



SOUTH AFRICAN REVENUE SERVICE

INTERPRETATION NOTE: NO. 24 (Issue 2)

DATE: 31 August 2007

ACT : INCOME TAX ACT, 1962 (the Act)
SECTION : SECTION 10(1)(cN)
SUBJECT : PUBLIC BENEFIT ORGANISATIONS (PBOs): TRADING RULES - PARTIAL TAXATION OF TRADING RECEIPTS

1. Purpose

The purpose of this Interpretation Note is to explain the amendments introduced by the Revenue Laws Amendment Act, No. 31 of 2005 (RLAA 31 of 2005) pertaining to PBOs and in particular to provide clarity with regard to the practical application relating to the introduction of the principle of partial taxation. In terms of the above-mentioned amendments the receipts and accruals derived from certain business undertakings or trading activities are subject to normal tax. Amendments introduced by the Revenue Laws Amendment Act, No. 20 of 2006 (RLAA 20 of 2006) and the Taxation Laws Amendment Act, No. 8 of 2007 have also been taken into account.

2. Background

When the new legislation pertaining to PBOs was introduced in 2001, it contained strict provisions prohibiting approved PBOs from conducting trading or business activities outside narrowly defined permissible trading rules. There were four categories of rules where the trading activities conducted by a PBO did not affect its tax exempt status. Where PBOs fell foul of these permissible trading provisions their tax exempt status could be terminated altogether or, in order to retain their exemption, were required to transfer the non-compliant trading activity to a separate taxable entity. Furthermore, where a PBO was engaged in trading activities the legislation did not allow the PBO to apply the related and /or unrelated trading rules as well as the *de minimis* exclusion rule simultaneously. A PBO could access either the threshold exclusion (*de minimis*) or the related and unrelated trading rules. As a result of the harsh consequences for some PBOs, SARS relaxed this requirement in view of the proposed amendment to the legislation and allowed PBOs to access all the exclusion rules under certain circumstances. This was explained in the first issue of this Note which can be accessed on the SARS website, under Interpretation Notes/Archives.

In his 2005 Budget Speech, the Minister of Finance announced that legislation would be introduced to allow for a system of partial taxation for PBOs, whereby the receipts and accruals derived from trading or business activities in excess of

the prescribed limits would become taxable without undermining the exemption enjoyed by the PBO for the underlying public benefit activities.

Appropriate legislation has been introduced by section 16(1)(b) of the RLAA 31 of 2005 amending section 10(1)(cN) to give effect to this concept of partial taxation for PBOs. In terms of section 16(2)(a) of the RLAA 31 of 2005 the legislation came into operation on 1 April 2006 and applies to PBOs in respect of their year of assessment commencing on or after that date.

The trading provisions which were previously included in section 30 of the Act, now form part of the amended section 10(1)(cN) to create the platform for the partial taxation of trading receipts. The provisions relating to the requirement of ministerial approval and to related and occasional trading activities essentially remain unchanged. However, a new basic exemption was introduced. Effectively PBOs are now permitted to carry on business or trading activities on a tax free basis within certain parameters, but will be taxed on the receipts and accruals derived from any business undertaking or trading activity that falls outside the parameters of these permissible trading rules, after deducting the basic exemption from the receipts and accruals of such business or trading activity, which is calculated as being the greater of 5% of the total receipts and accruals of the PBO or R100 000. The taxable income will be the balance of the trading receipts less any allowable deductions in accordance with the normal tax rules in the Act.

Note: The basic amount of R100 000 is applicable to a PBO as from its first year of assessment ending on or after 1 April 2007. Prior to this period the basic threshold was R50 000. That means that a PBO whose year of assessment commences on or after 1 April 2006 and ends on or before 31 March 2007, the basic exemption rule applicable will be the greater of 5% of the total receipts and accruals or R50 000.

