either ratification or accession, entered into by the national executive, binds the Republic without approval by the National Assembly and the National Council of Provinces, but must be tabled in the Assembly and the Council within a reasonable time.

(4) Any international agreement becomes law in the Republic when it is enacted into law by national legislation; but a self-executing provision of an agreement that has been approved by Parliament is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.

ARCHIVED

[17] See **www.dfa.gov.za** under the heading Foreign Relations. Click on bilateral agreements. [Accessed 6 December 2010].

> (5) The Republic is bound by international agreements which were binding on the Republic when this Constitution took effect.[18]
>
> (Emphasis added.)

The "international agreements" envisaged in section 231 of the Constitution which are relevant for tax purposes can broadly be categorised as follows:

- Any agreement for the avoidance of double taxation between the Republic and another country [section 231(2) of the Constitution].
- Any agreement of a technical, administrative or executive nature between South Africa and another country [section 231(3) of the Constitution].

The agreements mentioned in this Note fall under the second bullet point above.

Example 7 – Agreement between the Government of the Kingdom of Denmark and the Government of the Republic of South Africa on the Danish Assistance Programme to South Africa

The agreement entered into force on 18 February 1997. It was concluded under the interim Constitution and is a binding international agreement. Under paragraph (1) of Article 1 of this Agreement it is stated that under the Danish Traditional Assistance Programme as well as the Danish Environmental Co-operation Programme, Denmark will make available on a grant basis, financial assistance, technical assistance, material resources and training opportunities. On the other hand South Africa will ensure the effective utilisation of the assistance made available under this Agreement.

Under Article 2(3) of the agreement South Africa shall in respect of activities directly related to the execution of Projects, take *inter alia* the following measures, as far as applicable under South African law with regard to foreign Executive Agencies –

"(a) …

(b) exempt them from income tax or any other direct tax or charge in respect of any emoluments paid to them from resources outside the Republic of South Africa for their services in the Republic of South Africa in terms of this Agreement;

(c) exempt them from the duty to submit to the South African authorities any tax or financial declaration in respect of direct taxation required from private persons or corporations regarding emoluments referred to in subparagraph (b);

(d) …

(e) …".

3.6.3 Exemption under section 10(1)(*z*A) – Export incentives

Any amount received by or accrued to or in favour of any person by way of rebate or other assistance under any scheme for the promotion or financing of exports, is exempt from normal tax under section 10(1)(*z*A). The scheme must be approved by the Minister of Trade and Industry in concurrence with the Minister of Finance.

[18] Constitution of the Republic of South Africa, 1996.

ARCHIVED

Although several schemes were approved over the years, only the Export Marketing and Investment Assistance Scheme (EMIA) administered by the Department of Trade and Industry is currently still in existence.

The EMIA consists of the following sub-schemes –

- Primary Export Market Research and Foreign Direct Investment Research Scheme;
- Individual Inward Bound Mission;
- National Pavilions;
- Individual Exhibitions and In-Store Promotions;
- Outward Selling Trade Missions;
- Outward Investment Recruitment Missions;
- Inward Buying Trade Missions;
- Inward Investment Missions; and
- Sector Specific Assistance Scheme.[19]

A reduction in an amount payable does not, however, qualify for exemption under section 10(1)(*z*A) even if styled as a "rebate" because it is not a receipt or accrual. This is illustrated by the case of *Toyota South Africa Motors (Pty) Ltd v C: SARS.*[20] In that case the issue before the court was whether certain rebates on excise duty ("export rebates under Phase VI") were exempt from tax under section 10(1)(*z*A). In essence the company had sought to claim a deduction for the full duty before rebates and then contended that the reduction in duty was an amount of exempt income.

The court held that "excise duty rebates granted in respect of exports" were not exempt from tax under section 10(1)(*z*A).

