# THE SOUTH AFRICAN INCOME TAX IMPLICATIONS OF TRANSACTIONS ENTERED INTO TO EARN POINTS FOR A BROAD-BASED BLACK ECONOMIC EMPOWERMENT SCORECARD, WITH REFERENCE TO A SELECTION OF STRUCTURES

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## ABSTRACT

This thesis discussed the South African income tax implications, in terms of the Income Tax Act, No. 58 of 1962, arising from complying with Broad-Based Black Economic Empowerment requirements, and related principles established in case law. Various structures and transactions entered into for the purposes of earning points for the B-BBEE scorecard were identified. In the assessment of the deductibility of B-BBEE expenditure in terms of the preamble to section 11, section 11(a) and section 23(g) of the Act, it was highlighted that, in the South African economic environment, B-BBEE compliance represents a competitive advantage for entities. In addition, many South African organisations are required to comply with B-BBEE requirements for legal and regulatory purposes. The analysis of the deductibility of B-BBEE expenditure revealed that taxpayers that incur this expenditure would be carrying on a trade or commencing to do so. It was also concluded that B-BBEE expenditure is incurred in the production of income and would generally not be capital in nature, except in certain circumstances, in which case the Act provides certain allowances. Any deduction will only be allowed in the year of assessment in which the expenditure is actually incurred, or when the taxpayer incurs an unconditional legal obligation. This thesis explored several alternatives to achieve the requirements of the ownership element of B-BBEE and highlighted the income tax implications that arise because of these structures. It was also observed that there are a number of incentives in the Act that could be beneficial to taxpayers seeking to earn points for the remaining elements of the B-BBEE scorecard. A legal interpretive approach, in particular a doctrinal research methodology, was adopted in carrying out this research. This research concluded that the Act facilitates most of the B-BBEE transactions and structures, but due to the complex and sometimes uncertain nature of the tax consequences of B-BBEE transactions and structures, there is a need for further guidance in this area of tax law.

Key words:

Broad-Based Black Economic Empowerment, B-BBEE, B-BBEE expenditure, B-BBEE scorecard, income tax.

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## LIST OF ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| B-BBEE | Broad-Based Black Economic Empowerment |
| BCR | Binding class ruling |
| BPR | Binding private ruling |
| Codes | Broad-Based Black Economic Empowerment Codes of Good Practice |
| CSI | Corporate social investment |
| ED | Enterprise development |
| EEIP | Equity Equivalent Investment Programme |
| JSE | Johannesburg Stock Exchange |
| King IV report | King IV Report on Corporate Governance for South Africa |
| NQF | National Qualifications Framework |
| SARS | South African Revenue Service |
| SED | Socio-economic development |
| The Act | Income Tax Act, No. 58 of 1962 |
| The B-BBEE Act | Broad-Based Black Economic Empowerment Act, No. 53 of 2003 |
| The Companies Act | Companies Act, No. 71 of 2008 |
| The SDL Act | Skills Development Act, No. 97 of 1998 |
| VCC | Venture capital company |

# CHAPTER 1: INTRODUCTION

## 1.1 Context of the research

Since the end of Apartheid in 1994, South Africa has experienced significant change as Government made efforts to reverse the impact, which Apartheid had on black people[1]. In this endeavour, Government introduced the Broad-Based Black Economic Empowerment Act, No. 53 of 2003 (the "B-BBEE Act"). According to the preamble of the B-BBEE Act, this Act was introduced in order to:

> promote the achievement of the constitutional right to equality, increase broad-based and effective participation of black people in the economy and promote a higher growth rate, increased employment and more equitable income distribution; and establish a national policy on broad-based black economic empowerment so as to promote the economic unity of the nation, protect the common market, and promote equal opportunity and equal access to government services.

In terms of section 9 of the B-BBEE Act, to promote the purposes of the Act the Minister may, by notice in the Government Gazette, issue codes of good practice on black economic empowerment. In this regard, the Minister of Trade, Industry and Competition has issued the Codes of Good Practice (Department of Trade, Industry and Competition: Online). The current Codes of Good Practice ("Codes") were published on 11 October 2013 (Government Gazette 36928) and came into effect on 1 May 2015. The Codes were subsequently amended through Government Gazette 38766, which came into effect on 6 May 2015 and Government Gazette 42496, which came into effect on 31 May 2019.

The Codes refer to three priority elements, which represent the focal points of the B-BBEE regulations. These are ownership, skills development, and enterprise and supplier development.

Such Codes may be generic or may apply to a specific sector of the economy. An entity's

[1] In terms of section 1 of the B-BBEE Act, "black people" is a generic term which means Africans, Coloureds and Indians—
(a) who are citizens of the Republic of South Africa by birth or descent; or
(b) who became citizens of the Republic of South Africa by naturalisation—
(i) before 27 April 1994; or
(ii) on or after 27 April 1994 and who would have been entitled to acquire citizenship by naturalization prior to that date.

compliance with the B-BBEE regulations is measured against a B-BBEE scorecard, and for the purposes of this thesis, only the generic scorecard will be considered. The elements of the generic scorecard are as follows:

- Ownership
- Management Control
- Skills Development
- Enterprise and Supplier Development
- Socio-Economic Development

Entities may implement various initiatives in order to meet the requirements of the B-BBEE scorecard. In achieving the B-BBEE ownership element, black people may hold rights of ownership in an entity directly or indirectly through a company, trust, broad-based ownership scheme or an employee share ownership scheme, amongst others. The implementation of such ownership structures may include an issue of new shares, outright disposals of shareholdings or assets, the issue and transfer of hybrid instruments, and asset-for-share transactions. The way in which these ownership restructures are funded is also important. The structure of the B- BBEE transactions will give rise to different tax consequences and the related income tax implications of the costs incurred for these various initiatives will depend on the facts of each case.

*General deduction formula*

The deductibility of many types of expenditure is governed by the so-called general deduction formula which is found in the preamble to section 11 and section 11(a), read with section 23(g) of the Income Tax Act, No. 58 of 1962 (the "Act"). The sections stipulate certain requirements to be met before an amount is found to be deductible. In terms of the preamble to section 11 and section 11(a): "for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived, expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature." Section 23(g) of the Act specifies that "no deductions shall in any case be made in respect of the following matters, namely any moneys, claimed as a deduction from income derived from a trade, to the extent to which such moneys were not laid out or expended for the purposes of trade."

The individual aspects of the general deduction formula will be analysed with regard to costs incurred to earn points for a taxpayer's B-BBEE scorecard and will include a consideration of relevant case law where the legislation fails to provide adequate guidance. The *Warner Lambert SA (Pty) Ltd v CSARS* 2003 (5) SA 344 (SCA), 65 SATC 346, case is particularly relevant. This case dealt with social responsibility expenditure incurred by an American company conducting business in South Africa and which was obliged to comply with the Sullivan code. The Sullivan code required this company to perform certain social responsibility activities, failing which the company would lose its subsidiary status in the American group and the funding and reputational benefits, which came with this association. The facts and findings of this case will be discussed in conjunction with the legislation and expenses relating to B-BBEE scorecard elements.

In relation to the elements of the B-BBEE scorecard, other than the ownership element, a taxpayer may benefit from several other tax deductions in the Act in respect of legal, consulting and professional fees, donations, learnership allowances, scholarships and bursaries, staff training, investment in venture capital companies and capital allowances in respect of low-cost residential units.

It is also relevant to consider a taxpayer's compliance with the King IV Report on Corporate Governance for South Africa (the "King IV Report"). The current King IV Report was issued on 1 November 2016 and lists "corporate citizenship" as one of its fundamental concepts (The Institute of Directors in Southern Africa NPC, 2016: 23). It is submitted that an entity's compliance with the Codes will fall within "corporate citizenship" as contemplated in the King IV report. Mazars (Online) has clarified that "King IV is effective for financial years commencing on or after 1 April 2017, it is mandatory for companies listed on the Johannesburg Stock Exchange from November 2017 and voluntary for all other companies."

The research question to be addressed is: What are the income tax consequences for a selection of B-BBEE transactions and structures entered into for the purposes of earning points for the B-BBEE scorecard?

This research is relevant in the current climate of South Africa as compliance with B-BBEE regulations is a high priority for businesses. Mazars (Online) has stated that: "Broad-Based Black Economic Empowerment (B-BBEE) is a significant strategic issue, challenge, threat and

potential opportunity facing businesses of all sizes, structures and shapes in South Africa today." B-BBEE expenditure incurred by taxpayers is often significant and any related tax benefit may further encourage businesses to turn their attention to B-BBEE compliance. In light of the changes to the Codes in 2015 and 2019, and the King IV Report in 2016, research into the deductibility of B-BBEE expenditure would contribute to the body of knowledge.

## 1.2 Research objectives

The goal of the research is to determine the South African income tax implications of transactions entered into to earn points for a B-BBEE scorecard, with reference to a selection of B-BBEE structures. The goal of the research will be achieved by addressing the following sub-goals:

- identify a selection of B-BBEE transactions or structures that may be entered into for the purpose of earning points for the various elements of the B-BBEE scorecard;
- identify the types of expenditure incurred in implementing these B-BBEE transactions or structures entered into for the purpose of earning points for the B-BBEE scorecard;
- analyse provisions of the Act that apply to B-BBEE expenditure, transactions or structures;
- discuss case law that will be relevant in determining the income tax implications of B-BBEE expenditure, transactions and structures identified; and
- conclude to what extent the expenditure identified will be deductible.

## 1.3 Research methodology

A legal interpretive approach will be adopted in carrying out this research. In particular, a doctrinal research methodology will be adopted. In an eJournal of Tax Research, (McKerchar, 2008: 18) it was stated that:

> Doctrinal research is described as the traditional or 'black letter law' approach and is typified by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary. It is typically a library-based undertaking, focused on reading and conducting intensive, scholarly analysis.

To address the research question, South African legislation and case law will be analysed and interpreted. In addition, relevant tax articles and opinions from various professionals will be considered. The research will comprise a literature review that will be analysed and interpreted in relation to the B-BBEE expenditure in an extended natural language argument.

The literature to be reviewed will comprise, *inter alia,* the following:

- financial publications, academic journals and articles
- discussion papers
- South African Government reports
- the Income Tax Act, No. 58 of 1962
- the Broad-Based Black Economic Empowerment Act, No. 53 of 2003

The structures selected for the purpose of the research are the most commonly encountered structures in practice and were used to illustrate the application of the legislative provisions. These were generic structures dealt with by the researcher in practice.

No ethical concerns will arise during the course of this research, as the data used are publicly available. No interviews will be conducted, and all opinions will be studied in their written form. In addition, all sources of information will be appropriately referenced, and a complete reference list will be provided.

### 1.4 Limitations of scope

In view of the restriction on the number of pages in a mini thesis, a full research of ownership structures in use in South Africa is not possible. Furthermore, the focus of the thesis was on the tax consequences, illustrated by a selection of structures encountered in practice.

### 1.5 Overview of the research

Chapter two addresses the income tax implications of expenditure incurred for the purposes of earning points for the B-BBEE scorecard in terms of the general deduction formula and relevant principles established through case law.

Having established, in chapter two, the deductibility of B-BBEE expenditure in terms of the general deduction formula, chapter three considers the income tax implications of B-BBEE

structures implemented for the purposes of earning points for the ownership element of the B-BBEE scorecard, with reference to relevant provisions of the Act and principles established through case law.

Chapter four investigates the tax implications arising from a selection of transactions and structures entered into for the purposes of earning points for the remaining elements of the B-BBEE scorecard – management control, skills development, enterprise and supplier development, and socio-economic development.

Chapter five summarises the key findings of this research and in doing so, revisits the research objectives and sets out the conclusions reached.

# CHAPTER 2: DEDUCTIBILITY OF BROAD-BASED BLACK ECONOMIC EMPOWERMENT EXPENDITURE IN TERMS OF THE GENERAL DEDUCTION FORMULA

## 2.1 Introduction

This chapter will address the research goal of determining the income tax implications of expenditure incurred for the purposes of earning points for the B-BBEE scorecard, in terms of the Act and relevant case law. Entities may enter into various transactions, or implement various structures in order to meet the requirements of the B-BBEE scorecard. The structure of the B-BBEE transactions will give rise to different tax consequences and the related income tax implications of the costs incurred for these various initiatives will depend on the facts of each case. The deductibility of many types of expenditure is governed by the so-called general deduction formula, which is found in the preamble to section 11, section 11(a) and section 23(g) of the Act.

In terms of section 11(a):

> for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived, expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

Section 23(g) of the Act specifies that "no deductions shall in any case be made in respect of the following matters, namely any moneys, claimed as a deduction from income derived from a trade, to the extent to which such moneys were not laid out or expended for the purposes of trade."

This chapter will include an overview of the requirements of the general deduction formula and the interpretation of the individual requirements of the legislation with reference to case law. Additionally, case law applying specifically in respect of the taxation of corporate social responsibility expenditure will be explored and the principles established in these cases will then be applied to B-BBEE expenditure. Lastly, relevant rulings issued by the South African Revenue Service ("SARS") will be considered in order to provide examples of how the SARS

has treated such expenditure in the past. In this way, this chapter will address the extent to which B-BBEE expenditure will be deductible in terms of the general deduction formula.

## 2.2 Compliance with Broad-Based Black Economic Empowerment regulations

Since the end of Apartheid in 1994, South Africa has experienced significant change as Government made efforts to reverse the impact of Apartheid. As part of this endeavour, Government introduced the B-BBEE Act. Additionally, compliance with the B-BBEE Act has been incorporated into the corporate governance rules, as well as requirements for listed companies in South Africa. Compliance with the B-BBEE regulations can give organisations a competitive advantage, which serves as an incentive for organisations that are not legally obliged to comply with B-BBEE.

### 2.2.1 The Broad-Based Black Economic Empowerment Act

In terms of section 10 of the B-BBEE Act, every organ of state and public entity must apply the Codes in respect of:

- determining qualification criteria for the issue of licenses, concessions or other authorisations in respect of economic activity in terms of any law;
- developing and implementing a preferential procurement policy;
- determining qualification criteria for the sale of state-owned enterprises;
- developing criteria for entering into partnerships with the private sector; and
- determining criteria for the awarding of incentives, grants and investment schemes in support of Broad-Based Black Economic Empowerment.

Further, section 13G of the B-BBEE Act requires that all spheres of government, public entities and organs of state must report on their B-BBEE compliance in their audited annual financial statements and annual reports. In particular, all public companies listed on the Johannesburg Stock Exchange must provide to the B-BBEE Commission, in such manner as may be prescribed, a report on their compliance with B-BBEE. It is clear that for all spheres of government, public entities and organs of state, compliance with the B-BBEE Codes is critical for the everyday running of operations. In turn, due to the preferential procurement policy, which is required in terms of section 10 of the B-BBEE Act, B-BBEE compliance would also

be a high priority for an entity wishing to conduct business with any sphere of government, public entities or organs of state.

### 2.2.2 The King IV Report on Corporate Governance for South Africa

The King IV Report on Corporate Governance for South Africa (The Institute of Directors in Southern Africa NPC, 2016) (the "King IV Report") builds on its predecessors and has been revised to take current matters such as global economies and climate change into account. Organisations are expected to operate within a triple context of the economy, society and the environment. The current King IV Report was issued on 1 November 2016. Mazars (Online) has clarified that:

> King IV is effective for financial years commencing on or after 1 April 2017, it is mandatory for companies listed on the Johannesburg Stock Exchange from November 2017 and voluntary for all other companies.
>
> […]
>
> While King is still legally voluntary for all other entities, it is important to note that the South African Courts are now using King as the required standard of care in their rulings against directors and some practices of good governance have been legislated. It is therefore now considered binding and part of our common law, specifically where it impacts the appropriate standard of conduct for those charged with governance.

The King IV Report lists "corporate citizenship" as one of its fundamental concepts (The Institute of Directors in Southern Africa NPC, 2016: 23). Corporate citizenship is defined (The Institute of Directors in Southern Africa NPC, 2016: 11) as:

> the recognition that the organisation is an integral part of the broader society in which it operates, affording the organisation standing as a juristic person in a society with rights but also responsibilities and obligations. It is also the recognition that the broader society is the licensor of the organisation.

The King IV Report clarifies the role of the social and ethics committee, which is required for certain companies in terms of section 72 of the Companies Act, No. 71 of 2008 (the "Companies Act"). The King IV Report encourages all organisations to create a social and ethics committee even if not required in terms of the Companies Act.

In part 5.1 of the King IV Report (The Institute of Directors in Southern Africa NPC, 2016: 45), principle 3 requires that “the governing body should ensure that the organisation is and is seen to be a responsible corporate citizen.” The recommended practice in this regard is, *inter alia*, that (The Institute of Directors in Southern Africa NPC, 2016: 45):

> the governing body should oversee and monitor, on an ongoing basis, how the consequences of the organisation’s activities and outputs affect its status as a responsible corporate citizen. This oversight and monitoring should be performed against measures and targets agreed with management.

The report goes on to list employment equity in the workplace and economic transformation, amongst others, as areas in which performance should be measured. B-BBEE is a strategic initiative, which addresses the need for employment equity in the workplace and economic transformation. In this way, the King IV Report supports B-BBEE compliance by organisations.

### 2.2.3 Johannesburg Stock Exchange regulations

Upon the release of the King IV Report, the Johannesburg Stock Exchange (“JSE”) amended its listing requirements to ensure that all listed entities disclose their compliance with the B-BBEE Act and the Codes annually (Businesslive: Online). JSE listed companies, public entities and organs of state are required to submit their B-BBEE compliance reports to the B-BBEE Commission annually within 30 days of the approval of the entity’s audited financial statements. In addition, listed companies are required to make the compliance report submitted available on their website and issue a SENS[2] announcement. The additional B-BBEE reporting requirements took effect from 1 April 2018. The information required to be disclosed in the compliance report must reflect the state of compliance with each element of the B-BBEEscorecard.

[2] According to the JSE (2021: Online), a “SENS announcement” is a service offered by the JSE that, “provides the user with access to company announcements such as mergers, take-overs, rights offers, capital issues, cautionaries - all of which have a direct impact on the movement in the market. This service is called Stock Exchange [N]ews Service.”

### 2.2.4 Competitive advantage

A significant benefit of B-BBEE compliance and a high B-BBEE point score is being able to conduct business with government sectors (including municipalities) and public entities. For small to medium entities, a B-BBEE certificate is an advantage, as larger corporations earn additional B-BBEE points under the enterprise and supplier development element of the B-BBEE scorecard for supporting small to medium companies holding B-BBEE certifications. A further benefit of having a BBBEE certificate is the impact it has on an organisation's reputation. A good B-BBEE rating is important in building an organisation's image as a corporate citizen.

## 2.3 Interpretation of the general deduction formula

B-BBEE expenditure may take many different forms and, as such, there is no single approach that can be applied when determining the deductibility of this expenditure. The Act does not provide any specific provision for the deductibility of B-BBEE expenditure. Therefore, in assessing the deductibility of the expenditure, the general deduction formula in terms of the preamble to section 11 and section 11(a) read together with section 23(g) of the Act is the most important consideration.

In terms of section 11(a):

> for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived, expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

Section 23(g) of the Act specifies that "no deductions shall in any case be made in respect of the following matters, namely any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade."

Additionally, principles established in case law are relevant in interpreting the individual components of the general deduction formula, including case law relating to social responsibility expenditure.

### 2.3.1 In the carrying on of any trade

The first requirement of the general deduction formula is that the taxpayer must be carrying on a trade. The term "trade" is defined in section 1 of the Act and includes

> every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature.

In *Burgess v CIR* 1993 (4) SA 161 (A), 55 SATC 185, it was established (at 189) that "'trade' should be given a wide meaning and includes a 'venture', being a transaction in which a person risks something with the object of making a profit." In *De Beers Holdings (Pty) Ltd v CIR* [1986] 1 All SA 310 (A), it was further noted (at 323) that "the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade." De Koker and Williams (2020: Online) clarified, however, that "[i]n spite of its wide meaning, the term 'trade' does not embrace all activities that might produce income, for example, income in the form of interest, dividends, annuities or pensions."