3. The law

Section 10(1)(cN) of the Act:

10. Exemptions. – (1) There shall be exempt from normal tax –

(cN) the receipts and accruals of any public benefit organisation approved by the Commissioner in terms of section 30(3) to the extent that the receipts and accruals are derived –

(i) otherwise than from any business undertaking or trading activity; or

(ii) from any business undertaking or trading activity –

(aa) if the undertaking or activity –

(A) is integral and directly related to the sole or principal object of that public benefit organisation as contemplated in paragraph (b) of the definition of ‘public benefit organisation’ in section 30;

(B) is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost; and

(C) does not result in unfair competition in relation to taxable entities;

- (bb) if the undertaking or activity is of an occasional nature and undertaken substantially with assistance on a voluntary basis without compensation;
- (cc) if the undertaking or activity is approved by the Minister by notice in the *Gazette*, having regard to –
- (A) the scope and benevolent nature of the undertaking or activity;
 - (B) the direct connection and interrelationship of the undertaking or activity with the sole or principal object of the public benefit organisation;
 - (C) the profitability of the undertaking or activity; and
 - (D) the level of economic distortion that may be caused by the tax exempt status of the public benefit organisation carrying out the undertaking or activity; or
- (dd) other than an undertaking or activity in respect of which item (aa), (bb) or (cc) applies and do not exceed the greater of –
- (i) 5 per cent of the total receipts and accruals of that public benefit organisation during relevant year of assessment; or
 - (ii) R100 000;

4. General meaning of certain terminology

- 4.1 **Basic exemption** – The threshold is determined by calculating the amount of receipts and accruals derived from business or trading activities not otherwise excluded, which is exempt from income tax. In terms of this exclusion an amount constituting the greater of 5% of the total receipts and accruals of the PBO or R100 000 will be exempt.

Example 1

An approved PBO conducts public benefit activities (PBAs) from a property which it owns. In order to augment its income, it lets a portion of the property which is not used for carrying on the PBAs. The following total receipts and accruals were received for the year ended 30 June 2007.

Donations received	R450 000
Rental income (gross)	90 000
Interest income	<u>50 000</u>
Total receipts	<u>R590 000</u>

- In terms of section 10(1)(cN)(ii)(dd), an amount being the greater of 5% of the total receipts and accruals or R100 000 will be exempt from tax.
- Five per cent of the total receipts (R590 000) amounts to R29 500.
- This means that the total receipts from letting of the property (R90 000) will be exempt as the PBO gets the benefit of the greater of R100 000 or R29 500.

- 4.2 **Business** – Business is not defined in the Act. However, based on tax law, it is generally accepted to include anything which occupies the time, attention and labours of man for profit. There are no hard and fast rules in determining what is

business, however a number of factors will be taken into account such as the intention, motive, frequency and the nature of the activity.

Example 2

The passive investment of surplus funds in shares or in an investment in a financial institution, is not normally regarded as a business undertaking or trading activity. However, where it is undertaken in an active manner such as the advancing of interest bearing loans at market related rates, it could be regarded as a business activity.

4.3 Integral and directly related – The activity must be directly connected, linked and associated with the approved public benefit activity (PBA) which is conducted by the PBO.

Example 3

A PBO conducts a PBA of providing health care services to poor and needy persons. In addition to providing a medical consultation service, the PBO also provides medication at a cost which is not market related. The provision of medication at a cost is regarded to be integral and directly related to the activity of providing a medical consultation service to poor and needy.

4.4 Occasional – The activity is conducted on an irregular or infrequent basis or as a special event.

Example 4

Activities of an occasional nature may include:

- An annual jumble sale selling unwanted clothing.
- Annual fundraising events such as cake sales, fêtes or the sale of raffle tickets where the prizes have been donated.
- A gala dinner held to raise funds.

4.5 Recovery of cost – The goods are not sold to maximise profits but rather with the intention of recovering the direct and reasonable indirect costs.

