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Submission File

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South African Revenue Service
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BY E-MAIL: policycomments@sars.gov.za

Dear SARS

COMMENTS ON THE DRAFT INTERPRETATION NOTE ON ASSOCIATIONS: FUNDING REQUIREMENTS

The South African Institute of Chartered Accountants (SAICA), welcomes the opportunity to make a submission to the South African Revenue Service (SARS) on the draft Interpretation Note (IN) on Associations: Funding Requirements that provides guidance on the interpretation and application of the "funding" requirement contemplated in section 30(2)(*b*)(*ix*) of the Income Tax Act (ITA) requiring that substantially the whole of any entity's funding must be derived from its annual or other long-term members or from an appropriation by the government.

We set out below our comments in this regard.

COMMENTS

General

1. We appreciate SARS' efforts in providing the latest SARS interpretations in this draft IN, however, we are concerned that the requirements resulting from certain of the current interpretations were not known at the time that the entities applied for section 30B status.

2. These amended and expanded interpretations have a significant impact on many bodies and trade unions who will now have to significantly change their business models that have been applicable for a decade and which SARS have been approving to date without concern or comment.

3. Submission: As these applications were approved by SARS, the changes included in the draft IN would be regarded as a change in practice generally prevailing. Clarity on the effective date of the proposed changes should be included in the draft IN and should be the beginning of years of assessment commencing after the effective date of the publication of the final IN.

4. Guidance should also be given where bodies and unions were approved on the basis of their current business models which this IN now makes exception to.

Paragraph 5 - Application of the law

5. On page 5, it is stated that if the founding document of an entity does not provide for the prescribed requirements, the entity will be deemed to comply if the person who has accepted fiduciary responsibility for the funds and assets of the entity, furnishes the Commissioner with a written undertaking that the entity will be administered in compliance with the prescribed requirements.

6. Section 30B(10) states that:

"Any person who is in a fiduciary capacity responsible for the management or control of the income and assets of any approved association and who intentionally fails to comply with any provision of this section or of the constitution, or other written instrument under which such association is established to the extent that it relates to the provisions of this section, shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding 24 months."

7. Submission: Given what fiduciary responsibility entails, it would be appropriate that SARS explain its expectations of such persons and discuss/highlight the consequences for failure.

8. In relation to the written undertaking, footnote 15 states that a specimen written undertaking form EI 2A is available to assist persons accepting fiduciary responsibility to administer an entity in accordance with the prescribed requirements.

9. Submission: It should be stipulated that the form EI 2A is available on the SARS website and for completeness sake, it should also be included in the draft IN as an Annexure.

Paragraph 5.1 - Meaning of "funding"

10. As the word "funding" is not defined in the Act, the draft IN provides a dictionary definition of the word "fund", followed by "funding".

11. "Funds" are referred to in section 30B(2)(b)(iv). This sub-section states that the entity is required to utilise substantially the whole of its funds for the sole or principal object for which it has been established.

12. The draft IN does, however, not provide clarity on how SARS would interpret and apply the above if an entity has multiple and/or diverse objectives.

13. Submission: Clarity is required on how SARS would interpret and apply the requirement in section 30B(2)(b)(iv) in the above instances. Guidance is also required as to how entities would be required to allocate their funds as practically, funds are not generally allocated per objective.

14. The draft IN also states that "*The word "funding" is a broader concept than income and is not interpreted to mean gross income. In the context of section 30B(2)(b)(ix), "funding" therefore refers to all the sources of funding derived by an entity"*.

15. It should be noted that the word "funding" is used in other sections of the ITA, such as section 30C (Small Business Funding Entity – these entities provide developmental funding to SMME's, including business support and training), section 7C, section 10(1)(bA), and various other sections that deal with the funding of assets or research (for example section 23(n), section 23K, 23M, 23N, 44, 45).