A further consideration is the level of activity required for trade to have commenced. In *Borstlap v SBI* 1981 (4) SA 836 (A), 43 SATC 195, the court concluded that pre-production expenditure incurred prior to the commencement of construction of a commercial property was capital nature and was not incurred in the carrying on of a trade. Clegg and Stretch (2020: Online) suggested that:

> [T]he real determinant of the point at which trade commences, is that:
>
> - there must be in existence at least one fundamental asset, facility or resource, without which the envisaged trade income cannot be earned; and

- the process of acquiring the remaining assets, facilities or resources, continues.

Section 11A of the Act allows a deduction for any expenditure and losses actually incurred by a taxpayer prior to the commencement of and in preparation for carrying on a trade. This deduction may be claimed once trading commences, provided the deduction would have been allowed had the taxpayer been carrying on a trade. This provision is subject to certain exclusions and limitations.

Section 23(g) of the Act prohibits the deduction of any amount "to the extent to which such moneys were not laid out or expended for the purposes of trade." Expenditure is often incurred with mixed intentions, as expenditure may be incurred partly for the purposes of trade and partly for other purposes. As confirmed by *CSARS v Mobile Telephone Networks Holdings (Pty) Ltd* (966/12) [2014] ZASCA 4, where expenditure has been incurred for dual purposes, the expenditure must be apportioned and only the portion of expenditure incurred in for the purposes of trade may be claimed as a deduction.

In *CIR v Pick 'n Pay Wholesalers (Pty) Ltd* 1987 (3) SA 453(A), 49 SATC 132, the taxpayer undertook to donate an amount of R500 000 to a charity known as the Urban Foundation. The amount was to be paid in five equal annual instalments. The taxpayer claimed the donations made in the first two years as a deduction in terms of section 11(a) of the Act on the basis that the donations constituted advertising and that the announcement of the donation did have the desired effect on turnover. The Commissioner disallowed the deduction on the basis that the amounts were not incurred wholly and exclusively for the purposes of trade. Legislation at the time the case was heard required amounts to be incurred *wholly and exclusively* for the purposes of trade. Section 23(g) of the Act has since been amended to only prohibit the deduction of amounts to the extent that such moneys were not laid out or expended for the purposes of trade, and expenditure may now therefore be apportioned.

The taxpayer in the *Pick 'n Pay* case put forward an argument that the donations made were part of the company's advertising strategy. They were incurred with the intention of obtaining media coverage and publicity and (at 134) "to place [the taxpayer] in the mind of the public as the 'consumer's champion'." It was held however (at 151) that:

> [T]he donation was presented at the press conference, and in the ensuing publ -icity, as an act of disinterested benevolence. I think that what was said about Pick 'n Pay in Mr Ackerman's presence is to be given its face value, and that Mr Ackerman's philanthropic purpose was genuine. The alternative - to regard it, so far as Pick 'n Pay was concerned, merely as a cynical ploy to trade on the charitable sentiments of the community, in order to promote the naked business advantage of Pick 'n Pay - is unworthy and unacceptable. The alternative is wholly inconsistent with the *persona* of a company concerned for people and aware of its social responsibility to the community, which Pick 'n Pay has sought over the years, no doubt sincerely, to build up.
>
> In all the circumstances I am of the opinion that Pick 'n Pay did not show, on the probabilities, that in making the donation it did not have a philanthropic purpose as well as a business purpose.

The dissenting judge, however, noted (at 155) that

> Whatever the subordinate and private or personal objective of Mr Ackerman may have been, from respondent's point of view it discharged the onus of proving that the donation was actuated purely by commercial motives; its purpose in benefiting the Urban Foundation was not an independent or distinct one; it was purely a means to an end, *viz*, to acquire indirect advertising in the form of favourable publicity; the latter was, in reality, its sole aim; the expenditure was entirely divorced from the element of charity for charity's sake.

It is submitted that in the *Pick 'n Pay* case, the basis for the judgement was the inability of the taxpayer to discharge its onus of proving that the purpose of the donation was for business and not that the taxpayer's argument was unfounded.

*Warner Lambert SA (Pty) Ltd v CSARS* 2003 (5) SA 344 (SCA), 65 SATC 346, dealt with social responsibility expenditure incurred by an American company conducting business in South Africa that was obliged to comply with the Sullivan code. The Sullivan code required this company to perform certain social responsibility activities, failing which the company would lose its subsidiary status in the American group and the funding and reputational benefits that came with this association. The Sullivan Code was described (at 3) as follows:

> The Sullivan Code principles provided for the non-segregation of races in the workplace, equal and fair employment for all employees, equal pay, development of training programs, increasing the number of disadvantaged persons in management and supervisory positions and improving the quality of employees' lives outside the work environment.
>
> […]
>
> The social responsibility expenses now claimed by the appellant, as deductions were the expenses incurred in 'Working to Eliminate Laws and Customs that Impede Social, Economic, and Political Justice'.

The Sullivan code principles eventually became enshrined in legislation. The social responsibility expenditure, as required by the Sullivan Code, represented 12% of the appellant's payroll and included (at 4) "participation in national conventions, peace initiatives, providing information technology support, adopting schools and helping small businesses [start-up] operations."

The court found that as the appellant could lose its subsidiary status if it did not comply with the social responsibility legislation, the social responsibility expenditure was incurred for the purposes of trade. The basis for this decision was as follows (at 9):

> A loss of the appellant's subsidiary status might have directly brought about the loss of all kinds of trade advantages. It was unthinkable that the appellant should not comply with the Sullivan Code at all. It was not certain what would become of it if it complied but failed to do so adequately; but the appellant was not obliged, and if the truth be told would not have been permitted, to take the risk of finding out. The Sullivan Code expenses were bona fide incurred for the performance of the appellant's income producing operation and formed part of the cost of performing it. The social responsibility expenditure was therefore incurred for the purposes of trade and for no other.

As has been established, the term trade has a very wide meaning and usually involves an intention to make a profit. It is submitted that a taxpayer seeking to earn points for its B-BBEE scorecard would be doing so with the intention of gaining a competitive advantage to improve its business prospects. In addition, as outlined above, many organisations are required to comply with the Code in terms of the B-BBEE Act, the King IV Report and JSE regulations. As a company seeking to earn B-BBEE points would be carrying on a trade or commencing or

preparing to carry on a trade, this aspect of the general deduction formula would be satisfied.

### 2.3.2 Expenditure and losses

The terms "expenditure" and "loss" are not defined in the Act. The Oxford Learner's Dictionaries (Oxford University Press, 2020: Online) defines "expenditure" as "the act of spending or using money; an amount of money spent." In *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354, the court provided a useful interpretation of the terms "expenditure" and "loss" when it stated (at 360) that "in relation to trading operations the word [loss] is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money." De Koker and Williams (2020: Online) confirmed that "the word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash."

Not all the empowerment structures would involve expenditure in the form of cash and may include payments in kind. Based on the principles established in case law, for B-BBEE expenditure to be actually incurred, there should be an ascertainable amount of expenditure or loss and this amount may be in cash or kind.

### 2.3.3 Actually incurred

It has been established in the *Port Elizabeth Electric Tramway Co v CIR* 1936 CPD 241, 8 SATC 13 (at 15), that the term "actually incurred" does not mean "necessarily incurred." It was held in *Edgars Stores Ltd v CIR* 1988 (3) SA 876(A), 50 SATC 81 (at 83), that "it is well established that only expenditure in respect of which the taxpayer has incurred an unconditional legal obligation during the year in issue may be deducted under [section 11(a) of the Act]." This principle was confirmed in *Ackermans Ltd v CSARS* 2010 (1) SA (1) SCA, 73 SATC 1 (at 2), when it was stated that "'expenditure incurred' meant the undertaking of an obligation to pay or (which amounted to the same thing) the actual incurring of a liability." It was also established in *Caltex Oil (SA) Limited v SIR* 1975 (1) SA 665(A), 37 SATC 1 (at 12), that expenditure actually incurred "does not mean expenditure actually paid during the year of assessment but means all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not."

Where establishing an empowerment structure involves expenditure, the deduction will only be allowed (provided it complies with all the requirements of the general deduction formula) in the year of assessment in which the B-BBEE expenditure is actually incurred, provided that an unconditional legal obligation exists in respect of the amount.

### 2.3.4 In the production of income

The term "income" is defined in section 1 of the Act as the amount remaining of gross income after deducting any amounts exempt from normal tax. Therefore, any amount incurred in the production of exempt income will not be incurred in the production of income. This is particularly relevant in relation to expenditure incurred in respect of empowerment structures that are implemented for the purposes of earning points for the ownership element of the B-BBEE scorecard. This will be discussed further in chapter three of the thesis.

The meaning of the expression "in the production of income" was dealt with in the *Port Elizabeth Electric Tramway* case. One of the principles established in this case (at 16) was that "[t]he purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible." The learned Judge stated further (at 17) that:

> The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

An important principle was established in *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271(A), where it was stated (at 58) that: "In a tax case, one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose."

It is not necessary for expenditure to have produced income in the year of assessment for which a deduction is being sought. *Sub-Nigel Ltd v CIR* 1948 (4) SA 580(A), 15 SATC 381, is authority for this view as it established (at 394) "that the court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purposes of earning income." In the *Joffe* case, it was noted (at 355), that deductible expenditure was regarded as expenditure, which was a "necessary concomitant" of the business operations.

In the *Warner Lambert* case, the Commissioner disallowed the taxpayer's deduction for the social responsibility expenditure on the basis that it was not incurred in the production of income. When the matter was taken to the Supreme Court of Appeal, the court (at 10) likened the expenditure to insurance premiums which "were required to preserve it from harm or at least to avert the risk of harm" and were thus revenue in nature. It was held (at 8) that:

> The evidence for the appellant is to the effect that the purpose of the Sullivan Code expenditure - all the Sullivan Code expenditure, not merely the social responsibility expenditure - was to insure against the risk of losing its treasured subsidiary status. If, therefore, the purpose of the admittedly deductible expenditure and that of the contested expenditure was the same, their tax treatment should also be the same. Both were expended in the production of income or neither was.

The court held that it was inconceivable that the taxpayer should not comply with the Sullivan Code and on this basis, the expenses were incurred for the performance of the taxpayer's income-producing operations and formed part of the cost of performing it. It is evident in this case that the taxpayer had a valid reason for incurring the expenditure, as it was required to comply with the Sullivan Code. The purpose of the expenditure in this case could be clearly determined. The Sullivan Code can be likened to B-BBEE requirements, which many companies in South Africa are required to comply with.

In *ITC 1906* (2018) 80 SATC 256, the taxpayer, a close corporation, entered into a transaction with its customer in terms of which the taxpayer credited the customer's account with an amount of R2 million on the understanding that the customer would pay that amount to the community on the taxpayer's behalf. The taxpayer referred to this expenditure as "social development expenditure" in its financial statements and stated that the expenditure was

incurred to earn points for its B-BBEE scorecard (referred to as "BEE points" in the case). The taxpayer sought to claim a deduction for the amount of R2 million.

SARS conducted an income tax audit of the taxpayer's tax return and through this audit identified the arrangement. As a result, SARS disallowed the deduction of the amount of R2 million on the basis that the amount was not incurred in the production of income. It also disallowed the objection that was lodged by the taxpayer. The matter was then taken to the Durban Tax Court on appeal. Having considered the *Warner Lambert* case, the court held (at 266) that "there are circumstances in which social development expenditure may legitimately be claimed as an expense deductible from gross income for tax purposes." The taxpayer in this case did not discharge the onus of proving that the expenditure was deductible in terms of section 11(a) of the Act and therefore the deduction was not allowed.

It is submitted that the differentiating factor in judgements in the *Pick 'n Pay* case and the *Warner Lambert* case is the reason for the taxpayer incurring the expenditure. In the *Pick 'n Pay* case, the taxpayer's argument was that the expenditure was incurred for advertising purposes. In *Warner Lambert*, the taxpayer was obliged by its parent company to comply with the Sullivan Code and in this way had no real other option but to incur the social responsibility expenditure. The taxpayer in the *Warner Lamber*t case was able to discharge the onus of proving that the expenditure was incurred in the production of income.

Applying this principle to B-BBEE expenditure, it is submitted that in the South African economic environment, non-compliance with B-BBEE would put entities at a significant disadvantage against competitors. Additionally, many organisations are required to comply with B-BBEE in terms of the B-BBEE Act, the King IV Report and JSE regulations. On this basis, B-BBEE expenditure is clearly incurred for the performance of taxpayer's income- producing operations and will form part of the cost of performing them.

Also, as stated in *Solaglass Finance Co (Pty) Ltd v CIR* 1991 (2) SA 257 (A), 53 SATC 1, "money spent in order to advance the interests of the group of companies to which a taxpayer belongs is not regarded as in the production of its own income." This is relevant in empowerment structures where one company in the group incurs expenditure, which is intended to be taken into account for the B-BBEE scorecard of all companies in the group. Due to the limitation of scope of this thesis, this issue was not explored further. I would recommend that

future research around this issue is performed.

### 2.3.5 Not of a capital nature

The term "capital in nature" is not defined in the Act; however, case law provides useful guidance on its interpretation. There is no single test that may be applied to determine if an amount is capital in nature and the facts and circumstances of each case must be taken account of in making this determination.

In *CIR v George Forest Timber Company Limited* 1924 AD 516, 1 SATC 20, the principle was established for determining whether expenditure is capital or revenue in nature (at 526 – 527):

> Now, money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not . . . .
>
> The reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit.

In *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155, the capital *versus* revenue question was again deliberated (at 163):

> Expenditure may also occur in the acquisition by the taxpayer of the means of production, i.e. the property plant, tools, etc., which he uses in the performance of his income-earning operations and not only for their acquisition but for their expansion and improvement. Both these forms of expenditure can be described as expenditure in the production of the income but the former is, as a rule, current or revenue expenditure, and the latter is, as a rule, expenditure of a capital nature. As to the latter the distinction must be remembered between floating or circulating and fixed capital.

In *Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes)* 1910 SC 519, it was established that expenditure of a capital nature is usually spent "once and for all", whilst revenue expenditure is usually of a recurrent nature. It is submitted that this test is not sufficient to

determine whether an amount is capital in nature. *British Insulated and Helsby Cables Ltd v Atherton*, 1926 AC 205 (10 T.C. 155), provided a more useful test (at 213), where it was held that expenditure which is not only "once and for all" but which is made "with a view to bringing into existence an asset or advantage for the enduring benefit of the [taxpayer's] trade" will be of a capital nature.

The *New State Areas* case provided a useful summary (at 170) as follows:

> The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is a revenue expenditure even if it is paid in a lump sum.

In the *Pick 'n Pay* case, the Appellate Division agreed with the conclusion of the court *a quo* that the expenditure was not capital in nature. The Special Court's finding was (at 155) "based on the witness testimony that advertising is a continuous process and that the impact of the donation to the Urban Foundation would be limited to several months subsequent to the donation and nothing more." At the court hearing, this was also supported by the testimony of a senior lecturer at the University of Stellenbosch, Dr Marius Leibold, who specialises in the field of marketing. In light of this evidence, it was clear to the court that there is no long-term benefit which could arise from a single act of advertising and, as there is no enduring benefit, the advertising expenditure could not be capital in nature.

In the *Warner Lambert* case, it was noted (at 9) that:

> The appellant's income earning structure had been erected long ago. It was now a question of protecting its earnings. Periodic payments were required to preserve it from harm, or at least to avert the risk of harm. I regard these payments as similar to insurance premiums. If they are anything like that, they were payments of a revenue nature. There is support for this approach in England. In Morgan (Inspector of Taxes) v Tate & Lyle Ltd [1954] 2

> All ER 413 (HL) it was held that expenditure incurred in a propaganda campaign against nationalising the sugar industry was revenue in nature. In Lawson (Inspector of Taxes) v Johnson Matthey plc [1992] 2 All ER 647 (HL) a payment by the appellant to avert a threat to its business due to the collapse of a banking subsidiary was held to be an expense of a revenue nature.

Based on the above judgments, it can be concluded that corporate social expenditure would not be capital in nature. Applying this principle to B-BBEE expenditure, it would follow that such expenditure would not be capital in nature. Costs incurred in implementing new empowerment structures (as will be covered in chapter three of this thesis) may be capital in nature, whereas expenditure incurred in respect of the other elements of the B-BBEE scorecard may be more easily seen as revenue in nature.

### 2.4 South African Revenue Service rulings

For the purposes of fully exploring the topic under consideration, relevant Binding Private Rulings (BPRs) and Binding Class Rulings (BCRs) will be discussed. These rulings are issued in favour of a specified taxpayer or class of taxpayers and may not be applied to any other taxpayer. Rulings are published by SARS for general information only and do not constitute a practice generally prevailing. In terms of section 82 of the Tax administration Act, No. 28 of 2011, a BPR or a BCR may not be cited in any proceedings, including court proceedings, other than a proceeding involving an applicant (in the case of a BPR) or a class member (in the case of a BCR).

#### 2.4.1 Binding Private Ruling 282

The background facts outlined in the ruling were that the taxpayer was a company that was in the business of generating electricity through wind power. The taxpayer was required, in terms of the electricity generation license issued by the regulator, to incur socio-economic development (SED) and enterprise development (ED) expenditure. The taxpayer, as a result, established a trust to undertake the responsibility of overseeing the entity's social development obligations and the taxpayer would contribute to the trust on a quarterly basis based on a specific percentage of its revenue to facilitate this process. It was clarified in the BPR (South African Revenue Service, 2017a: 1) that:

> Failure to incur the required SED or ED expenditure, or both, will result in the applicant incurring termination points under the agreement's termination point system. The maximum termination points that may be incurred for non-compliance are not sufficient to reach the threshold stipulated that will result in the termination of the agreement.

The ruling concluded that the applicant's contributions to the trust will be deductible in terms of section 11(a) of the Act and will not be a donation for the purposes of donations tax. This binding private ruling is valid for a period of five years from 21 August 2017.

### 2.4.2 Binding Class Ruling 002

The background facts outlined in the ruling were that the board of the company made a decision to improve its corporate social responsibility programme in order to meet the requirements of the B-BBEE scorecard by means of educational assistance with bursaries. It was stated (South African Revenue Service, 2009: 1) that

> the intention of Class members will be to spend at least 1% of their net profit after tax on future CSI [corporate social investment] programmes which is the minimum requirement under the socio-economic development category of the BEE Codes of Good Practice.
>
> […]
>
> The Applicant or G, will recharge the respective Class members for their respective share of the CSI programme expenditure prior to the financial year-end. The basis of the allocation will be at the discretion of EXCO, but it is expected that the contribution to group profit before tax will be the measurement used to determine the respective share of the CSI programme costs.

The ruling was that expenditure incurred in respect of the CSI programmes for purposes of earning BEE scorecard points would be deductible in terms of section 11(a) of the Act. It was further clarified that "each class member which will claim a deduction for expenditure incurred in respect of the CSI programme will have actually incurred such expenditure for purposes of its own BEE-rating and not for that of the group as a whole." (South African Revenue Service,2009: 2) This ruling was valid for a period of five years from 28 August 2008.

### 2.5 Conclusion

Compliance with the B-BBEE regulations is obligatory in certain cases, and can give organisations a competitive advantage that serves as an incentive for organisations that are not legally obliged to comply with B-BBEE to do so. A good B-BBEE rating is important in building an organisation's image as a corporate citizen. B-BBEE expenditure may take many different forms and, as such, there is no single approach that can be applied when determining the deductibility of this expenditure. The Act does not provide any specific provision for the deductibility of B-BBEE expenditure and therefore the deductibility of such expenditure is required to comply with the general deduction formula.

The first requirement of the general deduction formula is that the taxpayer must be carrying on a trade. The term trade has a very wide meaning and usually involves an intention to make a profit. A taxpayer seeking to earn points for its B-BBEE scorecard would be doing so with the intention of gaining a competitive advantage to improve its prospects for business and many organisations are required to comply with the Codes in terms of the B-BBEE Act, the King IV Report and JSE regulations. As a company seeking to earn B-BBEE points would be carrying on a trade, commencing, or preparing to carry on a trade, this aspect of the general deduction formula would be satisfied. Section 23(g) of the Act prohibits the deduction of any amount "to the extent to which such moneys were not laid out or expended for the purposes of trade." Therefore, where expenditure has been incurred for dual purposes, the expenditure must be apportioned and only the portion of expenditure incurred for the purposes of trade may be claimed as a deduction.