The following dictum of De Klerk J is relevant:[21]

> "The basic reason in principle why applicant cannot succeed, however, is that the rebate in this case is a deduction, a discount, ''n afslag'.
>
> "It is not money 'which is paid by the State' as meant in section 10(1)(*z*A) of Act 58 of 1962.
>
> "There was no set-off. The amounts which applicant now claims are exempt from tax are no more than factors in the formula to calculate the rebate.
>
> "By no stretch of the imagination can these amounts be described as amounts paid by the State.
>
> "If a rebate is granted the debtor owes that much less.
>
> "Applicant's accounting records contained a fiction by showing as a liability the full excise duty before the rebate was deducted. Because of the incentive scheme (phase VI) that liability never arose. It is fiction to label as income the amount which remained after the net excise duty had been paid. Just as the amount of foreign

[19] See **www.thedti.gov.za/exporting/exportincentives.htm** [Accessed 10 December 2010].
[20] [2001] 2 All SA 332 (T) 63 SATC 115.
[21] At SATC 116.

ARCHIVED

exchange earned is a factor in the calculation of the rebate, the rebate is a factor in the calculation of excise duty. It is not income. It is also not "a receipt" or an accrual."

3.6.4 Exemption under section 10(1)(*z*E) – Small Business Development Corporation Limited

Any amount received by or accrued to the Small Business Development Corporation Limited by way of any subsidy or assistance payable by the government, is exempt from normal tax.

3.6.5 Exemption under section 10(1)(*z*G) – Films

Any amount received by or accrued to a person by way of a subsidy payable by the government under any scheme designed to promote the production of films, is exempt from normal tax.

For example, this exemption covers an amount paid or payable to a film owner under the Film and Television Production Rebate Programme administered by the Department of Trade and Industry. Under the Programme the government will provide a cash grant to an eligible applicant for a sum totaling 15% for foreign productions or 25% for qualifying South African productions including official co-productions of the qualifying South African production expenditure that the applicant has expended on an eligible film production.

As a condition for the subsidy, the Department of Trade and Industry informally requires the use of a special purpose vehicle. The special purpose vehicle is needed as a separate mechanism for tracing all film funds associated with the subsidy. The use of this special purpose vehicle, however, undermines the tax-free treatment because transmission of the subsidy to the ultimate beneficiaries (for example, the investors) typically triggers tax.

Section 10(1)(*z*G) has been amended[22] to cater for subsequent transfers to investors. Accordingly, the payment of the subsidy to any film owner will be tax free. The amendment came into operation on 1 September, 2009 and applies in respect of any amounts received or accrued on or after that date.

3.6.6 Exemption under section 10(1)(*z*H) – Specific programmes

Any amount received by or accrued to a person is exempt from normal tax if it is received by that person from government as an allowance or incentive payable in accordance with the following programmes:

- The Small/Medium Manufacturing Development Programme (SMMDP) which came into operation on 1 October 1996; replaced by the Small Medium Enterprise Development Programme (SMEDP) – see below.
- The Tax Holiday Scheme under section 37H (applicable to any project which has been approved as a qualifying project for any application received on or before 30 September 1999) which came into operation on 1 October 1996.
- The SMEDP, which came into operation on 1 September 2000, was suspended on 31 August 2006.[23] See **www.governmentgrants.co.za/government-grants-**

[22] Section 10(1)(*z*G) was amended by section 13(1)(*k*) of the Taxation Laws Amendment Act, No. 17 of 2009.
[23] See **www.thedti.gov.za/smedp/smedp2007.htm** [Accessed 10 December 2010].

ARCHIVED

incentives-apply.htm for manufacturing and tourism grants [Accessed 10 December 2010].

- The Critical Infrastructure Programme (CIP) which came into operation on 1 September 2000, provides a non-refundable, cash grant that is available to an approved beneficiary upon the completion of an infrastructure project.

3.6.7 Exemption under section 10(1)(*z*l) – Public Private Partnership (PPP)

A **"Public Private Partnership"** is defined in section 1 to mean a Public Private Partnership as defined in Regulation 16 of the Treasury Regulations issued under section 76 of the Public Finance Management Act, No. 1 of 1999.

Any amount received by or accrued to a person from the government will be exempt from normal tax if the amount is received by that person as part of its obligations pursuant to a PPP. In addition, the person is also required to expend an amount at least equal to that amount for the improvement of any land or buildings owned by the government or over which the government holds a servitude.

A PPP is a contract between a government institution (for example, a government department, public entity or municipality) and a private party, in which the private party assumes substantial financial, technical and operational risk in the design, financing, building and operation of a project.