16. When interpreting the meaning of the word "funding" in terms of section 30B, it should be pointed out that section 10(1)(d)(iii)/(iv) (the exemption provision) exempts *receipts and accruals* of entities complying with section 30B (the administrative provision). The context and purpose of the exemption is to exempt taxable amounts – that is, amounts that are included in gross income that need to be exempted. This context[1] cannot be excluded in interpreting the meaning of "funding" in section 30B. The contextual connection is even more apparent when it is considered that section 30B is merely an exact inception and extension of a regulation previously issued under section 10(1)(d) itself.[2] In fact the rationale for inserting section 30B as stated in the Explanatory Memorandum to the TLAB2010 was merely to address the consequences on termination and not to create any new requirements[3].

17. Section 30B refers to "*funding"* which includes all amounts received (taxable and non-taxable). Using SARS' interpretation, "funding" therefore includes items such as loan capital and overdrafts received, other capital amounts and donations received – none of which would be included in 'gross income' as defined in section 1 of the ITA.

18. The funding requirement is, in the first instance, relevant for approval purposes (and must be dealt with in the entity's constitution). If factually, once approved, more than 90% of the funding is not from members (or by way of appropriation from government), this means that the entity failed to comply with its constitution and if not corrected in the time period

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[1] Natal Joint Municipal Pension Fund v Endumeni Municipality (920/2010) [2012] ZASCA 13; [2012] 2 All SA 262 (SCA); 2012 (4) SA 593 (SCA) (16 March 2012) at [18]: *Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence*.

[2] South Africa Government Gazette vol 521 no 31614 dated 21 November 2008

[3] Explanatory Memorandum to Taxation Laws Amendment Bill 2010 at 3.4: C*onditions for approval in respect of the above section 10(1)(d) entities are outlined in regulation (Government Gazette No. 31614, dated 21 November 2008). Pursuant to these regulatory conditions, the founding document of these entities must comply with certain requirements relating to ownership, financial control, permissible activities and payment of employees. …….Section 10(1)(d) lacks any exiting tax charge of this nature for impermissible transfers. Regulatory authority exists only for approval criteria. These entities can accordingly shift terminating transfers to profitable use without penalty*

provided for, it would not be regarded as a section 30B entity. The 90% requirement is especially relevant if the entity receives too much non-taxable income (such as donations etc) as this could reduce the percentage of member funding received below the required 90% (85%) limit.

19. SARS' interpretation therefore creates an anomaly as it implies that the extent of the receipt of non-taxable amounts (such as donations, grants etc) could put the exemption of the entity at risk when the exemption in context was not created for such purpose. Thus, the exemption provision would not integrate with the administrative provision in the legislation in terms of SARS interpretation as section 30B seems to supersede section 10(1)(d)(iv) instead of section 30B being read in the context of section 10(1)(d)(iv), the latter being the actual exemption provision.

20. Furthermore, this mismatch would cause absurd situations where entities would have to consider refusing to receive government grants or capital receipts so as not to jeopardise their exemption status when the receipt of such amounts should not raise concern as it does not create trading or competition and it still must be aligned to the objectives of the entity.

21. Submission: The purpose of section 30B is to regulate the operations of entities for the exemption of taxable amounts under section 10(1)(d)(iv) and it should integrate with and be interpreted in context with section 10(1)(d). "*Funding"* should thus not include all amounts received. Instead, section 30B should deal with amounts that would otherwise be taxable and that need to be exempted like member fees and other incidental trading income. All other receipts (such as donations, capital amounts etc) should be excluded from "*funding"*. Therefore, amounts that are not included in gross income should not be seen as a source of funding.

22. It is submitted that a legislative amendment may be required to clarify this and address the shortcomings of the interpretation of the term "funding" with a more suitable mechanism to address any of SARS' concerns with regard to the funding received by section 30B entities as relates to **trading activities** that are not member related.