The second requirement of the general deduction formula is that expenditure or losses must actually be incurred. Not all the empowerment structures would involve expenditure in the form of cash and may include payments in kind. Based on the principles established in case law, for B-BBEE expenditure to be actually incurred, there should be an ascertainable amount of expenditure or a loss and this amount may be in cash or kind. Where establishing an empowerment structure involves expenditure, the deduction will only be allowed (provided it complies with all the requirements of the general deduction formula) in the year of assessment in which it is actually incurred, provided an unconditional legal obligation exists in respect of the B-BBEE expenditure.

In order for B-BBEE expenditure to be deductible in terms of the general deduction formula, the expenditure must also be incurred in the production of income. Any amount incurred in the production of exempt income will not be incurred in the production of income, as defined in section 1 of the Act. This is particularly relevant in relation to expenditure incurred in respect of empowerment structures implemented for the purposes of earning points for the ownership element of the B-BBEE scorecard. The meaning of the expression "in the production of income" was established in the *Port Elizabeth Electric Tramway* case. One of the principles established in this case (at 16) was that "[t]he purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible."

The *Warner Lambert* case dealt with social responsibility expenditure incurred by an American company conducting business in South Africa, which was obliged to comply with the Sullivan Code. The Sullivan Code required this company to perform certain social responsibility activities, failing which the company would lose its subsidiary status in the American group and the funding and reputational benefits that came with this association. The court likened the expenditure incurred to comply with the Sullivan code to insurance premiums and noted that it was inconceivable that the taxpayer should not comply with the Sullivan Code. The expenses were therefore incurred for the performance of the taxpayer's income-producing operations and formed part of the cost of performing it.

Applying this principle to B-BBEE expenditure, it is submitted that in the South African economic environment, non-compliance with B-BBEE would put entities at a significant disadvantage against their competitors. Additionally, as many organisations are required to comply with B-BBEE in terms of the B-BBEE Act, the King IV Report and JSE regulations, B-BBEE expenditure is clearly incurred for the performance of taxpayer's income-producing operations and will form part of the cost of performing them.

Expenditure incurred to advance the interest of a group of companies will not be regarded as incurred in the production of an entity's own income. This is relevant in empowerment structures where one company in the group incurs expenditure, which is intended to be taken into account for the B-BBEE scorecard of all companies in the group.

Finally, the general deduction formula also requires that expenditure for which a deduction is being sought should not be capital in nature. The term "capital in nature" is not defined in the Act; however, case law provides useful guidance on its interpretation. There is no single test, however, which may be applied to determine if an amount is capital in nature and the facts and circumstances of each case must be considered in making this determination.

In the *Pick 'n Pay* case, it was noted that corporate social expenditure incurred for advertising purposes was not capital in nature on the basis that advertising is a continuous process whose effect would not be an enduring one. It was further noted in the *Warner Lambert* case that the expenditure incurred to comply with the Sullivan Code was similar to insurance premiums designed to protect future earnings. As the taxpayer's income earning structure had already been established, this expenditure was revenue in nature. Based on these judgments, it can be concluded that corporate social expenditure would not appear to be capital in nature. Applying this principle to B-BBEE expenditure, it would follow that corporate social expenditure would not, at the outset, be capital in nature. Costs incurred in implementing new empowerment structures for the ownership element of the B-BBEE scorecard may, however, be capital in nature, whereas expenditure incurred in respect of the other elements of the B-BBEE scorecard may be more easily seen as revenue in nature.

SARS has published several rulings in respect of corporate social responsibility expenditure. In terms of BPR 282, the ruling applicant's contributions to a trust created to undertake the responsibility of overseeing the entity's social development obligations will be deductible in terms of section 11(a) and will not be seen as a donation for the purposes of donations tax. Furthermore, in BCR 002, it was ruled that expenditure incurred in respect of the corporate social investment (CSI) programmes for purposes of earning BEE scorecard points would be deductible in terms of section 11(a) of the Act.

This chapter presented a discussion of the general deduction formula with reference to the deductibility of expenditure incurred for B-BBEE purposes. This provides the basis for the discussion, in the next chapter, of the income tax implications of transactions or structures entered into to earn points for the ownership element of the generic B-BBEE scorecard.

## CHAPTER 3: THE OWNERSHIP ELEMENT OF THE BROAD-BASED BLACK ECONOMIC EMPOWERMENT SCORECARD

### 3.1 Introduction

This chapter will address the research goal of determining the income tax implications of B-BBEE structures implemented for the purpose of earning points for the ownership element of the B-BBEE scorecard, with reference to relevant provisions of the Act and the associated principles established in case law. Statement 100 of the Codes highlights various structures through which the requirements of the ownership element of the generic scorecard may be satisfied. The transactions or structures to be considered in this chapter include share transactions, such as the sale of shares, the issue of new shares or asset-for-share transactions, as well as the sale of assets, including the sale of a going concern or the individual assets of a business. The Codes also provide for an Equity Equivalent Investment Programme that was created specifically for multi-nationals seeking to earn B-BBEE points, and the related income tax consequences of this programme for measured entities[1] will be discussed. In addition, this chapter will examine the income tax implications arising from equity instruments carrying preference rights, as well as share incentive schemes comprising broad-based employee share plans and other employee share plans. The income tax consequences arising from the inclusion of trusts in a B-BBEE empowerment structure will also be discussed. Lastly, this chapter will include an analysis of the income tax implications arising from funding obtained for the B-BBEE transactions contemplated above. Any reference to a section in this chapter refers to a section of the Act.

### 3.2 Ownership requirement

In terms of paragraph 3.3.2 of Statement 000 of the Codes, "a large enterprise[2] is required to comply with all the priority elements" whereas "a qualifying small enterprise[3] is required to comply with ownership as a compulsory element, and either skills development or enterprise

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1 According to Schedule 1 of the Codes, a measured entity means "an entity as well as an organ of state or public entity subject to measurement under the Codes" (Department of Trade and Industry, 2013: 100)

2 The Codes do not include a definition for "large enterprise." It is submitted that a large enterprise would be an entity which is not a "qualifying small enterprise[3]".

3 A qualifying small enterprise is defined in Schedule 1 of the Codes as "an entity that qualifies for measurement under the Qualifying Small Enterprise scorecard with a turnover of R10 million or more but less than R50 million." (Department of Trade and Industry, 2013: 103)

and supplier development." (Department of Trade and Industry, 2013: 000-4) The ownership element is therefore critical for any entity seeking to earn points for its B-BBEE scorecard.

Statement 100 of the Codes outlines the general principles for measuring ownership. The ownership element of the generic scorecard has a weighting of 25 points towards a measured entity's B-BBEE status and measures the effective ownership of measured entities by Black people. The ownership element of the B-BBEE scorecard is measured in terms of three indicators as outlined in paragraph 2 of Statement 100, which are:

- voting rights, which mean, "voting rights attaching to an equity instrument owned by or held for a participant" as defined in Schedule 1 of the Codes (Department of Trade and Industry, 2013: 331);
- economic interest, which means "a claim against the measured entity representing a return on ownership similar in nature to a dividend right as defined in Schedule 1 of the Codes" (Department of Trade and Industry, 2013: 314); and
- realization points, which represent net value as defined in Schedule 1 of the Codes – net value is calculated in terms of a formula in Annexe 100(E) of Statement 100. This formula takes into account the deemed value of Black participation in a measured entity and a time-based graduation factor which represents the growth of economic interest of the entity. The calculation of B-BBEE points earned by a measured entity according to the B-BBEE scorecard is not within the scope of this thesis, therefore, this formula will not be discussed further.

In terms of paragraph 3.2 of Statement 100, a measured entity is required to achieve a minimum of 40% on net value points and non-compliance with the sub-minimum requirement of net value will result in the achieved B-BBEE status level being discounted. This means that a measured entity may lose points on its B-BBEE scorecard, which could result in the measured entity dropping to a lower B-BBEE status level.

In terms of ownership, the Codes apply a "flow-through principle" which is outlined in paragraph 3.3 of Statement 100 (Department of Trade and Industry, 2013:100 – 5) as follows:

> As a general principle, when measuring the rights of Ownership of any category of Black people in a Measured [E]ntity, only rights held by natural persons are relevant. If the rights of Ownership of Black people pass through a juristic person, then the rights of Ownership

> of Black people in that juristic person are measurable. This principle applies across every tier of Ownership in a multi-tiered chain of Ownership until that chain ends with a Black person holding rights of Ownership.

The measured entity may not claim benefits under any other element of the scorecard as points are being claimed under the ownership element.

### 3.3 Shareholding structures

One of the ways in which points for the ownership element for the B-BBEE scorecard are earned is through the introduction of a "B-BBEE shareholder." Where the measured entity is a company, the structure would normally involve an issue or sale of shares to Black people or an entity through which Black people will indirectly hold their shares.

#### 3.3.1 Issue of new shares

The issue of new shares by a company will not have any income tax implications. In *CSARS v Labat Africa Ltd* (2012) 74 SATC 1 (SCA), the Supreme Court of Appeal held (at 7) that "an allotment or issuing of shares does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders, and that it can therefore not qualify as an expenditure." Based on this principle, it would follow that the issue of shares by a company would not constitute expenditure actually incurred by that company and no deduction would apply in terms of section 11(a) of the Act.

If the company has sufficient authorised share capital which remains unissued, it simply issues the shares and, if not, additional share capital must be authorised by the shareholders or board of directors as contemplated in section 36 of the Companies Act, No. 71 of 2008. If Black people subscribe for these shares, the amount subscribed will create additional contributed tax capital (paragraph (b)(ii) of the definition of "contributed tax capital" in section 1 of the Act) from which future dividends may be paid to shareholders without triggering Dividends Tax implications (as the payment of the dividends is simply a return of capital originally invested by way of a subscription for the shares). The B-BBEE shareholder is likely to hold the share as an investment (a capital asset) and not as trading stock (a revenue asset), as the intention of the shareholder would be to hold the asset on a long-term basis and thus allow the company to earn points for its B-BBEE scorecard. On this basis, the base cost of the shares (paragraph 20

of the Eighth Schedule to the Act) acquired by the B-BBEE shareholder will be equal to the amount incurred to subscribe for those shares.

### 3.3.2 Sale of shares

An outright sale of shares to a B-BBEE shareholder for a cash consideration will have income tax implications for the previous shareholders. Such a sale may be facilitated by a holding company (or a fellow subsidiary) selling all or a portion of its shareholding in a subsidiary company (the measured entity) to a B-BBEE shareholder. If the shares were held as a capital asset, the holding company, or fellow subsidiary, will have a capital gain where proceeds from the disposal (paragraph 11 of the Eighth Schedule to the Act) exceed the base cost (paragraph 20 of the Eighth Schedule) of the shares sold, or a capital loss where proceeds are less than the base cost of the shares. If the shares were held as trading stock (section 22 of the Act) by the holding company, or fellow subsidiary, any consideration received on the disposal will fall within "gross income" as defined in section 1 of the Act and will be fully taxable in the hands of the previous shareholder. In addition, the base cost of the shares acquired by the B-BBEE shareholder will be equal to the amount incurred to acquire those shares.

### 3.3.3 Asset for share transactions

An asset-for-share transaction involves the disposal of an asset or assets in exchange for equity shares and is a practical way to incorporate Black ownership into a company's shareholding. Assets could be disposed of by a prospective B-BBEE shareholder to a company in exchange for equity shares in that company. Alternatively, a company could dispose of all of its assets to a new company in exchange for shares in that new company. The prospective B-BBEE shareholder would then be able to acquire the appropriate shareholding in the new company. Following such a restructure, a company that did not have sufficient Black ownership would now qualify to earn B-BBEE points for the ownership element of the scorecard.

Section 42 of the Act allows an asset-for-share transaction to be conducted in a tax neutral manner by deferring the tax implications arising from the transaction. Where section 42 does not apply, such tax implications cannot be avoided, and these tax implications are discussed below.

In *CSARS v Labat Africa Ltd,* the Supreme Court of Appeal held (at 7) that "an allotment or issuing of shares does not in any way reduce the assets of the company . . . and that it can therefore not qualify as an expenditure." Based on this principle, and in the absence of the application of section 42, the issue of shares by a company as consideration for goods or services rendered would not constitute expenditure actually incurred by that company and no deduction would apply in terms of section 11(a) of the Act. This, in turn, would mean that the company that acquired the asset would not have a base cost for the asset and would not qualify for any capital allowances on the asset acquired.

The principles established in the *Labat* case have now been superseded by provisions of the Act, which have been introduced to clarify the income tax treatment of asset-for-share transactions where section 42 does not apply. In terms of section 40CA, where a company ("transferee) acquires any asset from another company ("transferor") in exchange for the issue of shares, the transferee is deemed to have incurred expenditure in respect of the acquisition of that asset equal to the market value of the shares immediately after the acquisition. The market value of the shares will represent consideration given for the acquisition of the asset. Section 40CA is silent about the income tax implications for transferor of the asset. De Koker and Williams (2020: Online) suggest that "he or it would have disposed of the asset for an amount equal to the market value of the shares received in exchange, and the shares (if capital in the hands of the acquirer) would have a base cost equal to such market value." In this regard, capital gains tax will be triggered in respect of the disposal of the asset, if the market value of the shares exceeds the base cost of the asset (or a capital loss where the market value of the shares is less than the base cost of the asset). Paragraph 38 of the Eighth Schedule to the Act provides that where there is a disposal for consideration not measurable in money, the proceeds are deemed to equal the market value of the asset disposed of. In a situation where both section 40CA and paragraph 38 would apply, the tax implications of these two provisions would contradict each other, and therefore, paragraph 38(2)(e) provides that the provisions of paragraph 38 will not apply to an asset-for-share transaction to which section 40CA applies. Where the asset is held as trading stock by the transferor, the market value of the shares received would fall within its gross income, as defined in section 1 of the Act. This principle was established in *Lace Proprietary Mines Ltd v CIR* 1938 AD 267, 9 SATC 349.

Section 24BA applies to asset-for-share transactions which are not at arm's length, where the consideration (the value of the shares) differs from the consideration that would have applied

had that asset been acquired in exchange for the issue of shares in terms of a transaction between independent persons dealing at arm's length. For the purposes of the discussion that follows, the transferor is the entity disposing of the asset and the transferee is the entity acquiring the asset. The implications of section 24BA are as follows:

- Where the market value of the asset immediately before the disposal exceeds the market value of the shares immediately after the issue, then –
  - for the transferee, the excess is deemed to be a capital gain; and
  - for the transferor, if the shares are acquired as a capital asset, the amount of the excess must be applied to reduce the base cost of the shares and if the shares are acquired as trading stock, the amount of excess must be applied to reduce the cost of the shares for the purposes of section 11(a) and section 22 of the Act.
- Where the market value of the shares immediately after the issue exceeds the market value of the asset immediately before the disposal, then –
  - the excess is deemed to be a dividend (for Dividends Tax purposes) that consists of a distribution of an asset *in specie* and is deemed to be paid by the transferee on the date of the issue.

Section 24BA does not apply where the transferor and the transferee form part of the same "group of companies"[4] or where the transferor holds all the shares in the transferee immediately after the asset-for-share transaction. Section 24BA will also not apply where paragraph 38 of the Eighth Schedule applies.

An asset-for-share transaction can be implemented in an income tax neutral manner with the application of section 42 of the Act. This section will apply to a disposal of an asset by a transferor to a resident company (transferee) in exchange for equity shares in that company. Section 42 refers to a second type of asset-for-share transaction in section 42(1)(b), which relates to the disposal of equity shares in a foreign company to another foreign company. This type of transaction would not be relevant for the purposes of this thesis and will not be discussed further.

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[4] As defined in section 1 of the Act, a "group of companies" means two or more companies in which one company (hereinafter referred to as the **"controlling group company"**) directly or indirectly holds shares in at least one other company (hereinafter referred to as the **"controlled group company"**), to the extent that at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.

For section 42 to apply, the following requirements must be met:

- The market value of the asset must equal or exceed the base cost where the asset is held as a capital asset or the cost where the asset is held as trading stock. “Asset” for the purposes of section 42 includes “property of whatever nature” in terms of the definition of an “asset” in paragraph 1 of the Eighth Schedule, but may not constitute personal goodwill or a restraint of trade.
- The transferee must hold a qualifying interest in the transferor at the end of the day on which the transaction took place or, must be a natural person who will be engaged in a full-time basis in rendering a service to the transferee or a controlled group company in relation to that company.
- The asset must be used by transferor for the same purpose as it was used by the transferee (either as a capital asset or as trading stock). If the parties to the transaction are not part of the same group of companies (as defined in section 1 of the Act), an asset acquired as trading stock may be held as a capital asset by the transferee.

A qualifying interest means any of the following:

- equity shares in a listed company (or a company which will become listed within twelve months of the asset-for-share transaction);
- equity shares which represent at least a ten percent holding and confer at least ten percent of the voting rights in that company;
- equity shares in a company that forms part of the same group of companies as the holder of those shares; or
- equity shares in a portfolio of collective investment scheme or a hedge fund collective investment scheme.

The income tax relief in section 42 is achieved by deferring the normal income tax and capital gains tax implications that would ordinarily arise on such re-organisation transactions. The income tax relief in terms of section 42 also extends to other types of taxes such as value-added tax, transfer duty and securities transfer tax. The discussion in this thesis will, however, be limited to a consideration of relief from income tax. The income tax implications, which would arise if section 42 applies, are as follows:

- The transferor
  - is deemed to have disposed of the asset at its base cost where the asset was held as a capital asset, or the cost of an asset held as trading stock; and
  - is deemed to have acquired the equity shares at the same base cost, where the asset was held as a capital asset, or the equivalent cost, where the asset was held as trading stock.
- The transferee
  - is deemed to be one and the same as the transferor in respect of the date of acquisition of the asset and the expenditure actually incurred in respect of that asset;
  - continues to claim capital allowances on an allowance asset until fully exhausted; and
  - will have contributed tax capital for the issue of shares equal to the base cost of the asset, where it was held as a capital asset, or the cost, where the asset was held as trading stock.

Section 42 of the Act also includes anti-avoidance provisions that may create adverse income tax implications for the transferor and/or transferee. These anti-avoidance rules will be triggered if any of the following events occur within eighteen months of the asset-for-share transaction:

- The equity shares acquired by the transferor are disposed of other than by way of –
  - an intra-group transaction, unbundling transaction, or liquidation distribution as contemplated in section 45, 46 and 47, respectively;
  - an involuntary disposal as contemplated in paragraph 65 of the Eighth Schedule[5]; or
  - the death of the transferor.
- The "qualifying interest" held by the transferor is lost.
- Where the transferor is a natural person, the person ceases to be engaged on a full-time basis in the rendering of a service to the transferor.
- The asset acquired by the transferee is disposed of.

[5] Paragraph 65 of the Eighth Schedule relates to an involuntary disposal of an asset by way of operation of law, theft or destruction and allows for any capital gain on such involuntary disposal to be disregarded provided all the requirements of paragraph 65 are met.

The provisions of section 42 will not apply if the parties to the transaction agree to this in writing. Further, section 42 does not supersede the provisions of section 24BA.

### 3.4 Sale of assets

Statement 102 of the Codes sets out the conditions where the seller may recognise a sale of individual assets, equity instruments and a business unit for the purposes of the ownership element of the scorecard. This allows a measured entity to earn points for the ownership element of its B-BBEE scorecard when its individual assets, equity instruments or business are sold to another entity. The qualifying criteria in terms of Statement 102 of the Codes are that the transaction must create a viable and sustainable business or business opportunity in the hands of Black people and must result in the transfer of critical and specialised skills, managerial skills, and productive capacity to Black people. In addition, the transaction must involve a separately identifiable related business, which has clients, customers, and suppliers other than the seller and should not have unreasonable limitations or conditions in respect of its clients and customers. The business must also have B-BBEE shareholders (or their successors if the resulting B-BBEE shareholding is the same or greater) holding the asset for a minimum of three years. If there are any operational outsourcing arrangements between the seller and the separately identifiable related business, these must be negotiated at arms-length on a fair and reasonable basis. The transaction should be subject to an independent verification of value by an independent expert. Statement 102 further notes that license, lease and other similar arrangements and the sale of franchises would not qualify for B-BBEE points on the ownership element of the scorecard. In addition, B-BBEE points may not be claimed if a repurchase transaction is entered into or proposed within three years of the original transaction, or if the seller has any right to enforce such a repurchase. Statement 102 requires that, in determining the value of the sale transaction, the separately identifiable related business must form part of the same chain of ownership and must be owned by the seller.