Two types of PPPs are specifically defined, namely, those in which –

- the private party performs an institutional function; or
- the private party acquires the use of state property for its own commercial purposes. A PPP may also be a hybrid of these types.

Payment in any scenario involves one of three mechanisms –

- the government institution paying the private party for the delivery of the service;
- the private party collecting fees or charges from users of the service; or
- a combination of these.

A list of projects in preparation, registered under Treasury Regulation 16, and municipal projects registered under the Local Government: Municipal Finance Management Act, No. 56 of 2003, and section 78(3) of the Local Government: Municipal Systems Act, No. 32 of 2000, are available at **www.ppp.gov.za** [Accessed 10 December 2010].

3.7 Government grants received for research and development expenses

Section 11D(8) provides that when a taxpayer receives a government grant to finance the acquisition of an asset or to fund an expenditure that is otherwise eligible for a deduction under section 11D(1), the deduction relating to that expenditure shall be limited to 100% instead of 150% to the extent of twice that amount, (except to the extent that the expenditure is prohibited under section 23(*n*)). For further detail see the Interpretation Note No. 50 "Deduction for Scientific and Technological Research and Development" (28 August 2009) available on the SARS website.

There is no specific exemption from normal tax for government grants received or accrued to cover research and development expenses. Whether such a grant is of a

ARCHIVED

capital nature and thus excluded from gross income must be determined by applying the general principles discussed in this Note.

Examples of grants currently paid by the government include the following:

- The Support Programme for Industrial Innovation (SPII) which is a programme designed to promote and assist technology development in South African industry through the provision of financial assistance for projects that develop innovative products or processes. The SPII is focused specifically on the phase that begins at the conclusion of basic research (at the stage of proof of concept) and ends at the point when a pre-production prototype has been produced.
- The Technology and Human Resources for Industry Programme (THRIP) is a partnership programme which challenges companies to match government funding for innovative research and development in South Africa.[24]

3.8 Anti-double-dipping rules [section 23(*n*)]

A taxpayer should not be able to use tax-free grants and scrapping payments to obtain a future tax benefit (that is, "double-dip"), for example, if exempt funds are used to acquire assets or incur expenditure and the taxpayer then claims depreciation or deductible operating expenses.

However, certain instances may arise in which a double-dip is permissible.

The anti-double-dipping rules are detailed in section 23(*n*). The section provides that any deduction or allowance for any asset or expenditure is not deductible in determining taxable income to the extent that the amount is granted or paid to the taxpayer and is exempt from tax under section 10(1)(*y*) or (*y*A) and was granted or paid for purposes of the acquisition of that asset or funding of that expenditure. Section 23(*n*) is not applicable if a grant is for programmes or schemes that the Minister has identified by notice in the *Gazette* for purposes of section 23(*n*).

Under paragraph 20(3)(*c*) of the Eighth Schedule the expenditure on an asset must be reduced by any amount that is exempt from tax under section 10(1)(*y*) or (*y*A) and is granted or paid for purposes of the acquisition of that asset. However, this base cost reduction rule does not apply to a government grant or government scrapping payment provided under programmes or schemes identified by the Minister of Finance in the *Gazette.*

Paragraph 64A of the Eighth Schedule provides that a person must disregard a capital gain or capital loss in respect of a disposal resulting in the person receiving a government scrapping payment in terms of a programme or scheme identified by the Minister for purposes of the paragraph by notice in the *Gazette*.

No scheme has been identified up to the date of this Note.

4. Conclusion

In determining whether a grant is subject to normal tax regard must be had to –

- general principles applicable in deciding whether a grant is of a capital or revenue nature, and hence whether it falls within gross income;

[24] See **www.nrf.ac.za/thrip/ifrms/bout.html** [Accessed 10 December 2010].

ARCHIVED

- specific inclusions in gross income (for example, farming subsidies and recoupments);
- any exemption under section 10;
- the disregarding under paragraph 64A of the Eighth Schedule of a capital gain or capital loss on disposal of an asset resulting from the receipt of a government scrapping payment; and
- the facts and circumstances of the particular case.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

ARCHIVED