Paragraph 5.2.1 - Funding derived from annual or other long-term members

23. Footnote 23 refers to the term "gross income" as defined in section 1(1).

24. Submission: It is suggested that reference is made to the Income Tax Act or rather "the Act" as defined in the *Preamble*. This applies throughout the whole document in relation to sections mentioned in the Income Tax Act.

Paragraph 5.2.2 - Funding derived from an appropriation by government

25. The draft IN expresses the view that a narrow interpretation of the phrase "appropriations from government" should be followed and limited to **direct receipts and accruals** from the National, Provincial and Local Government.

26. This would result in funding from all scheduled entities, agencies and SoEs being excluded and such appropriations will be non-member funding subject to the 10% (15%) threshold. Amounts from SETA's, Universities, Education Agencies etc. and scheduled entities like SARS or SEDA or foreign government aid or grants will also be non-member funding.

27. This narrow interpretation is quite problematic as government habitually uses other entities and agencies to do government's work and routes funds through these entities and agencies.

28. Also entities like the SETA's are specifically created to support entities like SAICA and therefore it is problematic that grants from SETA's will contribute to non-member funding even if such monies are directed to the entity's sole or main objective.

29. The reason given by SARS for this interpretation is as follows: "*Entities granted approval by the Commissioner under section 30B(2) are placed in a favourable position because their receipts and accruals are exempt under section 10(1)(d)(iii) or (iv) (see **7**). The courts have tended to reject a construction of a statutory provision, which implies the extension of a class privilege and to interpret it strictly.[44] It is for this reason that the word "government" referred to in section 30B(2)(b)(ix) must be interpreted strictly so as not to include any other state entities, for example, entities established as agents of the government or organs of state"*.

30. The footnote 44 referred to in the draft IN refers to the rule that was laid down in *Ernst v CIR* 1954 (1) SA 318 (A), 19 SATC 1 and approved in *CIR v D & N Promotions (Pty) Ltd* 1995 (2) SA 296 (A), 57 SATC 178 at 182 and *Western Platinum Ltd v C: SARS* [2004] 4 All SA 611 (SCA), 67 SATC 1 at 6.

31. Firstly, it must be pointed out that these cases are distinguishable from the current situation as these cases dealt with deductions, not exemptions and specifically not exemptions at an entity level.

32. Secondly, SARS have cited the relevant authority as if it was stated as an outright rule which it was not.

33. The following statement by the Judge in the original case (Ernst v CIR) is of importance and seems to have been overlooked by SARS: "*To this extent farmers are, as a class, placed in a favourable position but there is no justification in the paragraph for extending this exception. Craies on Statute Law, p. 109, says: "The Courts, in dealing with taxing Acts, will not presume in favour of any special privilege of exemption from taxation. Said LORD YOUNG in Hogg v. Parochial Board of Auchtermuchty (7 Rettie 986): 'I think it proper to say that, in dubio, I should deem it the duty of the Court to reject any construction of a modern statute which implied the extension of a class privilege of exemption from taxation, provided the language reasonably admitted of another interpretation.*"

34. The passage above cited with approval by the honourable justices creates a rebuttable presumption of "*provided the language reasonably admitted of another interpretation".*

35. In context of a taxing provision, the whole purpose which is to provide a total tax exemption of income, it is quite reasonable and express in fact that another interpretation other than a limited and strict class privilege should apply. The legislation quite clearly seeks to apply a broad class privilege.

36. It is submitted that the cited case law clearly does not imply, as SARS does, that all class privilege provisions should be strictly interpreted; this should only be done if the language does not support a different context. This view is supported in the *Natal Joint Estates* case where it was provided that where the language reasonably permits it, the standard position should be taken unless other interrogations are given in law. That is, the context in interpretating the legislation is of cardinal importance.

37. In the current context, clearly broad privilege is already provided and intended for and receipt of funds from government (in the broader sense) for **public good** should not jeopardise an entities exemption status merely because the government routes the money through other entities, as to not do so would undermine the intention of the legislation which was to give a full exemption to these entities.