The sale of a business could be structured as a sale of the equity shares of the company, or the sale of the assets of the business. The sale of equity shares by shareholders has already been discussed earlier in this chapter. The sale of assets of the business may be structured in several different ways including, but not limited to, an asset-for-share transaction (as has already been discussed in this chapter), or an outright sale of individual assets, or a business unit (going concern). As the measured entity is selling assets in order to earn points for its B-BBEE

scorecard and, in doing so, improve its business prospects for the future, it is unlikely that a measured entity will dispose of all its assets in anticipation of liquidation, deregistration or winding up and therefore this situation is not considered in this thesis.

As outlined above, Statement 102 allows a measured entity to earn points for the ownership element of the B-BBEE scorecard when it sells individual assets or a business unit to another entity and such a sale may be structured as an outright sale of assets or of a business unit (going concern). An outright sale of assets or a business will have income tax consequences for the seller.

- If the assets were held as a capital asset, the seller will have a capital gain where proceeds exceed base cost of the asset sold or a capital loss where proceeds are less than the base cost.
- If the assets were allowance assets (and capital allowances were claimed in respect of the asset), the seller may have a recoupment (section 8(4) of the Act) or a scrapping loss (section 11(o) of the Act) on the disposal.
- If the assets were held as trading stock, any consideration received on the disposal will fall within gross income as defined in section 1 of the Act and will be fully taxable.

### 3.5 Equity Equivalent Investment Programme

Statement 103 of the Codes outlines how contributions can be made under the Equity Equivalent Investment Programme ("EEIP") to earn points for the ownership element of the B-BBEE scorecard, through the granting of equity interests to Black people. Multi-nationals cannot easily include Black ownership in the shareholding, as foreign holding companies are often unwilling to surrender control. The EEIP allows such measured entities to earn points for the ownership element of the B-BBEE scorecard without including Black ownership in its structure. Practically, a measured entity could create a trust or a new company that will carry out the function of utilising the contributions, which it receives from the measured entity for the intended purpose. The contributions to the EEIP should be used for supplier and enterprise development or socio-economic development.

An overview of the EEIP is as follows (Department of Trade, Industry and Competition: Online):

> [T]he Codes of Good Practice have made provision for the recognition of contributions *in lieu* of a direct sale of equity. Such contributions are referred to as Equity Equivalent (EE) contributions. Such EE contributions count towards the ownership element of B- BBEE made by Multinationals. The value of these EE contributions may be measured against 25% of the value of the Multinational's South African operations or may be measured against 4% of the Total Revenue from its South African operations annually over the period of continued measurement.

In terms of Statement 103 of the Codes, ownership points are awarded on an annual basis if total revenue has been utilised for the measurement period and where contributions are determined with reference to the value of operations, contributions may be considered for the following periods:

- total contributions of more than R100 million can be considered for a period of up to ten years;
- total contributions between R75 million and R100 million can be considered for a period of up to seven years;
- total contributions between R50 million and R75 million can be considered for a period of up to five years; and
- total contributions of less than R50 million can be considered for a period of up to three years.

Statement 103 of the Codes allows multinationals to make partial contributions to the EEIP on a proportional ratio basis for the recognition of ownership points.

### 3.5.1 Deductibility of contributions for the Equity Equivalent Investment Programme

The requirements of the general deduction formula in section 11(a) of the Act, read with section 23(g), have been discussed in chapter two. As concluded in chapter two, B-BBEE expenditure is likely to be actually incurred in the production of income and the measured entity seeking to earn B-BBEE points is likely to be doing so in the carrying on of a trade. With regard to

contributions relating to the EEIP, the question that then becomes relevant is whether expenditure is capital in nature.

In determining the capital or revenue nature of the contributions, whether the expenditure incurred on EE contributions forms part of the measured entity's income producing operations or part of its income producing structure, is relevant. In *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155, it was noted (at 170) that:

> The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is a revenue expenditure even if it is paid in a lump sum.

Expenditure incurred on EEIP contributions, it is submitted, is akin to costs incidental to the performance of the income-producing operations. These contributions are made by measured entities (often multi-nationals) operating in South Africa for the purposes of protecting their earnings and remaining viable businesses in South Africa. In *Warner Lambert SA (Pty) Ltd v CSARS* 2003 (5) SA 344 (SCA), 65 SATC 346, B-BBEE expenditure was likened to insurance premiums and it was noted in this case (at 9) that "[i]f they are anything like that, they were payments of a revenue nature." Therefore, even though EEIP contributions may have a long-term benefit in certain circumstances, the true nature of the EEIP contributions is that they are incurred for the performance of the income-producing operations of the entity and are directly related to an entity conducting business in South Africa. The EEIP contributions are made for the purpose of improving an entity's business prospects by allowing it to remain competitive in the South African climate. These contributions would therefore be revenue in nature and deductible in terms of section 11(a) of the Act.

### 3.6 Equity instruments carrying preference rights

The Codes also allow ownership points to be earned in respect of equity instruments carrying preference rights. In terms of paragraph 3.14 of Statement 100, such an equity instrument is measurable in the same manner as ordinary equity instruments. It is further clarified (Department of Trade and Industry, 2013: 100-15) that "an equity instrument carrying preference rights that has characteristics of debt, regardless of whether the debt is that of an entity or a participant, must be treated as an ordinary loan. If the debt is that of a Black person, it may be subject to measurement under Net Value."

Preference shares can be used in a variety of ways to accommodate the introduction of a B-BBEE shareholder. Over and above the direct issue of preference shares to Black persons, a measured entity might convert some of its ordinary shares into preference shares for a value equal to the value of the ordinary shares. The preference shares represent debt in the business and would therefore diminish the value of the business so that it becomes more affordable for the prospective B-BBEE shareholder to acquire shares in the measured entity. Alternatively, a measured entity may acquire preference shares from a prospective B-BBEE shareholder. These funds could then be used by the B-BBEE shareholder to fund the acquisition of shares in the measured entity. The preference shares could then be redeemed by the measured entity at a later stage.

Preference shares normally provide for a fixed rate of interest, which determines the return to shareholders in the form of dividends. Preference shares can be redeemable by the holder after a certain period and could also be convertible into ordinary shares at the option of the company or the holder. The characteristics of a preference share make it a hybrid between equity and debt. Section 8E and section 8F of the Act set out specific anti-avoidance provisions in respect of hybrid equity instruments and hybrid debt instruments.

A "hybrid equity instrument", in terms of section 8E of the Act, includes, *inter alia*,

- any share, other than an equity share, where the issuer of that share is obliged to redeem the share within three years of the date of issue of those shares or where the holder of that share may exercise an option to do so;

- a share that does not rank *pari passu* with all other equity shares with regard to participation in dividends; or
- a share where dividends payable on such share are to be calculated with reference to a specified rate of interest.

Section 8E(2) provides that any dividend received by or accrued to a person in respect of a hybrid equity instrument must be deemed in relation to that person to be an amount of income accrued to that person. This means that the dividend will be taxable in the hands of the shareholder but will remain a dividend in the hands of the issuer and will not be deductible for income tax purposes.

Section 8F describes a "hybrid debt instrument" as an instrument which is, *inter alia*, convertible to ordinary shares. The implication of a "hybrid debt instrument" in terms of section 8F(2) is that any amount of interest incurred by a company in respect of that instrument is deemed to be a dividend *in specie* in respect of a share that is declared and paid by that company and is therefore not deductible for income tax purposes. The company that is deemed to have declared an *in specie* dividend is required to pay the dividend tax of 20% on the amount. The deemed dividend will be exempt in the hands of the shareholder in terms of section 10(1)(k)(i).

**3.7 Share incentive schemes**

Measured entities as employers can earn ownership points by means of employee share incentive schemes in which Black people participate. These schemes can be complex structures and often involve the use of a trust or a company as a vehicle to hold or vest shares. The Act provides for two main categories of share incentive schemes, namely, broad-based employee share plans as contemplated in section 8B, and other share plans in terms of section 8C. Income tax implications arise from share incentive plans upon the award and disposal of shares, as well as while the shares are held by an employee.

### 3.7.1 Disposal of shares - Broad-based employee share plans

Section 8B of the Act provides for the inclusion in income of any gain made by an employee on the disposal of any qualifying equity share acquired in terms of a broad-based employee share plan if it is disposed of within five years of that acquisition. This gain also constitutes "remuneration" as defined in paragraph 1 of the Fourth Schedule to the Act and therefore an employer must withhold employees' tax from the amount of the gain. Section 8B defines the term "gain" as the excess of the amount received or accrued for the disposal, over the consideration given for a qualifying equity share, right or interest (otherwise than in the form of services rendered or to be rendered or anything done or to be done or not to be done). Thus, gains made by an employee who receives shares in terms of this scheme are tax-free if the shares are not disposed of within five years of their acquisition. Section 8B outlines the requirements of a broad-based employee share plan.

- The employer must offer equity shares in itself or in a company that is an associated institution (as defined in the Seventh Schedule to the Act) in relation to the employer to its employees for consideration, which does not exceed the minimum consideration required by the Companies Act[6].
- The employees may not participate in any other equity scheme of the employer or an associated institution in relation to the employer.
- The offer to participate in the scheme must be made to at least 80% of all employees (excluding those who participate in another equity scheme of the employer or an associated institution) who are employed on a permanent basis on the date of grant and who have continuously been so employed on a full-time basis for at least one year.
- The employees who acquire the equity shares must be entitled to all dividends and full voting rights in relation to those shares.
- No onerous restrictions must be imposed in respect of the disposal of the shares, other than
    - a restriction imposed by legislation;
    - a right of any person to acquire those equity shares from the employee or former employee, where the employee or former employee is or was guilty of

[6] In terms of section 40 of the Companies Act, 71 of 2008, the board of a company may issue authorised shares only for adequate consideration to the company or as determined by the board in terms of conversion rights associated with previously issued securities of the company or as a capitalisation share.

misconduct or poor performance, at the lower of market value on the date of grant or the market value on the date of acquisition, or, in any other case, at market value on the date of acquisition by that person; or

- a restriction on the disposal of the shares by the employee or former employee who acquired the shares for a period not exceeding five years from the date of the grant.

For the purposes of section 8B, the date of grant of a share is the date on which the directors of the company or a similar authority approve such an offer. Furthermore, a "qualifying equity share" means an equity share acquired by a person in terms of a broad-based employee share plan, where the market value of all equity shares (as determined on the relevant date of grant of each equity share) which were acquired by that person in terms of that plan in that year and the four immediately preceding years of assessment, does not in aggregate exceed R50 000. In this regard De Koker and Williams (2020: Online) commented that:

> The construction of this definition may lead to difficulty of application. What is not clear is the exact outcome should the market value of the shares awarded exceed R50 000? Does the total amount not qualify or only the amount in excess of R50 000? It is respectfully submitted that the phrase 'does not in aggregate exceed R50 000' should preferably read 'to the extent that it does not in aggregate exceed R50 000'.

Section 8B supersedes section 9C of the Act, which provides (in section 9C(2)) that where a share is held for three years or more, any expenditure incurred in respect of the share and the proceeds from its disposal are deemed to be of a capital nature. Where the shares in a broad-based employee share plan are disposed of after five years of acquisition or the equity shares are not "qualifying equity shares", the disposal must be dealt with in terms of the Eighth Schedule to the Act for capital gains tax purposes. In terms of section 40C of the Act, where shares are issued for no consideration, the expenditure incurred on their acquisition is deemed to be nil. Thus, where an employee was issued with shares in terms of a broad-based employee share plan for no consideration, the base cost of the shares disposed of after five years of their acquisition will be nil.

Section 8B(2) provides for the situation where an employee replaces the qualifying equity shares held in a broad-based share plan with new shares. In this case, the replacement equity

shares, which are acquired, are deemed to be qualifying equity shares acquired on the date of grant of the original shares for consideration equal to consideration given for the original shares. In addition, section 8B(2A) provides that where a person acquires equity shares by virtue of any qualifying equity shares held, the new shares are deemed to be qualifying equity shares acquired on the date of grant of the original shares. Section 8B(2B) states that if a person disposes of any right or interest in a qualifying equity share, the amount of consideration incurred in respect of the acquisition of that qualifying equity share that is attributable to that right or interest must be determined in accordance with the ratio that the amount received for the disposal of that right or interest bears to the market value of that qualifying equity share immediately before that disposal.

### 3.7.2 Disposal of shares - Other employee share plans

Broad-based employee share plans are beneficial for employers and employees from an income tax and B-BBEE perspective. Despite this benefit, employers may prefer to link the awarding of equity shares to their employees' performance. These employee share plans are probably more suited to employees at managerial and director level. Because of the conditions attached to these plans, the equity shares become subject to certain restrictions and would no longer constitute "qualifying equity shares" as contemplated in section 8B. In these circumstances, the provisions of section 8C are likely to apply. Section 8C replaced section 8A which is still applicable to rights to marketable securities obtained before 26 October 2004. Section 8C will not apply in instances where section 8B applies or to an equity instrument acquired in exchange for an equity instrument that has already vested.

The purpose of section 8C is to defer the gain on an equity instrument until vesting. In this regard, paragraph 13(1)(a)(iiB) was inserted into the Eighth Schedule, which defers the time of disposal of an equity instrument by a trust to the qualifying employee beneficiary until the equity instrument is unrestricted and vests in the hands of the qualifying employee beneficiary for the purposes of section 8C.

Section 8C includes in the income of a taxpayer any gain or allows a deduction for any loss in respect of the vesting of an equity instrument if that equity instrument was acquired –

- by virtue of the taxpayer's employment or office as director of a company or from any person by arrangement with the taxpayer's employer;

- by virtue of any restricted equity instrument held by the taxpayer in respect of which section 8C will apply upon vesting of the instrument; or
- as a restricted equity instrument during the period of the taxpayer's employment by or office of director of any company -
  - from that company or any associated institution in relation to that company; or
  - from any person who is a director of that company or of any associated institution.

The gain or loss is of a revenue nature and generally calculated as the difference between the market value of the equity instrument at the time it vests and the sum of any consideration given in respect of that equity instrument. In certain cases, where there is a disposal of a restricted equity instrument to an employer at less than market value or where there is a release, abandonment or lapse of an option or a convertible financial instrument, the gain or loss is calculated as the difference between the amount received by or accrued to the taxpayer and the sum of any consideration given. Any other amount received by or accrued to a taxpayer in respect of a restricted equity instrument must be included in income if that amount does not constitute a return of capital or a dividend.

An "equity instrument" is defined in section 8C as a share or member's interest in a company, which includes an option, a financial instrument convertible into an equity instrument, or a contractual right, or obligation whose value is determined with reference to any share or member's interest.

The term "vesting" has a specific meaning in terms of section 8C and this meaning may differ from the vesting rules of a share scheme. An unrestricted equity instrument is deemed to vest at the time of that acquisition, whereas a restricted equity instrument is deemed to vest in the following instances:

- when all the restrictions cease to have effect;
- immediately before that, taxpayer disposes of that restricted equity instrument unless the disposal constitutes an equity instrument swap or non-arm's-length transaction;
- when an option that qualifies as a restricted equity instrument terminates (otherwise than by the exercise or conversion of that equity instrument);

- immediately before that taxpayer dies, if all the restrictions relating to that equity instrument are or may be lifted on or after death; or
- when an option to acquire an equity instrument, or financial instrument convertible into an equity instrument, is released, abandoned or lapses.

A restricted equity instrument is essentially an equity instrument with a restriction imposed on it and an "unrestricted equity instrument" is an equity instrument, which is not a restricted equity instrument. Section 8C defines a restricted equity instrument as an equity instrument –

- which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;
- which is subject to any restriction that could result in the taxpayer forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value or being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;
- if any person has retained the right to impose a restriction contemplated above;
- which is an option where the equity instrument that can be acquired in terms of that option will be a restricted equity instrument;
- which is a convertible financial instrument that, when converted, will be a restricted equity instrument;
- if the employer, associated institution in relation to the employer, or other person by arrangement with the employer has at the time of acquisition by the taxpayer of the equity instrument undertaken to cancel the transaction or repurchase that equity instrument from that taxpayer at a price exceeding its market value on the date of repurchase, if there is a decline in the value of the equity instrument after that acquisition; or
- which is not deliverable to the taxpayer until the happening of an event, whether fixed or contingent.

In terms of section 8C(4), where a taxpayer disposes of a restricted equity instrument for another restricted equity instrument in the taxpayer's employer company or an associated institution, the new instrument is deemed to be acquired by virtue of the taxpayer's employment or office of director. If there is any payment in a form other than a restricted equity instrument, the payment less any consideration attributable to the restricted equity instrument is deemed to

be a gain or loss, which must be included in or deducted from the income of the taxpayer in the year of assessment during which the original instrument is disposed of.

Section 8C includes specific anti-avoidance rules aimed at addressing the artificial reduction of taxable gains on equity instruments before the appreciation of the instrument is fully realised. In terms of section 8C(5), a disposal to a connected person or a disposal which is not at arm's length, is not treated as a vesting event. Instead, the transferee of the instrument "steps into the shoes" of the transferor. Therefore, when the instrument vests, the transferor will be taxed on the gain as though there was no transfer of the instrument. This deeming rule does not apply where a taxpayer, in terms of a restriction imposed, disposes of a restricted equity instrument to the taxpayer's employer, an associated institution or other person by arrangement with the employer, and the amount received is less than the market value of the instrument. Any subsequent transfer of a restricted equity instrument will also be deemed a non-event for vesting and any gain or loss will remain taxable or deductible in the hands of the first transferor. If an equity instrument was acquired by any person other than the taxpayer by virtue of the taxpayer's employment or office of director, that equity instrument must be deemed to have been acquired by that taxpayer and disposed of to that person. Equity instruments that have not yet vested when a taxpayer ceases to be a resident are excluded from the deemed disposal provisions of paragraph 12(2)(a) of the Eighth Schedule to the Act, which provide that, on ceasing to be a resident, the taxpayer is deemed to have disposed of his or her assets (subject to certain exclusions).

When equity instruments that are held by the taxpayer for speculative purposes are disposed of after vesting, section 9C may apply to deem the disposal to be capital in nature, if the equity instruments have been held for a period of at least three years. Where section 9C does not apply, the capital or revenue nature of the transaction must be determined. When the disposal occurs after vesting of an instrument held by the taxpayer on capital account, a capital gain or loss needs to be determined. The gain or loss will be calculated as the difference between the proceeds on disposal and the market value of the instruments at vesting date, which is treated as the base cost in terms of paragraph 20(1)(h) of the Eighth Schedule.

### 3.7.3 Award of shares

The award of shares as contemplated in section 8B or section 8C of the Act is excluded from being a taxable fringe benefit in terms of paragraph 2(a) of the Seventh Schedule. Any shares awarded to employees are also excluded from the special inclusion in paragraph (c) of the gross income definition in section 1 of the Act. Such an award would be included in gross income as defined as it is awarded in *lieu* of or in addition to remuneration, however, the value of such an award may qualify for exemption from normal income tax in terms of section 10(1)(nC) or section 10(1)(nD). Any amount received by or accrued to a person in the form of a qualifying equity share contemplated in section 8B will be exempt in terms of section 10(1)(nC). In terms of section 10(1)(nD), any amount received by or accrued to a person that constitutes an equity instrument (as contemplated in section 8C) acquired by that person, and in respect of which section 8C applies, will be exempt from normal income tax if the equity instrument had not yet vested (as contemplated in section 8C) at the time of that acquisition or disposal. Any consideration for the disposal of such an equity instrument prior to vesting will also be exempt in terms of section 10(1)(nD)(ii).

The employer in a broad-based share plan will qualify for a deduction in terms of section 11(lA) for an amount equal to the market value of any qualifying equity share granted to an employee as contemplated in section 8B, less any consideration given by the employee for those shares. This deduction may be claimed in the year in which any qualifying equity share is granted but will, however, be limited to R10 000 per employee in any year of assessment and any excess may be carried forward to the subsequent year of assessment.

It was held in *CSARS v Spur Group (Pty) Ltd* A285/2019, that if a taxpayer uses a trust as a vehicle through which to implement an employee share scheme, and the taxpayer contributes to the trust for this purpose, such contributions will be deductible by the taxpayer in terms of section 11(a). In this case, the employer contributed to the trust, which did not constitute loans to employees and was able to prove that there was a direct link between the contributions made and the improvements in employee relations and general business operations. The taxpayer’s case was aided by clear and complete supporting documentation, which outlined in detail the purpose of the contributions made and of the employee share scheme, as well as the fact that the taxpayer’s advisers and representatives had a good understanding of the pragmatics of the scheme. Although the case dealt with contributions made to a trust, taxpayers may have an

argument to claim a full deduction for contributions made to employees to enable them to participate in an employee share scheme, especially as the contributions made will form part of employees' remuneration if paid to employees to enable them to acquire shares in the company. On the basis that such contributions constitute remuneration as defined in paragraph 1 of the Fourth Schedule to the Act, the employee will be taxed on any contributions received. It would, therefore, be more tax efficient for an employer to grant shares to its employees as this will be exempt from income tax in the hands of the employees as contemplated above.

Employers may offer financial assistance to their employees to assist them to acquire shares in the form of interest-free or low-interest loans. If the loan is granted for the purposes of a broad-based employee share plan as contemplated in section 8B, this provision of an interest-free or low-interest loan is excluded from being a taxable fringe benefit in terms of paragraph 2(f) of the Seventh Schedule. Interest-free or low-interest loans granted to enable employees to acquire equity instruments contemplated in section 8C, are not however, excluded taxable benefits under paragraph 2(f) and this type of loan will result in a taxable fringe benefit.

### 3.7.4 Dividends

In terms of section 10(1)(k)(i) of the Act, dividends that are received by or accrue to a taxpayer (including an employee in terms of a share incentive scheme) will generally be exempt from income tax. There are, however, certain exceptions to this rule, which apply, *inter alia*, to equity instruments as contemplated in section 8C as follows:

- Proviso (ii) to section 10(1)(k)(i) states that the dividend exemption does not apply to dividends received in respect of services rendered other than a dividend received in respect of a restricted equity instrument (as contemplated in section 8C).
- Proviso (dd) of section 10(1)(k)(i) prevents the dividend exemption from applying to any restricted equity instrument (as contemplated in section 8C) unless
    - the restricted equity instrument constitutes an equity share (other than an equity share that is a hybrid equity instrument as defined in section 8E(1), ignoring the three-year period requirement contemplated in that definition);

    - the dividend constitutes an equity instrument as defined in section 8C; or
    - the restricted equity instrument constitutes an interest in a trust and, where that trust holds shares, all of those shares constitute equity shares (other than an equity share that is a hybrid equity instrument as defined in section 8E(1), ignoring the three-year period requirement contemplated in that definition).
- Proviso (jj) to section 10(1)(k)(i) states that the dividend exemption does not apply to a dividend in respect of a restricted equity instrument (as contemplated in section 8C) if the dividend constitutes:
    - an amount transferred or applied by a company as consideration for the acquisition or redemption of any share in that company;
    - an amount received or accrued in anticipation or in the course of the winding up, liquidation, deregistration or final termination of a company; or
    - an equity instrument that is not a restricted equity instrument as defined in s 8C.
- Proviso (kk) to section 10(1)(k)(i) prevents a dividend in respect of any restricted equity instrument (as contemplated in section 8C) from being exempt if that dividend is derived directly or indirectly from an amount transferred or applied by a company as consideration for the acquisition or redemption of any share in that company or an amount received or accrued in anticipation or in the course of the winding up, liquidation, deregistration or final termination of a company.

### 3.8 Trusts

A measured entity may achieve its B-BBEE objectives by granting ownership to Black persons through a trust. The Codes set out the requirements, which must be met for a trust to be considered for the ownership element of B-BBEE. These trusts may include broad-based ownership schemes such as a family trust where Black persons are beneficiaries of the trust or an employee share ownership trust, which facilitates the distribution of shares to employees of an entity. Edward Nathan Sonnenbergs (2009: Online) outlined the mechanics of a share incentive trust noting that:

> [t]he key characteristic of the SIT [share incentive trust] is that the underlying shares in the company are held by the SIT without any restriction, and because the beneficiaries do not have any vested rights in the underlying capital or assets of the SIT (i.e. the shares in the company), the trustees are empowered to dispose of the shares at their sole discretion.

> Until the shares are so disposed of, the voting rights attached to the shares are exercised by the trustees of the SIT for the benefit of the beneficiaries.

The trusts referred to above should be clearly distinguished from other trusts that are established for community development or employee wellness, as these trusts may not be considered for the ownership element of the B-BBEE scorecard. Such trusts may, however, fall within the ambit of the other elements of the B-BBEE scorecard, which are discussed further in chapter four of this thesis. According to Steyn (2019: Online) the B-BBEE Commissioner addressed this distinction stating that:

> Recent statements by the commissioner of the Broad-Based Black Economic Empowerment (B-BBEE) Commission, Zodwa Ntuli, have resulted in much media attention and commentary on the use of broad-based trusts in B-BBEE ownership structures. The commissioner stated that the "vast majority" of transactions involving such trusts are not compliant with the law and do not constitute genuine and effective black ownership. She also stated that the beneficiaries of a broad-based trust must be clearly identifiable and able to exercise voting rights; must receive the same economic benefits as other shareholders; and ultimately become the unencumbered owners of the shares in which they are invested.

Thus, although trusts are considered to be a simpler method of acquiring Black ownership in an entity, it is important that all the requirements of the Codes are met so that the measured entity may qualify to earn points for its B-BBEE scorecard.

### 3.8.1 Rate of income tax for trusts

The rate of income tax applicable to trusts depends on whether the trust is an ordinary trust or a special trust. Ordinary trusts are subject to a tax rate of 45%, while special trusts apply the sliding scale used for individuals[7]. In terms of paragraph 10 of the Eighth Schedule to the Act, a special trust's net capital gains are included in taxable income at a rate of 40%, whereas for other trusts, this inclusion rate is 80%. A special trust is defined in section 1 of the Act as a trust created –

[7] Available on SARS website (South African Revenue Service, 2021: Online)

- solely for the benefit of one or more persons who is or are persons with a disability as defined in section 6B(1) where such disability incapacitates such person or persons from earning sufficient income for their maintenance, or from managing their own financial affairs; or
- by or in terms of the will of a deceased person, solely for the benefit of beneficiaries who are relatives in relation to that deceased person and who are alive on the date of death of that deceased person (including any beneficiary who has been conceived but not yet born on that date), where the youngest of those beneficiaries is on the last day of the year of assessment of that trust under the age of 18 years.

A trust created for the purposes of B-BBEE is therefore likely to be an ordinary trust.

### 3.8.2 General income tax principles relating to trusts

Section 25B of the Act deals with the allocation of taxable income between the beneficiaries of a trust and the trust itself. The beneficiaries' vesting rights drive this allocation. To the extent that a beneficiary has a vested right to an amount, the amount is deemed to accrue to the beneficiary, otherwise the amount will be deemed to have accrued to the trust itself. The deeming rules of section 25B are subject to the provisions of section 7, which governs the attribution of income.

With regard to an employee share ownership trust created for a broad-based employee share plan, any gain or loss arising on disposal of an equity instrument will vest in the employee and not the trust. Such a gain on disposal of the equity instrument will be tax-free in the employee's hands provided that the employee has not disposed of the equity instrument within five years of acquisition. With regard to other employee share plans, a trust will be taxable on gains, and will be allowed a deduction for a loss, arising from equity instruments to which section 8C applies, provided such gain or loss has not yet vested in the hands of the employee. Where the equity instrument has vested in the employee, income tax implications of the gain or loss will arise for the employee as contemplated in section 3.7.2 above.

With the involvement of a trust in any arrangement, the conduit pipe or flow-through principle becomes relevant, which applies to ensure that the income of a trust retains its nature until it

reaches the party in whose hands such income is taxed. This principle was established in *Armstrong v CIR* 1938 AD 343, 10 SATC 1 (A) and is reinforced by section 25B(1) of the Act. Where income is allocated to parties, all expenditure (deductible and non-deductible) should be allocated between the parties accordingly. There are, however, measures (section 25B(4)) which prevent the beneficiaries from claiming an assessed loss where their deductible expenditure exceeds income.

Paragraph 80 of the Eighth Schedule to the Act provides for the same flow-through principle in respect of capital gains. In terms of paragraph 80(2), where a capital gain arises in a trust in a year of assessment during which a trust beneficiary has a vested interest (or acquires a vested interest) in that capital gain but not in the asset, the disposal of which gives rise to the capital gain, the capital gain so vested must be taken into account for the purposes of calculating the aggregate capital gain of the beneficiary in whom the gain vests. This attribution only applies to capital gains, as capital losses are retained in the trust. In addition, paragraph 80 specifically does not apply to equity instruments as contemplated in section 8C of the Act (paragraph 80(1)).

In *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271(A), the question of whether an employee share trust was involved in a scheme of profit making was deliberated. The trust in this case was created for the purpose of administering a share scheme for the benefit of Pick 'n Pay employees by giving employees the opportunity to acquire shares and align their personal interests with those of the company. Practically, the trust would acquire shares and sell these shares to employees. Once sold, the shares would be held by the trust on behalf of the employee for at least five years or until the employee left the company. Where an employee left employment before the five-year period had expired or if he or she was dismissed for dishonest conduct, the shares held on behalf of that employee would be forfeited. When these forfeited shares are later sold, the trust would usually make a profit. The question, which arose in the case, was whether this profit was capital or revenue in nature. In this regard, the trust contended that it did not have an intention to make a profit from its activities and the profit earned on forfeited shares was simply incidental. The trust simply bought and sold shares as it was required to and did not have the ability to trade freely in the market like other companies that are in the business of share dealing. Furthermore, the trust was obliged to repurchase shares that were forfeited. Smalberger JA clarified (at 280) that the question of whether a receipt is capital or revenue in nature "still depends on whether thebusiness was conducted with a

profit-making purpose." On the basis that the trust did not have an intention to conduct business as it operated primarily as a conduit, the profits earned by the trust would be capital in nature. It can be concluded therefore, that the profit earned by an employee share trust on the disposal of shares would be capital in nature.

### 3.8.3 Attribution rules

The anti-avoidance rules in respect of the attribution of income and capital gains are housed in section 7 and paragraphs 68 to 73 of the Eighth Schedule (collectively, the "attribution rules"). These provisions prevent income and capital gains from being redirected to a trust or its beneficiaries in terms of section 25B and paragraph 80 of the Eighth Schedule, respectively. Section 7 is not only applicable where a trust is involved and may apply to other arrangements as well. For the purposes of this thesis, the attribution rules will not be considered in further detail.

## 3.9 Funding

Due to the onerous requirements of the ownership element of the B-BBEE scorecard, and the complexity of the transactions entered into in order to comply with these requirements, companies and other business structures often require significant funding for these B-BBEE initiatives. B-BBEE transactions may be funded by a measured entity by means of additional capital, preference shares or debt. The tax implications of issuing further share capital or preference shares have already been discussed in this chapter. With regard to debt, it would be important to consider the income tax implications of borrowing costs incurred in respect of such debt. Borrowing costs may comprise interest as well as guarantee fees, raising fees, and other similar fees. The deductibility of these costs is determined in terms of section 24J.

The definition of interest in section 24J includes the gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of, or in respect of a financial arrangement or amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled. The definition also includes interest in a sale and leaseback transaction, which is not relevant for the present discussion. The meaning of the term "interest" is not defined in the Act, however, its ordinary meaning is

consideration for the use of money, as was established in *CIR v Genn* 1955 (3) SA 293 (A), 20 SATC 113. In *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA), the court held that interest is the stipulated return which a lender would require if he lends money to a borrower.

Section 24J refers to a yield-to-maturity according to which interest is calculated in respect of any instrument such as any interest-bearing arrangement or debt. For interest to be deductible, it should be incurred in the carrying on of a trade and in the production of income. Section 24J does not, however, require a determination of whether or not interest is capital in nature, and therefore all interest is considered to be revenue in nature. The concepts of "in the carrying on of trade" and "in the production of income" have been discussed in detail in chapter two in relation to B-BBEE expenditure and those principles would apply similarly to interest expenditure. Therefore, a company or other business structure would be carrying on a trade and the B-BBEE initiative would have as its purpose the production of income.

A prospective B-BBEE shareholder may obtain shares in a measured entity and may incur debt in order to fund the acquisition of those shares. On the basis that interest expenditure incurred in acquiring shares in a company is incurred for the purposes of earning dividend income (which would normally be exempt), this interest expenditure would not be incurred in the production of the shareholder's income as required by section 24J.

### 3.9.1 Foreign funding

Where funding is obtained from foreign sources, further income tax implications may arise. The withholding tax in terms of section 50A on interest payable to the foreign lender may become applicable. The standard rate of the withholding tax on interest is 15%, but this rate may be reduced in terms of a double tax agreement between South Africa and the country of the foreign lender. For the purposes of this thesis, the detailed provisions in respect of the withholding tax on interest will not be discussed further.

In addition to the withholding tax, the interest limitation rules of section 23M are relevant. This interest limitation applies where an amount of interest is incurred by a debtor in respect of a

debt owed to a creditor that is in a controlling relationship[8] with that debtor, or if not in a controlling relationship, if that creditor obtained funding for the debt advanced to the debtor from a person who is in a controlling relationship with that debtor (section 23M(2)). In addition, section 23M will only apply to the extent that the amount of interest incurred by the debtor is not subject to tax in the hands of the creditor (this includes where the rate of withholding tax on interest is reduced to nil in terms of a double tax agreement). In terms of section 23M(3), the amount of interest that is allowed to be deducted must not exceed the sum of –

- the amount of interest received by or accrued to the debtor;
- an amount determined by multiplying the adjusted taxable income of that debtor for that year of assessment by a percentage to be determined in accordance with the formula outlined in subsection (3)[9];
- reduced by so much of any amount of interest incurred by the debtor in respect of debts, other than debts from foreign entities that are not subject to income tax in South Africa, as exceeds any amount not allowed to be deducted in terms of section 23M.

Adjusted taxable income as defined in section 23M(1) means taxable income calculated before applying the provisions of section 23M. This amount must be reduced by the following:

- any amount of interest received or accrued that forms part of taxable income;
- any amount included in the income of a person as a result of the imputation of income of a controlled foreign company (contemplated in section 9D (2)); and
- any amount recovered or recouped in respect of an allowance contemplated in respect a debt benefit arising of debt used to fund a capital asset (contemplated in section 19).

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[8] For the purposes of section 23M, a "controlling relationship" means a relationship where a person holds at least 50 per cent of the equity shares of a company or can exercise at least 50 per cent of the voting rights in that company.

[9] Percentage determined in terms of the following formula:

$$A = B \times \frac{C}{D}$$

in which formula—

(*a*) "A" represents the percentage to be determined;

(*b*) "B" represents the number 40;

(*c*) "C" represents the average repo rate plus 400 basis points; and

(*d*) "D" represents the number 10,

however, not exceeding 60 per cent of the adjusted taxable income of that debtor.

In addition, the amount must be increased by the following:

- any amount of interest incurred that has been allowed as a deduction from income;
- any amount allowed as a deduction in respect of a capital asset, other than the determination of any capital gain or capital loss;
- 75 per cent of the receipts or accruals derived from the letting of any immovable property; and
- any assessed loss or balance of assessed loss allowed to be set off against income.

### 3.9.2 Arm's length principle

South Africa's "thin capitalisation" rules are provided for in section 31 and are based on an arms-length principle. The transfer pricing rules measure, *inter alia*, the arm's length nature of the terms of financing, the debt burden and the interest charge. Excessive interest is not deductible and may also, in terms of section 31, be subject to a secondary tax adjustment in the form of a deemed dividend. Where a South African company obtains funding for a B-BBEE transaction from a foreign holding company or fellow subsidiary, the provisions of section 31 may become relevant. The purpose of section 31 is to ensure that international transactions are at arm's length and addresses the risk of a depleted tax base in South Africa arising, *inter alia*, from excessive debt funding of South African residents by non-residents.

The provisions of section 31 apply where there is an "affected transaction" as defined in subsection (1). An affected transaction means any transaction, operation, scheme, agreement or understanding that has been directly or indirectly entered into or effected between or for the benefit of either or both –

- a person that is a resident and any other person that is not a resident;
- a person that is not a resident and any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;
- a person that is a resident and any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or
- a person that is not a resident; and any other person that is a controlled foreign company in relation to any resident (this is not relevant for B-BBEE transactions).

In each of the above situations, the parties concerned must be connected persons in relation to each other as contemplated in section 1 of the Act. For the purposes of B-BBEE, the relevant section of the "connected person" definition in section 1 of the Act is in relation to a company and means –

- any other company that would be part of the same group of companies as that company if there is a shareholding of at least 50 per cent;
- any person, other than a company that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of the equity shares in the company or the voting rights in the company;
- any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company[10];
- any other company if such other company is managed or controlled by any person who or which is a connected person in relation to such company or any person who or which is a connected person in relation to that connected person.

An additional requirement of an "affected transaction" is that there must be a term or condition which is different from the terms and conditions which would have applied if the parties were dealing at arm's length as independent persons. This would apply where the interest rate charged on a foreign debt is not an "arm's length" rate and/or the amount of the debt itself is such as would not have been granted between parties dealing at arm's length. Section 31 makes provision for two adjustments to taxable income of the parties concerned. The primary adjustment arises when there is an affected contract whose terms and conditions result in a tax benefit for any party to the contract. In this case the taxable income of the parties concerned must be calculated as though the transaction had been entered into on an arm's length basis (section 31(2)). The secondary adjustment deems the amount of the primary adjustment to be a dividend *in specie* (which will attract dividends tax) where a resident company made the primary adjustment. Where the primary adjustment is made by a resident other than a company, this adjustment is deemed to be a donation, which will attract Donations Tax (not discussed in this thesis). The remaining provisions of section 31 are not relevant for B-BBEE transactions and, in addition, have therefore not been discussed further.

[10] In terms of section 31(4), the expression "and no holder of shares holds the majority voting rights in the company" in the definition of "connected persons" must be disregarded.

### 3.9.3 Generally accepted practice regarding interest

Although it has been concluded earlier that interest incurred for B-BBEE purposes will be incurred in the production of income and in the carrying on of a trade, SARS has nevertheless adopted a practice of allowing a deduction for any interest expenditure to the extent that it does not exceed income. This practice may be beneficial to companies (that are not in the business of moneylending) who advance interest-bearing loans to fellow subsidiaries to fund a B-BBEE transaction. According to Practice Note no 31, (South African Revenue Service, 1994: Online):

> While it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, **it is nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income.** This practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue. (emphasis added)

Thus, despite the requirements of section 24J that interest should be incurred in the production of income in carrying on a trade, interest expenditure would normally be allowed as a deduction to the extent that it does not exceed interest income. The provisions of section 23M and section 31 are not, however, superseded by this practice.

### 3.9.4 Proposed amendments to the limitation of interest expenditure

During the annual budget speech presented by the South African Minister of Finance in 2020, the National Treasury released, as part of the budget documentation, a document outlining the proposed overhaul of interest limitation rules. These proposals were released for public comment and have not yet become effective. National Treasury (2020b: Online) outlined the following proposed amendments and comments:

- The interest limitation rules will be extended to apply to the total (external and connected) net interest expense and equivalent payments and to all entities operating in South Africa that form part of a foreign or South African multi-national group.

- The definition of interest will be broadened beyond the section 24J definition to include payments economically equivalent to interest.
- The interest limitation will be applied to "income tax EBITDA"[11] and the proposed level for the fixed ratio (relevant for the formula in section 23M(3)) will be reduced to 30%, which will result in a stricter limitation on interest. Excessive interest expense, which is not deductible, may be carried forward and this carry forward is limited to five years on an annual first-in-first-out basis.
- The limitation will be subject to a *de minimis* rule which will be set at between R2 million and R5 million, where the interest limitation rules will not apply to debts with a value lower than this threshold.
- The amended rules were expected to replace section 23M, however section 23N[12] is expected to remain in place.
- Transfer pricing rules in section 31 should be applied first. This means that the interest limitation rules should apply to net interest that has already passed the arm's length test.
- A safe harbour approach for "thin capitalization" (excessive debt-to-equity) is being considered.