38. It could never have been the intention of the legislature in context of the legislation as drafted to prevent bodies from receiving funds from a sphere of government to perform a public good just because a sphere of government decided to appropriate the monies in a particular way through a particular state-controlled organ. Such an interpretation would result in a glaring absurdity.

39. Submission: The strict rule of interpretation to class privilege does not apply in all contexts as submitted by SARS and the exemption legislation is clear that it should have a wide application as to money given by the government, directly or through an organ of state etc for a public purpose.

40. SAICA does accept that taking a wider interpretation may create scope challenges as to monitoring and enforcement by SARS. However, unless government stops using entities outside the 3 tiers of government to perform its public duty, which is also impractical, it remains impossible to comply with this requirement in a strict sense.

41. It is submitted that SARS urgently approach National Treasury to have the legislation clarified to properly reflect the expanded interpretation of "sphere of government" that includes other government entities as this would still be in line with the purpose and intention of the Act.

Paragraph 5.3 - Funding derived from sources other than from members or an appropriation by government

42. Section 30B(2)(b)(ix) prescribes that substantially the whole of an entity's funding must be **derived** from its annual members or other long-term members or an appropriation by the government.

43. The word "derived" is defined in the Cambridge dictionary[4] as:

    "*coming from or caused by something else*"

44. The meaning of the word therefore does not equate to "directly received from" but has a broader meaning namely that the funding was "caused by something else" e.g. interest from invested member fees received.

45. The draft IN states that investment income earned on funds or capital is not related to an entity's annual or long-term members or from an appropriation by the government regardless of whether the funds invested were originally derived from members or from an appropriation by the government.

46. Given the meaning of the words "derived from" we disagree with SARS' interpretation, and do not believe that at a minimum, returns on invested member funding in cash investments or bank deposits can be seen as non-member funding. It is submitted that the mere act of banking money or investing money cannot turn it into non-member funding and that the fruit of the tree (i.e. interest) should retain its nature for the purposes of member funding. On the same principle charging interest on late member fee payments or imposing disciplinary charges is still member funding.

47. Furthermore, should SARS' logic be followed, the following would apply: If R10m was received in member fees and this amount is then invested in bonds and then later sold for R10m, the R10m received from the sale would then not be member funding even though it's the exact same amount. On a broader interpretation of the SARS position, what if the bonds were sold for R11m, then is the R10m member funding but the R1m is not?

48. The reason given in the draft IN for the funds losing their nature in such situations is that "it becomes onerous and cumbersome to determine the source of member's and government funds and could be subject to abuse".

49. Submission: It is submitted that amounts of funding that are "derived" from members extend beyond direct receipts such as membership fees and includes amounts that are "coming from" or "cause by" direct funding from members or government appropriations. Member funds that are directly invested therefore retain their nature as being derived from members.

[4] https://dictionary.cambridge.org/dictionary/english/derived

50. We accept that tracing mixed funds (i.e. trading vs member funding) may be problematic, but this is not impossible and we would rather seek tracing than total exclusion and SARS could even issue guidance in the IN that should associations mix their investment funds, they do so at own risk as they carry the onus to prove that an exemption applies.

51. We submit that SARS cannot interpret the legislation in a negative manner merely because the administration is onerous. As the courts have held, just because it is onerous does not mean it cannot and should not be done.

Paragraph 5.4 - Substantially the whole of an entity's funding

52. Reference is made to Binding General Ruling (BGR) 20 and SARS notes that it will interpret "substantially the whole" as 90% or more but will accept 85% or more as meeting the criteria.

53. As mentioned in our previous submission, dated 30 April 2020, in our view the law does not allow SARS to take a position contrary to the promulgated law and SARS' own express interpretation of it and thus we consider the BGR position to be unlawful.