**3.10 Conclusion**

The Codes refer to three priority elements, which represent the focal points of the B-BBEE regulations. These are ownership, skills development, and enterprise and supplier development. All measured entities are required to comply with the ownership element of B-BBEE, which makes ownership structures critical for any taxpayer seeking to improve its B-BBEE status. Statement 100 of the Codes highlights various structures through which the requirements of the ownership element of the generic scorecard may be satisfied.

One of the ways in which points for the ownership element for the B-BBEE scorecard are earned is through the introduction of a "B-BBEE shareholder." Where the measured entity is a company, the structure would normally involve a sale or issue of shares to Black people or an

[11] Earnings before interest, income tax, depreciation and amortisation

[12] Where an amount of interest is incurred by a company in terms of a debt obtained for the purpose of funding an "acquisition transaction" or a "reorganisation transaction", as defined in section 23N, the amount of interest allowed to be deducted must be limited in terms of section 23N(3). In terms of section 23N of the Act, an "acquisition transaction" as contemplated in section 24O, and a "reorganisation transaction" means a corporate transaction to which section 45 or section 47 of the Act applies.

entity through which Black people will indirectly hold their shares. The issue of new shares by a company will not have any income tax implications. An outright sale of shares to a B-BBEE shareholder for cash consideration will have income tax implications for the previous shareholder, which will include capital gains tax if the asset was held as a capital asset. Such a sale may be facilitated by a holding company selling all or a portion of its shareholding in a measured entity to a B-BBEE shareholder. An asset-for-share transaction involves the disposal of an asset or assets in exchange for equity shares and is a practical way to incorporate Black ownership into a company's shareholding. The deeming provisions in terms of section 40CA, which deals with assets acquired in exchange for shares or a debt, and section 24BA, where asset for share transactions are not at arm's length, were discussed with regard to B-BBEE transactions, as well as section 42, which allows an asset-for-share transaction to be conducted in a tax neutral manner (provided all relevant requirements are met).

Statement 102 of the Codes sets out the conditions where a sale of assets, equity instruments and other business may be recognised for the purposes of the ownership element of the scorecard by the seller. This may include an outright sale of assets, which will trigger income tax implications for the seller, including capital gains tax if the asset was held as a capital asset, or an inclusion in gross income, if the asset is held as trading stock.

The Codes also provide for an Equity Equivalent Investment Programme that was created specifically for multi-nationals seeking to earn B-BBEE points. It was concluded that even though contributions in respect of an Equity Equivalent Investment Programme may have a long-term benefit in certain circumstances, the true nature of the contributions is that they are incurred for the income-producing operations of the entity and are directly related to an entity conducting business in South Africa. These contributions would therefore be revenue in nature and deductible in terms of section 11(a) of the Act.

This chapter also discussed the income tax implications arising from equity instruments carrying preference rights, and the provisions of section 8E and section 8F dealing with hybrid equity instruments and hybrid debt instruments, respectively. These provisions have the effect of deeming interest to be dividends and *vice versa* in specific circumstances outlined in the sections and may be relevant in relation to share structures underpinning B-BBEE share ownership transactions.

A measured entity can earn ownership points by means of share incentive schemes involving Black persons. These schemes may comprise broad-based employee share plans and other employee share plans. The income tax implications for both the employee or director and the company that arise from share incentive plans upon award and disposal of shares, as well as while the shares are held by an employee were discussed.

A measured entity may achieve its B-BBEE objectives by granting ownership to Black persons through a trust. The Codes set out the requirements which must be met for a trust to be considered for the ownership element of the B-BBEE Codes. A trust created for the purposes of B-BBEE is likely to be an ordinary trust, will be taxed at a rate of 45% and will have a capital gains tax inclusion rate of 80%. The provisions of section 25B in relation to the vested rights of beneficiaries in a trust, as well as the flow-through principle of trusts were discussed.

Due to the onerous requirements of the ownership element of the B-BBEE scorecard, and the complexity of the transactions entered into in order to comply with these requirements, B-BBEE initiatives often require significant funding. The income tax implications of borrowing costs incurred in respect of such funding were therefore discussed, which included section 24J, section 23M and section 31. National Treasury have proposed amendments to these sections, which are not yet effective.

This chapter presented a discussion of the income tax implications arising from transactions or structures entered into for the purposes of earning points for the ownership element of the generic scorecard. In the next chapter, the income tax implications of transactions or structures entered into to earn points for the remaining elements of the generic scorecard will be discussed. These elements include management control, skills development, enterprise and supplier development, and socio-economic development.

# CHAPTER 4: OTHER ELEMENTS OF THE BROAD-BASED BLACK ECONOMIC EMPOWERMENT SCORECARD

## 4.1 Introduction

In the previous chapter, the tax implications arising from transactions and structures entered into for the purposes of earning points for the ownership element of the B-BBEE scorecard were discussed. This chapter will investigate the tax implications arising from transactions and structures entered into for the purposes of earning points for the remaining elements of the B-BBEE scorecard. Chapters three and four therefore address the goals of the research as set out in chapter one:

- identify a selection of B-BBEE transactions or structures that may be entered into for the purpose of earning points for the various elements of the B-BBEE scorecard;
- identify the types of expenditure incurred in implementing these B-BBEE transactions or structures entered into for the purpose of earning points for the B-BBEE scorecard;
- analyse provisions of the Act that apply to the B-BBEE expenditure, transactions or structures;
- discuss case law that will be relevant in determining the income tax implications of the B-BBEE expenditure, transactions or structures identified; and
- conclude to what extent the expenditure identified will be deductible.

Management control is the second element of the B-BBEE scorecard and represents the participation of Black people and Black women at Board, Executive, Senior Management, Middle Management and Junior Management levels, as well as Black employees with disabilities. Management control by Black persons may be achieved through preferential recruitment policies or by promoting employees from within the entity. Management control is closely linked to the other elements of the B-BBEE scorecard in that skills development and socio-economic development may assist a measured entity to achieve its management control goals.

Skills development is the next element of the B-BBEE scorecard and is the measurement of an entity’s expenditure on learning programmes, bursaries, learnerships, apprentices and internships that benefit Black persons. The Act provides a tax allowance for employers who offer approved learnerships to its staff in terms of section 12H. In addition, employees who

receive bursaries from their employers may qualify for an exemption in terms of section 10(1)(q) or section 10(1)(qA) of the Act. These exemptions have recently been the subject of scrutiny by the National Treasury and the proposed amendments to these provisions will be discussed. Staff training also forms a crucial aspect of skills development and the income tax consequences of this expenditure will be considered.

The fourth element of the B-BBEE scorecard is enterprise and supplier development, which is a measurement of an entity's preferential procurement, enterprise development and supplier development. Measured entities are encouraged to align supply chain requirements with their enterprise and supplier development in order to establish their preferential procurement policy. The intention is for measured entities to develop enterprises so that they may become preferred suppliers in the supply chain. This could be achieved by skills development and capacity building, or by establishing new businesses. Skills development and capacity building could be done in the form of contributions to enable these businesses to develop. For the establishment of new businesses, a tax allowance for taxpayers who invest in venture capital companies as contemplated in section 12J may apply. This incentive will be discussed in this chapter.

The fifth and final element of the B-BBEE scorecard is socio-economic development, which assesses a measured entity's contributions for the socio-economic development of Black persons and their communities. Socio-economic development contributions are measured as a percentage of a measured entity's net profit after tax. In this regard, social responsibility contributions may qualify for an income tax deduction for qualifying donations made in terms of section 18A. In addition, as discussed in chapter two, corporate social responsibility contributions may also qualify for an income tax deduction in terms of section 11(a) read with section 23(g), where section 18A will not apply (section 23B(3) specifically prohibits a deduction in terms of section 11(a) where a deduction or allowance is granted under any other provision of the Act). These provisions will also be discussed. The building allowances that may be claimed by a measured entity that develops residential units, including low-cost residential units, for occupation by Black persons, and the sale of these units to Black persons for the purpose of socio-economic development, will be dealt with.

Lastly, legal, consulting and professional fees may be incurred in general for the purposes of any and all elements of the B-BBEE scorecard. The income tax deductibility of these costs will be discussed in this chapter.

**4.2 Learnership allowances**

Learnership agreements may be entered into with Black persons, including apprentices, to promote skills development. The additional tax deduction in respect of learnership agreements in terms of section 12H of the Act is granted in the form of an annual allowance and a completion allowance in respect of each registered learnership agreement an employer and its employee are party to. The deduction must be made against income derived from the particular trade. According to the South African Revenue Service (2017b: Online) in Interpretation Note no. 20, however, the wording of section 12H "does not prevent the allowance from creating a loss from the particular trade. There is also nothing in the wording to prevent such a loss from being set off against income from another trade." Where there is more than one employer that is a party to a registered learnership agreement, the employer that is identified in that agreement as the lead employer, will be the employer for the purposes of section 12H. The provisions of section 12H were amended for learnership agreements entered into on or after 1 October 2016. For any learnership agreements entered into prior to 1 October 2016, the previous version of section 12H would apply. This version is not discussed in this thesis.

A "registered learnership agreement", as defined in section 12H(1), is a learnership agreement registered in accordance with the Skills Development Act, 97 of 1998 (the "SDL Act"), entered into between a learner and an employer before 1 April 2022. In practice, registrations of learnership agreements may be delayed and therefore, in terms of section 12H(2)(c) and 12H(2A)(c), any learnership agreement that has not been registered from the inception of the agreement will be deemed to have been registered on the date it was entered into, provided it is registered within 12 months after the last day of the employer's year of assessment. The definition of "learner" in section 12H(1) means a learner as defined in the SDL Act, which includes an apprentice.

The annual and completion allowances contemplated in section 12H are determined with reference to the National Qualifications Framework (NQF) level of the learner or the employee. An NQF level is a level of qualification determined in accordance with chapter two of the

National Qualification Framework Act, No. 67 of 2008. NQF levels comprise ten different levels, which range from successful completion of Grade 9 (level 1) to successful completion of a doctorate degree (level 10).

In terms of section 12H(2), an employer is entitled to an annual allowance of R40 000 per annum in respect of each learnership agreement entered into where the learner holds an NQF qualification of level 1 up to and including level 6. Where the learner holds an NQF qualification of level 7 up to and including level 10, an employer is entitled to an annual allowance of R20 000 per annum in respect of each learnership agreement entered into in terms of section 12H(2A). In addition, where a learner is a person with a disability, in terms of section 12H(5) and section 12H(5A), this annual allowance is increased to R60 000 for learners with an NQF qualification level of 1 up to and including level 6 and is increased to R50 000 for learners with an NQF qualification level of 7 up to and including level 10. Section 12H(2) and section 12H(2A) require an apportionment of the annual allowance for the number of full months that the learner was party to the learnership agreement during a year of assessment, where a learner was party to a learnership agreement for a period of less than 12 months in any year of assessment.

An employer is entitled to a completion allowance in a year of assessment in which a learner successfully completes a learnership. In terms of section 12H(3) and section 12H(4), where the learner holds an NQF qualification of level 1 up to and including level 6, an employer is entitled to a completion allowance of R40 000 and in terms of section 12H(3A) and section 12H(4A), where the learner holds an NQF qualification of level 7 up to and including level 10, the employer may claim a completion allowance of R20 000. In addition, where a learner is a person with a disability, in terms of section 12H(5), this completion allowance is increased to R60 000 for learners with an NQF qualification level of 1 up to and including level 6 and in terms of section 12H(5A), is increased to R50 000 for learners with an NQF level qualification of 7 up to and including level 10. Section 12H(4) and section 12H(4A) require the completion allowance to be multiplied by the number of consecutive 12-month periods within the duration of a learnership agreement where that agreement is for a period that equals or exceeds 24 full months.

As stated in Interpretation Note no. 20, the South African Revenue Service (2017b: Online) "requires sufficient proof of the successful completion of the learnership agreement in order to

allow the completion allowance under section 12H." This can be achieved through confirmation from the relevant Sector Education and Training Authority (SETA). In practice, according to Interpretation Note no. 20, it has been accepted (South African Revenue Service, 2017b: Online) that there may be delays with this process.

> In view of these difficulties, SARS will consider alternative proof. Any objective evidence as proof of successful completion will be accepted, for example – a statement of results issued by an accredited training provider; [or] an evaluation report by a registered assessor on workplace experience.

According to section 12H(6), no allowance will apply where a learner who is party to a learnership agreement previously failed to complete any other registered learnership agreement with the employer or where the registered learnership agreement contained the same education and training component as that other learnership agreement.

### 4.3 Employer provided scholarships or bursaries

An employer can also provide Black people with skills development by granting scholarships or bursaries to enable them to obtain further skills or qualifications. Section 10(1)(q) provides for the exemption of any *bona fide* scholarship or bursary granted to enable or assist any person to study at a recognized educational or research institution. Section 10(1)(qA) provides for a similar exemption for a *bona fide* scholarship or bursary which enables or assists any person with a disability to study. In the case of a scholarship or bursary that is granted to enable or assist an employee (including an employee who has a disability), the exemption in terms of section 10(1)(q) and section 10(1)(qA) will not apply unless the employee agrees to reimburse the employer if the employee fails to complete his or her studies for reasons other than death, ill-health or injury. In the case of a scholarship or bursary that will enable or assist a person with a disability to study who is a relative of an employee, the employee should be liable for family care and support for that person. In addition, for a scholarship or bursary that is granted to enable or assist a relative of an employee to study, the exemption in terms of section 10(1)(q) and section 10(1)(qA) will not apply unless certain monetary thresholds are met. Firstly, the remuneration proxy[13] as defined in section 1 of the Act derived by the employee in relation to

[13] Essentially an employee's salary or wage and other employment benefits earned during the previous year of assessment

a year of assessment should not exceed R600 000. Secondly, the monetary thresholds with regard to the value of the bursary are as follows:

- for a scholarship or bursary to fund the cost of grade R to grade twelve education as contemplated in the definition of "school" in section 1 of the South African Schools Act, 84 of 1996, the bursary should not exceed R20 000, or R30 000 where the bursary or scholarship will assist or enable a person with a disability to study;
- for a scholarship or bursary which funds a qualification that has an NQF qualification of level 1 up to and including level 4 allocation, the bursary should not exceed R20 000, or R30 000 where the bursary or scholarship will assist or enable a person with a disability to study; and
- for a scholarship or bursary which funds a qualification that has an NQF qualification of level 5 up to and including level 10 allocation, the bursary should not exceed R60 000, or R90 000 where the bursary or scholarship will assist or enable a person with a disability to study.

The National Treasury has identified abuse of the exemptions in terms of section 10(1)(q) and section 10(1)(qA) and as a result, has amended the legislation. According to the Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2020 (National Treasury: 2020a), taxpayers have sought the assistance of professional advisers to assist in implementing schemes where tax-exempt bursaries are provided to employees or relatives of employees without affecting an employee's cost to company. These schemes were effected by means of a salary sacrifice and therefore the employer would incur no additional cost for the scholarship or bursary. As a result, Government felt the need to review the policy in respect of the tax exemption for scholarships and bursaries provided to employees and relatives of employees. The amendment to section 10(1)(q) and section 10(1)(qA) has the effect that the exemptions will not apply if any remuneration to which the employee was entitled or might in the future have become entitled to was in any manner reduced or forfeited as a result of the scholarship or bursary. Effectively, employers may no longer implement a "salary sacrifice" in providing a scholarship or bursary to employees or relatives of employees. The amendment to section 10(1)(q) and section 10(1)(qA) of the Act (as amended by the Taxation Laws Amendment Act, 23 of 2020) will come into operation on 1 March 2021 and will apply in respect of years of assessment commencing on or after that date.

### 4.4 Staff training

Staff training by an employer is another way in which a business can develop the skills of Black people and earn points for the skills development element of the B-BBEE scorecard. Expenditure incurred on staff remuneration is inherently revenue in nature. Employers are generally bound by an employment contract with their employees and there is a clear and close link between remuneration paid to employees and the general operations of a business. This expenditure incurred by employers is therefore deductible for income tax purposes in terms of section 11(a) of the Act, having been incurred in the production of income. Staff training, on the other hand, is not as clear-cut, as training is not generally included in the terms and conditions of an employment contract. In addition, depending on the content and nature of the training, the link between the training and the operations of a business may be tenuous. The deductibility of expenditure incurred on staff training will need to be granted in terms of section 11(a) and section 23(g) of the Act (the general deduction formula). The various aspects of the general deduction formula have been discussed in detail in chapter two and will only be discussed with specific regard to staff training in this section.

As established in chapter two, a measured entity seeking to earn B-BBEE points is, in all likelihood, carrying on a trade and it is assumed that the staff training expenditure will represent an expenditure actually incurred. Based on the principles established in *CIR v George Forest Timber Company Limited,* 1924 AD 516, 1 SATC 20, and *New State Areas Ltd v CIR,* 1946 AD 610, 14 SATC 155, when determining whether expenditure is capital in nature, it is necessary to determine whether the expenditure is contributing to the income-earning structure of a business or to its income-earning operations. In addition, as established in *Port Elizabeth Electric Tramway Co v CIR,* 1936 CPD 241, 8 SATC 13, the purpose of expenditure must be established in order to determine if expenditure is incurred in the production of income, as required by the general deduction formula. In *Mobile Telephone Networks Holdings (Pty) Ltd v CSARS* (2011) 73 SATC 315, the employer found it necessary to provide training to its staff in order to enable them to operate a computerised record-keeping system that would assist and improve the business's accounting and reporting process. The court held (at 324) that the training expenditure was sufficiently closely connected to its income earning operations and was not therefore capital in nature. In *ITC 876* (1959) 23 SATC 221(F), the facts were that due to the rapid expansion of its business, the taxpayer found it necessary to obtain additional staff who were trained and experienced. As a result, the taxpayer arranged for the appropriate staff

to be brought out from England. The court held (at 221) that the expenditure incurred for this purpose was

> clearly incurred for the purposes of appellant company's business or in the production of its income and inasmuch as the company was already established and carrying on business when the expenditure became necessary because of the expansion of that business the expenditure was not part of the initiation of the business and was not of a capital nature.

Staff training, it is submitted, is more closely linked to the income-earning operations of an entity as opposed to its income-earning structure. Unless the staff who are provided with training enter into a long-term contract with the employer, there is no expectation of an enduring benefit to the business (*British Insulated and Helsby Cables Ltd v Atherton*, 1926 AC205 (10 T.C. 155). Expenditure incurred on staff training, including expenditure for which B- BBEE points may be earned for the skills development element of the scorecard, is therefore likely to be deductible in terms of section 11(a) in the hands of an employer who incurs such expenditure.

**4.5 Venture capital companies**

Investment in the shares of a venture capital company (VCC) is one of the ways in which a measured entity may facilitate its enterprise and supplier development for the B-BBEE scorecard. A VCC is created for the main purpose of managing investments in qualifying companies and must be approved by the Commissioner for the South African Revenue Service as a VCC. The main purpose of a VCC should be the management of investments in qualifying companies and a VCC is not therefore allowed to conduct any other business of its own. A VCC will, however, be allowed to conduct business operations which are incidental to its main purpose, such as renting out excess office space. This will be assessed by the Commissioner on a case-by-case basis to determine the extent to which a VCC has strayed from its intended purpose.

The cost of share investments held for speculation purposes (as trading stock) would be reflected as opening stock at the beginning of the year of assessment, and closing stock at the end of the year of assessment (in terms of section 22 of the Act), and the cost would only be

deducted when the shares are disposed of. Shares held as investments would be capital in nature, in which case the subscription price for the shares is the base cost in terms of paragraph 20 of the Eighth Schedule. The shares acquired in a VCC for B-BBEE purposes would clearly be acquired to be held indefinitely. Section 12J was introduced as a tax incentive to encourage investment in qualifying companies through VCCs by allowing a full deduction of the cost of the investment in a VCC. According to the Guide on Venture Capital Companies (South African Revenue Service: Online), only costs directly connected with the acquisition of the venture capital shares are deductible; costs such as borrowing costs to fund the investment will not be allowed as a deduction. The provisions of section 12J are effective for investments in VCCs acquired on or after 1 July 2009 but on or before 30 June 2021. For expenditure incurred in investing in a VCC on or after 21 July 2019, a monetary limit to the deduction was introduced. In terms of section 12J(2), the deduction must not exceed R5 million for a company and the deduction must not exceed R2,5 million for a person other than a company. There is no roll-forward for any excess of expenditure for which a deduction was not allowed based on the monetary limits. The Guide on Venture Capital Companies (South African Revenue Service: Online) confirms that the section 12J deduction may create or increase an assessed loss for a taxpayer. In addition, in terms of section 12J(4), a claim for a deduction must be supported by a certificate issued by the venture capital company stating the amounts invested in that company and that the Commissioner approved that company as a VCC.

For the purposes of section 12J (as defined in section 12J(1)), a "venture capital share" is an equity share held by a taxpayer in a VCC which was issued to that taxpayer and not purchased by the taxpayer from a previous shareholder. This share should not constitute a hybrid equity instrument (as contemplated in section 8E) and should not be a third-party backed share (as contemplated in section 8EA).

A VCC invests in "qualifying" companies. The requirements for a "qualifying company" are onerous and are outlined in section 12J(1). A qualifying company is any company where all of the following requirements are met.

- The company is a resident.
- The company is not a controlled group company (i.e. at least 70% held) in relation to a group of companies of which a VCC to which that company has issued any shares forms

part. This requirement applies from the date the company issued shares to a VCC and at any time thereafter.

- The tax affairs of the company are in order and the company has complied with all its tax obligations as required under the laws administered by the Commissioner.
- The company is not a listed company or a junior mining company, which is any company that is solely carrying on a trade of mining exploration or production, which is either an unlisted company as defined in section 41 of the Act or listed on the alternative exchange division of the JSE Limited.
- The company is not carrying on any impermissible trade. This includes:
  - any trade carried on in respect of immovable property, other than a trade carried on as an hotelkeeper. Under this category, except for carrying on the trade of an hotelkeeper, trades such as the letting of immovable property, refurbishment or development of immovable property as well as trading in such property will be considered impermissible trades. According to the Guide on Venture Capital Companies, the South African Revenue Service (2020: Online) clarified the concept of trade in respect of immovable property as follows:

    > However, taking the purpose and context of the section into account and the work that the plumber or electrician does in conducting the repairs, it is considered that this interpretation would be too restrictive and unintended and should not be adopted
    > […]
    > Notwithstanding that until harvested a crop is part of immovable property, crops which are planted, grown, harvested and sold are not intended to be and are not dealt with as sales of immovable property

  - any trade carried on by a bank as defined in the Banks Act, No. 94 of 1990, a long- term insurer as defined in the Long-term Insurance Act, No. 52 of 1998, a short- term insurer as defined in the Short-term Insurance Act, No. 53 of 1998 and any trade carried on in respect of money-lending or hire-purchase financing;
  - any trade carried on in respect of financial or advisory services, including trade in respect of legal services, tax advisory services, stock broking services, management consulting services, auditing or accounting services;
  - any trade carried on in respect of gambling;

    - any trade carried on in respect of liquor, tobacco, arms or ammunition; and
    - any trade carried on mainly outside the Republic.
- During a period after the expiry of a period of 36 months from the date on which the company first issued any share to a VCC, the sum of the investment income, as defined in section 12E(4)(c), derived by that company does not exceed an amount equal to 20 per cent of the gross income of that company for that year; and not more than 50 per cent of the aggregate amount received by or that accrued to that company from the carrying on of any trade was derived, directly or indirectly, from a person—
    - who holds a share in that venture capital company; or
    - who is a connected person in relation to a person referred to above.
- No person who holds a share in a VCC to which that company has issued any shares holds, directly or indirectly and whether alone or together with any connected person in relation to that person, more than 50 per cent of the participation rights, as defined in section 9D(1) of the Act, or of the voting rights in that company.
- That company does not carry on any trade in relation to a venture, business or undertaking or part thereof that was acquired by that company, directly or indirectly, from a person who holds a share in a venture capital company to which that company has issued any share or who is a connected person in relation to this person.

Where a taxpayer has obtained funding for the purposes of acquiring an investment in a VCC and there is an amount of debt due in this regard at the end of a year of assessment, the deduction in terms of section 12J must be limited to the amount for which the taxpayer is deemed to be at risk in terms of section 12J(3). The taxpayer will be deemed to be at risk if the repayment of the outstanding debt will result in an economic loss to the taxpayer in the event that no income would be received by or accrued to the taxpayer in future years in respect of the investment in the VCC. In determining if a taxpayer will be deemed to be at risk, all relevant surrounding circumstances must be considered, including any transactions, agreements, arrangements, understandings or schemes that were entered into before or after the expenditure was incurred on the acquisition of the venture capital shares. A taxpayer will not be deemed to be at risk to the extent that the loan has a repayment period of more than five years and the loan was granted directly or indirectly to the taxpayer by the VCC.

Section 12J(3A) includes an anti-avoidance provision that prevents a deduction from being claimed in terms of section 12J where the taxpayer is a connected person in relation to the VCC. This anti-avoidance provision was problematic as VCCs had limited investors when starting up and therefore investors were very likely to become connected persons in relation to the VCC on the basis that the investor held at least a 20% shareholding. As a result, with effect from 21 July 2019, this test must be performed at the end of every year of assessment, which is more than 36 months after the first issue of venture capital shares, by the VCC. This gives the VCC time to obtain other investors so that no single investor holds more than a 20% shareholding. In the event that a taxpayer already held shares in a VCC and becomes a connected person in relation to the VCC in a specific year of assessment, the Commissioner may grant leniency to the VCC and give the VCC an opportunity to rectify the non-compliance. If the VCC does not rectify the non-compliance within the period allowed by the Commissioner, the investor will be denied a deduction in terms of section 12J and the Commissioner must withdraw the approval of the VCC with effect from the date it was originally approved. In addition, the VCC will be required to include in its income an amount equal to 125% of the expenditure incurred by any and all investors to acquire venture capital shares issued by that VCC to the investors. If the approval as a VCC is withdrawn with effect from the date it was granted, it could mean that, with retrospective effect, investors who previously claimed a deduction might need to reverse the deduction and re-submit their income tax returns.

In addition, in terms of section 12J(3B), if a taxpayer holds more than a 20% holding in a VCC at the end of the 36-month period from the date the VCC first issued venture capital shares of any class to that taxpayer, the investor will be denied a deduction in terms of section 12J and the Commissioner must withdraw the approval of the VCC with effect from the date it was originally approved. The VCC will also be required to include in its income an amount equal to 125% of the expenditure incurred by any and all investors to acquire venture capital shares issued by that VCC to the investors. According to the Explanatory Memorandum on the Taxation Laws Amendment Act, 23 of 2020 (National Treasury: 2020a), this provision had unintended consequences and was therefore amended. This subsection will not apply during any year of assessment where that taxpayer holds more than 20 per cent of the venture capital shares of a class and that venture capital company during that year of assessment gives notice to the Commissioner in writing that the venture capital company will cancel all the issued shares in that class of shares, and that venture capital company cancels all the issued shares in

that class of shares within six months from the date on which that notice is given. This amendment comes into operation on 31 July 2021 and applies in respect of years of assessment ending on or after that date.

A further anti-avoidance provision becomes applicable in terms of section 12J(6A), if, at the end of any year of assessment after the expiry of a period of 48 months commencing on the first date of the issue of venture capital shares, less than 80 per cent of the expenditure incurred by the company to acquire assets held by the company was incurred to acquire qualifying shares issued to the company by qualifying companies, each of which, immediately after the issue, held assets with a book value not exceeding R500 million, where the qualifying company was a junior mining company or R50 million, where the qualifying company was a company other than a junior mining company. The anti-avoidance rule in section 12J(6A) will also apply where more than 20 per cent of any amounts received in respect of the issue of shares in the company was utilised to acquire qualifying shares issued to the company by any one qualifying company. Where these situations occur, the Commissioner must give due notice to the company and provide the company an opportunity to rectify the non-compliance. If the company does not do so, the Commissioner may withdraw the VCC's approval from the date it was originally granted. If the Commissioner withdraws the approval of a company, section12J(8) requires that an amount equal to 125 per cent of the expenditure incurred by any person for the issue of shares held in the VCC must be included in the income of the VCC in the year of assessment in which the approval is withdrawn by the Commissioner.

Section 12J(9) provides that no amount shall be recovered or recouped in respect of the disposal of a venture capital share if that share has been held by the taxpayer for a period longer than five years. A similar deeming provision is included in section 9C which deems any amount received or accrued upon disposal of an equity share to be of a capital nature if that equity share had been held for a period of at least three years. This means that for equity shares held for longer than three years, the full amount received or accrued on disposal of the share will be deemed to be of a capital nature and, a capital gain will arise where the proceeds from a sale of investment in VCC exceed the base cost.

### 4.6 Contributions

Statement 400 of the Codes outlines the requirements with which a measured entity must comply in order to earn points for the enterprise and supplier development element of the B-BBEE scorecard. In addition, Statement 500 outlines the requirements relating to the socio-economic development element of the B-BBEE scorecard. Both these statements include a non-exhaustive list of contributions that may be made in order to meet the requirements of the B-BBEE scorecard. These contributions may include, *inter alia*, investments, loans, guarantees, credit facilities, preferential terms, grants, direct contributions as well as training and mentoring of beneficiaries. The deduction for enterprise and supplier development contributions and socio-economic development contributions (collectively "B-BBEE contributions") may be claimed as a donation in terms of section 18A, or in terms of section 11(a), read with section 23(g).

#### 4.6.1 Section 18A donations

Contributions relating to the socio-economic development element of the B-BBEE scorecard are likely to be made to public benefit organisations in the form of donations. These B-BBEE contributions may be deductible in terms of section 18A if the contributions were made to specific organisations that are described in section 18A(1). The organisations listed in section 18A(1) that would assist a measured entity to achieve its B-BBEE socio-economic goals are set out below:

- a public benefit organisation that is a non-profit company[14], or a trust, or an association of persons that has been incorporated, formed or established in South Africa (as contemplated in paragraph (*a*)(i) of the definition of "public benefit organisation" in section 30(1)) and that has been approved by the Commissioner under section 30;
- any institution, board or body (other than a company as defined in the Companies Act, 71 of 2008, any co-operative, close corporation, trust, or water services provider) established by or under any law and which, in the furtherance of its sole or principal object, conducts scientific, technical or industrial research, provides necessary or useful

[14] In terms of section 1 of the Companies Act, a "non-profit company" means a company that has, *inter alia*, the objective of public benefit or an objective relating to one or more cultural or social activities, or communal or group interests.

commodities, amenities or services to the State (including any provincial administration) or members of the general public, or carries on activities (including the rendering of financial assistance by way of loans or otherwise) designed to promote commerce, industry or agriculture or any branch thereof that carries on in the Republic any public benefit activity contemplated in Part II of the Ninth Schedule, or any other activity determined from time to time by the Minister by notice in the *Gazette* for the purposes of this section; the constitution of such an organisation must comply with the requirements of section 18A(1C) and should be approved by the Commissioner for the purposes of section 18A;

- any public benefit organisation contemplated in section 30(1) approved by the Commissioner under section 30, which provides funds or assets to any public benefit organisation, institution, board or body and which has been approved by the Commissioner for the purposes of section 18A; and
- any department of government of the Republic in the national, provincial or local sphere, which has been approved by the Commissioner for the purposes of section 18A, to be used for purpose of any activity contemplated in Part II of the Ninth Schedule (which outlines specific public benefit activities).

In terms of section 18A(1), the deduction may not exceed 10% of the taxable income of the donor as calculated before allowing the deduction of the donation, or is limited in terms of the formula outlined in section 18A(1) where the taxpayer is a portfolio of a collective investment scheme. Therefore, where the donor is in an assessed loss position, no section 18A deduction may be claimed in that year. The value of any donations that are not claimed as a deduction due to the 10% limitation may be carried forward and will be deemed to be a donation actually paid in the next succeeding year of assessment. A claim for a deduction must be supported by a receipt issued by the donee concerned, which meets the requirements outlined in section 18A(2).

**4.6.2 General deduction formula**

Corporate social responsibility contributions may also qualify for an income tax deduction in terms of section 11(a), read with section 23(g), where section 18A does not apply (section 23B(3) specifically prohibits a deduction in terms of section 11(a) where a deduction or

allowance is granted under any other provision of the Act). Enterprise and supplier development contributions, however, are more likely to be related to businesses and would therefore have to comply with the provisions of section 11(a), read with section 23(g). It was established in chapter two that in the South African economic environment, non-compliance with B-BBEE would put entities at a significant disadvantage against competitors. Additionally, many organisations are required to comply with B-BBEE in terms of the B-BBEE Act, the King IV Report and JSE regulations. B-BBEE contributions would therefore be incurred for the performance of taxpayer's income-producing operations and will form part of the cost of performing it.

Both enterprise and supplier development contributions and corporate social responsibility contributions are incurred in terms of the B-BBEE Act. The decision in *Warner Lambert SA (Pty) Ltd v CSARS* would apply to both types of contribution. In the case, it was held that the expenditure incurred to comply with the Sullivan Code was incurred as an insurance policy to protect future earnings. It was noted in the judgement that, as the taxpayer's income earning structure had already been established, this expenditure was revenue in nature. Applying these principles to B-BBEE contributions it would follow that these contributions would not be capital in nature and would be deductible for income tax purposes in the hands of the measured entity.

### 4.7 Low-cost residential units

A measured entity may develop residential units for the benefit of Black persons and communities and in so doing, may earn points for the socio-economic development element of the B-BBEE scorecard. The Act provides for a several allowances in respect of residential units developed by taxpayers.

#### 4.7.1 Section 13*ter*

Section 13*ter* of the Act applies to residential units erected by taxpayers between 1 April 1982 and 21 October 2008. As this section is not applicable to current developments of residential units, the provisions of section 13*ter* will not be discussed in this thesis.

### 4.7.2 Section 13*sex*

In terms of section 13*sex*(1) of the Act, a taxpayer will qualify for an allowance in respect of any new and unused residential unit (including an improvement to the unit) owned by the taxpayer, provided such unit or improvement is used by the taxpayer solely for the purposes of a trade, the unit is situated in South Africa, and the taxpayer owns at least five residential units in South Africa, which are used for the purpose of a trade. The allowance may be claimed at a rate of five per cent on the cost of the unit. In terms of section 13sex(2), the rate of allowance is increased to ten per cent where the residential unit constitutes a low-cost residential unit.

A low-cost residential unit is defined in section 1 of the Act as:

- an apartment qualifying as a residential unit in a building located within the Republic,
    - where the cost of the apartment does not exceed R350 000; and
    - the owner of the apartment does not charge a monthly rental in respect of that apartment that exceeds one per cent of the cost, or
- a building qualifying as a residential unit located within the Republic,
    - where the cost of the building does not exceed R300 000; and
    - the owner of the building does not charge a monthly rental in respect of that building that exceeds one per cent of the cost, plus a proportionate share of the cost of the land and the bulk infrastructure.

For the purpose of calculating the allowance, section 13*sex*(3) deems the cost of the residential unit to be the lesser of the actual cost to the taxpayer and the cost which would have applied had the unit been acquired under a cash transaction concluded at arm's length. Further, in terms of subsection (8), to the extent that a taxpayer has acquired a residential unit (or improvements to a residential unit) which represents part of a building, the cost of the residential unit will be deemed to be 55 per cent of the acquisition cost of the residential unit, and 30 per cent of the acquisition price of an improvement to a residential unit. In terms of section 13*sex*(6), no deduction shall be allowed where the residential unit has been disposed of in a previous year of assessment or where the taxpayer qualifies for a deduction in respect of the residential unit in terms of any other section of the Act. In terms of section 13*sex*(7), the deductions shall not in aggregate exceed the cost of the residential unit.

### 4.7.3 Section 13*sept*

In terms of section 13*sept*(1) of the Act, a taxpayer may claim a deduction upon the disposal of a low-cost residential unit to an employee of the taxpayer (or an associated institution). Sub-section (2) states that the allowance is equal to 10 per cent of any amount owing to the taxpayer by an employee at the end of the year of assessment and may not be claimed in the eleventh and subsequent years of assessment after the disposal.

In terms of section 13*sept*(3), no deduction shall be allowed if the disposal to the employee is subject to any condition other than that the employee is required to dispose of the low-cost residential unit to the employer or an associated institution upon termination of employment, or consistent failure for a period of three months to pay the amount owing in respect of that unit. Further, no deduction may be claimed in terms of section 13*sept*(3) if the employee must pay interest on the amount owing in respect of the low-cost residential unit, or if the disposal of the unit is for an amount which exceeds the actual cost of the unit (excluding borrowing costs or finance costs) to the taxpayer.

Section 13*sept*(4) requires that, if any amount owing by the employee (for which a deduction was claimed by the taxpayer) is subsequently paid to the taxpayer, the taxpayer is deemed to have recovered or recouped an amount equal to the lesser of the amount so paid or the amounts claimed as a deduction in the current and any previous year of assessment.

### 4.8 Legal, consulting and professional fees

The requirements of the various elements of the B-BBEE scorecard are complex and onerous. It would therefore be in a measured entity's best interests to seek advice and assistance from legal and professional advisers with the appropriate experience when considering possible transactions or structures to be entered into for B-BBEE purposes. This may include advice from B-BBEE specialists, as well as related legal and professional advice, to ensure that the proposed transactions or structures will assist the measured entity in achieving its B-BBEE goals.

The deduction for legal fees is governed by section 11(c) of the Act, whereas the deductibility of professional and consulting fees incurred in respect of B-BBEE transactions or structures

must be determined in terms of section 11(a), read with section 23(g). The requirements of these provisions have been considered in detail in chapter two of this thesis.

Legal fees incurred for B-BBEE purposes may relate to drafting legal agreements in respect of the sale of shares, assets or businesses or drawing up employment contracts. Legal advice may also be required when establishing a trust for B-BBEE purposes or amending a company's founding documents to facilitate the issue of equity shares or preference shares.

Section 11(c) provides a deduction for any legal expenses (being fees for the services of legal practitioners, expenses incurred in procuring evidence or expert advice, court fees, witness fees and expenses, taxing fees, the fees and expenses of sheriffs or messengers of court and other expenses of litigation that are of an essentially similar nature to any of the said fees or expenses) actually incurred by the taxpayer during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of the taxpayer's trade. The legal fees should not be capital in nature. No deduction will be allowed if the legal fees are incurred in respect of any claim made against the taxpayer for the payment of damages or compensation if the payment of the damages or compensation claim would not rank for deduction from the taxpayer's income under section 11(a). In addition, no deduction may be claimed if the legal fees are incurred in respect of any claim where any payment to the taxpayer would not constitute income.

The relevant requirement of section 11(c) and the general deduction formula with regard to legal, professional and consulting fees incurred in relation to B-BBEE transactions is that the expenditure may not be capital in nature. A business must therefore determine whether the fees contribute to its income-earning structure or to its income-earning operations. Fees incurred for the former will be capital in nature while fees incurred for the latter will be revenue in nature and thus deductible. As established in *CIR v George Forest Timber Company Limited* (at 526 – 527), "[t]here is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it." It is submitted that the specific transaction or structure in respect of which the advice is being sought will be the deciding factor in whether the fees incurred are capital in nature.

Where legal, professional and consulting fees are incurred in respect of the change of the ownership structure of an entity, for example, for the purposes of the ownership element of the

B-BBEE scorecard, the expense is likely to be capital in nature as it is linked to the income-earning structure of the business. A similar situation arises with professional and consulting advice in respect of investments for the purposes of enterprise and supplier development as these investments represent a source of profits created for the measured entity, even though it may be made for altruistic or philanthropic purposes. On the other hand, where legal, professional and consulting fees are incurred as part of the day-to-day operations of the business, such as staff training, skills development and human resource planning, the fees are more likely to be revenue in nature and thus deductible.