54. SAICA does support the 85% threshold as a better interpretation of the law but is of the view that it should be included in law to avoid uncertainty and debate, especially should a dispute arise where SARS will invariably argue that 90% is its formal position on the interpretation.

55. Submission: Though we support the 85% threshold, we believe that SARS should engage National Treasury to align the legislative position to the SARS practice.

56. We also express concern that this threshold is not disclosed in ITR12EI which has resulted in enforcement being very difficult for the SARS TEU as the financial disclosures do not compel a split between member and non-member funding. Compliance by associations or trade unions with the 85% threshold is thus questionable.

57. SAICA met with the SARS TEU in 2019 and submitted that the ITR12EI should be amended to reflect disclosure of the section 30B (and other exempt entity disclosures) compliance requirements to make oversight by SARS TEU easier. Currently this is a manual process and only possible for SARS TEU if the financial statements disclose enough information to actually apply the various financial tests.

Paragraph 5.4 - Substantially the whole of an entity's funding - Model

58. We do not believe that the SARS concerns and those of the associations and trade unions can be resolved by mere interpretation and that the lesser compliance model may most probably have to be replaced with a higher administrative compliance but more lenient income model, such as the part exempt model for PBO's or at least something similar.

59. Submission: We believe that SARS and the National Treasury should engage the associations and unions on changing the exemption model, with greater enforcement of the current regime the alternative to ensure parity of compliance in this sector.

60. This section also states that funding comprises of all the income received by an entity irrespective of whether such income is of a revenue or capital nature.

61. Submission: As mentioned above, the wide interpretation of "funding" cannot be supported and thus also the inclusion of capital amounts for the section 30B funding threshold. Only taxable amounts should be included as "funding".

62. Furthermore, inclusion of these amounts could force an entity to yoyo between being tax exempt and being taxable from one year to the next, which is not desirable nor practical for all concerned.

Paragraph 6 - Withdrawal of approval

63. In respect of non-compliance, it seems (though unclear) that SARS takes the position if the non-compliance is not corrected after notice was given, the exemption is withdrawn from the year of first non-compliance and not from the current year of assessment.

64. The legislation is not clear on this, and the above would seem impracticable because if for example the entity failed the funding test 3 years ago, it would never be able to correct it and would at most be able to correct from the current year when the notice was received.

65. It also would mean that if the exemption is withdrawn retrospectively, that following years would be taxable and would have to be reassessed as a company with resubmission of an ITR14.

66. It is our view that one cannot have a correction required going forward, but where the withdrawal by SARS of the exemption is retrospective as the sections refer to the same year, though unclear which year that is.

67. We accept that if the withdrawal is only applicable after notice provided by SARS, compliant taxpayers are at a disadvantage as many taxpayers will now "ride the system" till caught, but similarly if SARS is compelled by the current legislation to compel the association or union to correct historical positions that they can't, that is also impractical.

68. We believe that the only way to get to an equitable and practical solution is to amend the legislation.

69. Submission: It is proposed that SARS engage National Treasury to provide clarity on the above.

70. It is suggested that the legislation is amended so that the sanction for non-compliance is not only withdrawal (not retrospective), but that other sanctions such as penalties be introduced. This would ensure a balance between SARS ability to regulate the industry and also sanction historical non-compliance without creating an incentive for non-compliance.

71. However, in the interim we would support an interpretation that withdrawal can only apply after notice of corrective steps and if that the entity does not take steps to correct going forwarding after the notice is received.

Conclusion

72. The proposed interpretation in the draft IN is problematic from many perspectives as highlighted above. We therefore urge SARS to defer the issuance of this interpretation note until the legislation has been appropriately amended.

73. SAICA will be making an Annexure C submission in this regard to ensure that legislative clarity and certainty is provided for taxpayers and SARS.

74. We once again thank SARS for the ongoing opportunity to provide constructive comments in this regard. SAICA continues to believe that a collaborative approach is best suited in seeking solutions to complex challenges and should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

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The South African Institute of Chartered Accountants