All legal, professional and consulting fees incurred must be considered on a case-by-case basis with regard to the specific facts and circumstances that apply. Where fees are found to be capital in nature, no income tax deduction may be claimed by the taxpayer. In this case, in terms of paragraph 20(c) of the Eighth Schedule, legal, professional and consulting fees that are directly related to the acquisition or disposal of an asset may be included in the base cost of that asset.

**4.9 Conclusion**

In this chapter, the tax implications of transactions and structures entered into for the purposes of earning points for the elements other than the ownership element of the B-BBEE scorecard were discussed. These elements are management control, skills development, enterprise and supplier development, and socio-economic development. The income tax implications arising from a measured entity's efforts to meet its B-BBEE goals are varied due to the broad range of activities in which a measured entity may engage. This chapter has analysed several specific provisions of the Act that may become applicable because of a measured entity's efforts to achieve its B-BBEE goals.

A tax allowance may be claimed by measured entities who offer learnerships to its employees, including Black persons, in terms of section 12H of the Act. Such learnerships will contribute to the entity's skills development goals of the B-BBEE scorecard. In terms of section 12H, an additional tax deduction in respect of learnership agreements is granted in the form of an annual allowance and a completion allowance in respect of each registered learnership agreement to which an employer is party with its employee. The annual and completion allowances contemplated in section 12H are determined with reference to the NQF qualification level of

the learner who is an employee, and the value of the tax allowance is increased where learnerships are provided to persons with a disability.

Employees who receive bursaries from their employers may qualify for an exemption in terms of section 10(1)(q) and section 10(1)(qA) of the Act. Section 10(1)(q) provides for the exemption of any *bona fide* scholarship or bursary granted to enable or assist any person to study at a recognized educational or research institution and section 10(1)(qA) provides for a similar exemption for a *bona fide* scholarship or bursary which enables or assists any person with a disability to study. In order to qualify for exemption, there are certain requirements outlined in section 10(1)(q) and section 10(1)(qA) that must be met and these include certain monetary thresholds. In addition, due to abuse of this exemption by taxpayers, section 10(1)(q) and section 10(1)(qA) were amended to prevent employers from implementing a "salary sacrifice" scheme, together with the provision of a scholarship or bursary to employees or relatives of employees.

Staff training may also contribute to a measured entity's skills development goals. Staff training is more closely linked to the income-earning operations of an entity, as opposed to its income-earning structure, as staff training is unlikely to create a long-term source of profit for an entity. Expenditure incurred on staff training, including expenditure for which B-BBEE points may be earned for the Skills Development element of the scorecard, will thus be deductible in terms of the general deduction formula in the hands of an employer who incurs such expenditure.

Investment in a VCC is one of the ways in which a measured entity may facilitate its enterprise and supplier development for the purposes of the B-BBEE scorecard. Section 12J of the Act was introduced as a tax incentive to encourage investment in qualifying companies through VCCs by allowing a full deduction of the cost of the investment in a VCC, provided that the requirements of section 12J are met. Section 12J also includes anti-avoidance provisions to prevent misuse or abuse of the allowance.

A measured entity may qualify for a deduction in terms of section 18A of the Act, or in terms of section 11(a), read with section 23(g) of the Act, in respect of contributions made for enterprise and supplier development as well as socio-economic development. Section 18A allows a deduction for donations made to the organisations listed in subsection (1), which

includes a public benefit organisation as contemplated in section 30. The deduction is limited and section 18A also sets out other requirements that must be met in order to qualify for a deduction. Where the requirements of section 18A are not met, socio-economic development contributions may fall within the ambit of the general deduction formula. Enterprise and supplier development contributions are more likely to be made in a business context and would be considered for deduction in terms of the general deduction formula. It was concluded that B-BBEE contributions would not be capital in nature and would be incurred in the production of income. This expenditure, which does not qualify for a section 18A deduction, would thus be deductible for income tax purposes in the hands of the measured entity.

The development of residential units, including low-cost residential units, may also contribute to a measured entity's socio-economic development goals, and the Act offers tax allowances in respect of residential units. In terms of section 13*sex*, a taxpayer will qualify for an allowance in respect of any new and unused residential unit (including an improvement) owned by the taxpayer, provided such unit or improvement is used by the taxpayer solely for the purposes of a trade and provided all requirements of section 13*sex* are met. In terms of section 13*sept*, a taxpayer may claim a deduction upon the disposal of a low-cost residential unit to an employee of the taxpayer, again subject to certain requirements.

Lastly, legal, consulting and professional fees may be incurred in general for the purposes of any and all elements of the B-BBEE scorecard. All legal, professional and consulting fees incurred must be considered on a case-by-case basis with regard to the specific facts and circumstances that apply. Legal fees that qualify in terms of section 11(c) of the Act are deductible, provided they are not of a capital nature. Professional and consulting fees may qualify for deduction in terms of section 11(a) of the Act, again provided they are not of a capital nature.

The next chapter will provide a summary of the income tax implications arising from B-BBEE transactions and structures in respect of all elements of the B-BBEE scorecard.

# CHAPTER 5: CONCLUSION

## 5.1 Introduction

The primary goal of this research was to establish the tax implications of transactions or structures entered into by measured entities for B-BBEE purposes. This thesis therefore set out to address the following sub-goals:

- identify a selection of B-BBEE transactions or structures that may be entered into for the purpose of earning points for the various elements of the B-BBEE scorecard;
- identify the types of expenditure incurred in implementing these B-BBEE transactions or structures entered into for the purpose of earning points for the B-BBEE scorecard;
- analyse provisions of the Act that apply to the expenditure;
- discuss case law that will be relevant in determining the tax implications of B-BBEE expenditure identified; and
- conclude to what extent the expenditure identified will be deductible.

The aim of the research, in addressing the goals, was to establish the income tax implications of B-BBEE transactions and structures. This chapter will summarise the findings in chapters two to four and link those conclusions to the research goals. Any reference to a section in this chapter refers to a section of the Act.

## 5.2 Summary of findings

The B-BBEE Act represents an effort by the Government of South Africa to reverse the impact that Apartheid had on black people. Chapter one provided an outline of B-BBEE in South Africa and it was observed that, to support the B-BBEE Act, the Minister of Trade and Industry has issued the Codes of Good Practice. These Codes were published on 11 October 2013 and were subsequently amended on 6 May 2015 and 31 May 2019. The Codes were issued in the form of government gazettes and refer to three priority elements that represent the focal points of the B-BBEE regulations. These are ownership, skills development, and enterprise and supplier development. Codes may be generic or may apply to a specific sector of the economy. An entity's compliance with the B-BBEE regulations is measured against a B-BBEE scorecard

and, in addition, it was clarified in chapter one that for the purpose of this thesis, only the generic scorecard was considered. The elements of the generic scorecard are as follows:

- Ownership
- Management Control
- Skills Development
- Enterprise and Supplier Development
- Socio-Economic Development

This research is relevant in the current climate of South Africa as compliance with B-BBEE regulations is a high priority for businesses.

A legal interpretive approach was adopted in carrying out this research. In particular, a doctrinal research methodology was adopted.

Chapter two addressed the income tax implications of B-BBEE expenditure in terms of the Act and relevant case law. The Act does not provide any specific provision for the deductibility of B-BBEE expenditure and therefore the deductibility of such expenditure is determined in terms of the general deduction formula set out in the preamble to section 11, and section 11(a), read with section 23(g). The preamble to section 11 and section 11(a) allows a deduction from taxable income derived by any person from carrying on any trade of expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature. Section 23(g) of the Act specifies that "no deductions shall in any case be made in respect of the following matters, namely any moneys, claimed as a deduction from income derived from a trade, to the extent to which such moneys were not laid out or expended for the purposes of trade." In chapter two, it was concluded that, as a company seeking to earn B-BBEE points would be carrying on a trade, or commencing to carry on a trade, or (as provided for in section 11A) preparing to carry on a trade, this aspect of the general deduction formula would be satisfied. In addition, the deduction will only be allowed in the year of assessment in which the expenditure is actually incurred or when an unconditional legal obligation is incurred by the taxpayer.

Compliance with the B-BBEE regulations can give organisations a competitive advantage that serves as an incentive for organisations that are not legally obliged to comply with B-BBEE. A good B-BBEE rating is important in building an organisation's image as a corporate citizen.

In the South African economic environment, non-compliance with B-BBEE would put entities at a significant disadvantage against their competitors, and many organisations are required to comply with B-BBEE in terms of the B-BBEE Act, the King IV Report, and JSE regulations. On this basis, it was concluded that B-BBEE expenditure is clearly incurred for the performance of taxpayer's income-producing operations and will form part of the cost of performing them. In addition, based on the principles established in the *Warner Lambert* and the *Pick 'n Pay* cases, it was concluded that, in general, B-BBEE expenditure would not be capital in nature. Costs incurred in implementing new empowerment structures for the ownership element of the B-BBEE scorecard may, however, be capital in nature, whereas expenditure incurred in respect of the other elements of the B-BBEE scorecard will more easily be seen as revenue in nature.

Chapter three addressed the income tax implications arising from specific B-BBEE transactions and structures entered into to satisfy the ownership element of the B-BBEE scorecard. The ownership element was found to be critical for any entity seeking to earn points for its B-BBEE scorecard, as all organisations wishing to comply with the Codes would have to satisfy the ownership requirement. One of the ways in which points for the ownership element for the B-BBEE scorecard are earned is through the introduction of a "B-BBEE shareholder." Where the measured entity is a company, the structure would normally involve an issue or sale of shares to Black people or an entity through which Black people will indirectly hold their shares. The issue of new shares by a company will not have any income tax implications. An outright sale of shares to a B-BBEE shareholder for a cash consideration will have income tax implications for the previous shareholders, such as capital gains tax if the asset was held as a capital asset or a recoupment if the asset was held for revenue purposes. A B-BBEE shareholder may also be introduced by means of an asset-for-share transaction. Tax implications will arise on an asset-for-share transaction in terms of section 40CA and section 24BA, however, these tax implications may be deferred through the rollover relief available in terms of section 42, which allows an asset-for-share transaction to be completed in a tax neutral manner.

The Codes set out the conditions where a sale of individual assets, equity instruments and a business unit may be recognised for the purposes of the ownership element of the scorecard by the seller. This allows a measured entity to earn points for the ownership element of its B-BBEE scorecard when its individual assets, equity instruments or its entire business are sold to another entity. The sale of a business could be structured as a sale of the equity shares of the

company, the sale of individual assets or the sale of a business unit. With regard to the sale of assets or a sale of a business unit, this transaction may be structured as an asset-for-share transaction or an outright sale of individual assets or a business unit. An outright sale of assets will trigger income tax consequences for the seller.

The Codes also provide for an Equity Equivalent Investment Programme (EEIP) that was created specifically for multi-nationals seeking to earn B-BBEE points. Multi-nationals cannot easily include Black ownership in their shareholding, as foreign holding companies are often unwilling to surrender control. The EEIP allows such measured entities to earn points for the ownership element of the B-BBEE scorecard without including Black ownership in its structure. Practically, a measured entity could create a trust or a new company that will carry out the function of utilising the contributions, which it receives from the measured entity for the intended purpose. Contributions may be measured against the value of a measured entity or against total revenue from its South African operations annually over the period of measurement. Ownership points are awarded on an annual basis if total revenue is used as a measurement or over a number of years where contributions are made in relation to value of the entity. It was concluded that even though contributions may have a long-term benefit in certain circumstances, the true nature of the contributions is that they are incurred for the income-producing operations of the entity and are directly related to an entity being able to conduct business in South Africa. These contributions would therefore be revenue in nature and deductible in terms of section 11(a).

Chapter three also discussed the income tax implications arising from equity instruments carrying preference rights and the provisions of section 8E and section 8F were discussed with regard to hybrid equity instruments and hybrid debt instruments, respectively. These provisions have the effect of deeming interest to be dividends and *vice versa* in specific circumstances outlined in the sections.

Measured entities as employers can earn ownership points by means of employee share incentive schemes in which Black people participate. These schemes can be complex structures and often involve the use of a trust or a company as a vehicle to hold or vest shares. The Act provides for two main categories of share incentive schemes, namely, broad-based employee share plans as contemplated in section 8B and other share plans in terms of section 8C. Income

tax implications arise from share incentive plans upon award and disposal of shares as well as while the shares are held by an employee.

Section 8B of the Act provides for the inclusion in income of any gain made by an employee on the disposal of any qualifying equity share acquired in terms of a broad-based employee share plan if it is disposed of within five years of that acquisition. Thus, gains made by an employee who receives shares in terms of this scheme are tax-free if the shares are not disposed of within five years of their acquisition.

Employers may prefer to link the awarding of equity shares to their employees' performance. These employee share plans are probably more suited to employees at managerial and director level. Because of the conditions attached to these plans, the equity shares become subject to certain restrictions and would no longer constitute "qualifying equity shares" as contemplated in section 8B. In these circumstances, the provisions of section 8C are likely to apply. The purpose of section 8C is to defer the gain on an equity instrument until vesting.

The award of shares as contemplated in section 8B or section 8C of the Act is excluded from being a taxable fringe benefit in terms of paragraph 2(a) of the Seventh Schedule. Any shares awarded to employees are also excluded from the special inclusion in paragraph (c) of the gross income definition in section 1 of the Act. These awards would be included in gross income as defined as it is awarded in *lieu* of or in addition to remuneration, however, the value of such an award may qualify for exemption from normal income tax in terms of section 10(1)(nC) or section 10(1)(nD).

The employer in a broad-based share plan will qualify for a deduction in terms of section 11(lA) of the Act for an amount equal to the market value of any qualifying equity share granted to an employee as contemplated in section 8B, less any consideration given by the employee for those shares. Employers may offer financial assistance to their employees to assist them to acquire shares in the form of interest-free or low-interest loans. A loan is granted for the purposes of a broad-based employee share plan as contemplated in section 8B (but not section
8C) is excluded from being a taxable fringe benefit in terms of paragraph 2(f) of the Seventh Schedule. In terms of section 10(1)(k)(i), dividends that are received by or accrue to a taxpayer (including an employee in terms of a share incentive scheme) will generally be exempt from income tax.

Alternatively, a measured entity may achieve its B-BBEE objectives by granting ownership to Black persons through a trust. The Codes set out the requirements, which must be met for a trust to qualify for the ownership element of B-BBEE. These trusts may include broad-based ownership schemes such as a family trust where Black persons are beneficiaries of the trust or an employee share ownership trust, which facilitates the distribution of shares to employees of an entity. It was established that a trust employed for B-BBEE purposes would be an ordinary trust, which is subject to a tax rate of 45% and a capital gains tax inclusion rate of 80%. Section 25B deals with the allocation of taxable income between the beneficiaries of a trust and the trust itself, which is driven by the beneficiaries' vesting rights. The deeming rules of section 25B are subject to the provisions of section 7, which governs the attribution of income. With the involvement of a trust in any arrangement, the conduit pipe or flow-through principle becomes relevant which applies to ensure that the income of a trust retains its nature until it reaches the party in whose hands such income is taxed.

For an employee share ownership trust created for a broad-based employee share plan, any gain or loss arising on disposal of an equity instrument will vest in the employee and not the trust and the gain on disposal of the equity instrument will be tax-free in the employee's hands provided that the employee has not disposed of the equity instrument within five years of acquisition. With regard to other employee share plans, a trust will be taxable on gains, and will be allowed a deduction for a loss, arising from equity instruments to which section 8C applies, provided that the gain or loss has not yet vested in the hands of the employee. Where the equity instrument has vested in the employee, income tax implications of the gain or loss will arise for the employee. Based on the principles established in *CIR v Pick 'n Pay Employee Share Purchase Trust*, it was concluded that the income earned by an employee share trust would be capital in nature even though the activities of the trust may be similar to those of a business that trades in shares.

Due to the onerous requirements of the ownership element of the B-BBEE scorecard, and the complexity of the transactions entered into in order to comply with these requirements, B-BBEE initiatives often require significant funding in the form of additional share capital, preference shares or debt. With regard to debt, the deductibility of borrowing costs (comprising interest, guarantee fees, raising fees and other similar fees) must be assessed in terms of section 24J of the Act. For interest to be deductible in terms of section 24J, it should be incurred in the carrying on of a trade and in the production of income. Section 24J does not, however, requirea

determination whether or not interest is capital in nature, and therefore all interest is considered to be revenue in nature. A company or other business structure would be carrying on a trade and the B-BBEE initiative would have as its purpose the production of income; therefore, interest expenditure incurred for B-BBEE purposes would be deductible in terms of section 24J. This deduction may, however, be limited in terms of section 23M and section 31.

In chapter four, the tax implications of transactions and structures entered into for the purposes of earning points for the elements other than the ownership element of the B-BBEE scorecard were discussed. These elements are management control, skills development, enterprise and supplier development, and socio-economic development. The income tax implications arising from a measured entity's efforts to meet its B-BBEE goals are varied due to the broad range of activities a measured entity may conduct.

Learnership agreements may be entered into with Black persons, including apprentices, to promote skills development. The additional tax deduction in respect of learnership agreements in terms of section 12H is granted in the form of an annual allowance and a completion allowance in respect of each registered learnership agreement an employer and its employee are party to. An employer can also provide Black people with skills development by providing scholarships or bursaries to enable them to obtain further qualifications. These scholarships and bursaries may be exempt in the hands of the recipient in terms of section 10(1)(q) and section 10(1)(qA) provided that the requirements of those sections are met. Staff training by an employer is another way in which a business can develop the skills of Black people and earn points for the skills development element of the B-BBEE scorecard. It was concluded that expenditure incurred by employers on staff training is deductible for income tax purposes in terms of section 11(a) of the Act as such expenditure will be incurred in the production of income and is not likely to be capital in nature.

Investment in a venture capital company (VCC) is one of the ways in which a measured entity may facilitate its enterprise and supplier development for the B-BBEE scorecard. Section 12J serves as a tax incentive to encourage investment in qualifying companies through VCCs by allowing a full deduction of the cost of the investment in a VCC. A measured entity may qualify for a deduction in terms of section 11(a) or section 18A in respect of contributions made for enterprise and supplier development as well as socio-economic development. It was concluded that B-BBEE contributions would not be capital in nature and would be incurred in the

production of income. This expenditure would thus be deductible for income tax purposes in terms of section 11(a) in the hands of the measured entity. Section 18A allows a deduction for donations made to the organisations listed in subsection (1), which include a public benefit organisation as contemplated in section 30. The deduction is limited to 10% of the taxable income of the donor.

The development of residential units, including low-cost residential units, may also contribute to a measured entity's socio-economic development goals, and the Act offers tax allowances in respect of residential units. In terms of section 13*sex*, a taxpayer will qualify for an allowance in respect of any new and unused residential unit (including an improvement) owned by the taxpayer, provided such unit or improvement is used by the taxpayer solely for the purposes of a trade and provided all requirements of section 13*sex* are met. In terms of section 13*sept*, a taxpayer may claim a deduction upon the disposal of a low-cost residential unit to an employee of the taxpayer.

Lastly, legal, consulting and professional fees may be incurred in general for the purposes of any and all elements of the B-BBEE scorecard. Legal expenses would be deductible in terms of section 11(c), provided they are not of a capital nature, while other fees that are revenue in nature would qualify for deduction in terms of section 11(a). All legal, professional and consulting fees incurred must be considered on a case-by-case basis with regard to the specific facts and circumstances, which apply. Where fees are found to be capital in nature, no income tax deduction may be claimed by the taxpayer however such fees may be included in the base cost of an asset where it can be directly attributed to the disposal or acquisition of such an asset.

**5.3 Concluding comments**

From the analysis of B-BBEE structures and transactions in this thesis, it appears that the provisions of the Act allow deductions for many types of transactions and even for certain transactions and structures that would normally give rise to capital gains tax consequences.

Due to the complex and sometimes uncertain nature of the tax consequences of B-BBEE transactions and structures, it is recommended that the South African Revenue Service issue further guidance with regard to the income tax implications of B-BBEE transactions, in the form of an Interpretation Note or a guide to assist taxpayers. The legislative framework

developed in this thesis could be used to analyse other B-BBEE structures.

Due to the multiplicity of transactions and structure that may be undertaken to earn B-BBEE points, a full analysis of all possible situations and the related income tax implications is beyond the scope of this thesis. Therefore, further research on this area of tax law will be valuable.

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