Example 5

An approved PBO which carries on educational PBAs, operates a tuck shop which serves and sells refreshments to the learners for a consideration which is determined by taking into account the cost of the goods. Assistance in the tuck shop is provided by volunteers. The cost of the goods sold includes purchase price, costs such as telephone, electricity, repairs and maintenance, stationery, cleaning materials, an amount for a reserve created for future replacement costs of capital assets such as a refrigerator, microwave, deepfreeze, etc. A minimum profit margin is also taken into account which is utilised by the PBO to fund its PBAs.

4.6 Sole or principal object – The word “principal” is used in conjunction with the word “sole” in light of the recognition that PBOs may utilise trading activities as a source of funding their approved PBAs. However this concept means that the

sole, main, predominant and foremost aim or objective must remain the carrying on of one or more PBA. It will not be acceptable for a PBO to have a sole or principal object of conducting a commercial business activity in order to fund a PBA. The trading activity may never supersede or take preference over the carrying on of the PBAs. A number of factors could be taken into account such as time, cost, space allocated, etc or a combination thereof.

Example 6

An organisation conducting a commercial business activity of a supermarket is open seven days a week. Some of the stock-in-trade is utilised to provide free meals to homeless people on a regular basis. In this particular instance the sole or principal object is not to provide meals to homeless people but to conduct a commercial trading activity.

4.7 Substantially with assistance on a voluntary basis – Means significantly, greatly, to a large extent.

Example 7

At a school fête each of the 20 classes is assigned to run a stall selling donated goods in order to raise funds. All the stalls are manned by volunteers who include teachers, parents and learners. In this particular fundraising event, the assistance provided was substantially voluntary.

4.8 Substantially the whole – Is regarded as being 90% or more. However, in order to conform with the provisions of section 30 and to overcome certain practical difficulties, a percentage of not less than 85% will be accepted. This concept may be motivated by taking into account time or cost (refer to example 11).

Example 8

An approved PBO provides educational PBAs. In order to fund the provision of these approved PBAs, the PBO charges tuition fees. The fees are based on the estimated cost to the PBO in providing the tuition. The tuition fee is the principal source of income for the PBO. It is considered that substantially the whole of the PBA is carried out on a cost recovery basis.

- 4.9 Total receipts and accruals** – Includes the total sum of all receipts and accruals from any source within or outside South Africa, irrespective of whether on capital or revenue account.

Example 9

The total receipts and accruals will include the total amount received or accrued from all sources, whether of a capital nature or not, such as donations, subsidies, school fees, rent, accommodation charges, fund-raising activities, investment income, the sale of movable and immovable assets and bequests.

- 4.10 Trade** – Is defined in section 1 of the Act and includes every profession, trade, business, employment, calling, occupation or venture, letting of property and the use of or the grant of permission to use a patent, trademark or copyright. The courts have interpreted trade to be neither exhaustive nor restrictive and will include any activity where a person risks something with the object of making a profit.

Example 10

Trade will include activities such as the letting of immovable property, conducting farming activities, providing legal services, the use of a copyright or patent.

5. Application of the law

In terms of section 10(1)(cN), PBOs are now permitted to carry on business or trading activities within certain specific parameters. Legislation now provides for four categories of exemption and each rule is applied separately. There are three categories of permissible trading activities where there is no limit to the amount of receipts and accruals which are exempt from normal tax. Each category has its own conditions and requirements. The fourth exclusion rule provides for a basic exemption which is determined by calculating a threshold which is applied to the commercial trading activities which do not qualify in terms of the other three exclusion rules. Where a PBO carries on more than one commercial trading activity, the basic exemption rule (greater of R100 000 or 5% of total receipts) is applied collectively to the total receipts derived from all such other taxable trading activities.

However, the requirements of section 30 must continue to be complied with and in particular, the sole or principal object of the PBO must remain the carrying on of one or more approved PBAs. The amendment now introduced permits a PBO to conduct a trading activity or business undertaking where the activity is utilised as a source of funding for the approved PBAs, provided that the carrying on a business involving a commercial activity with the intention of earning a profit does not in effect become the sole or principal object or activity. Where PBO approval has been granted but it subsequently transpires that the PBO did not comply with the requirements, the exempt status may be withdrawn retrospectively.

If a PBO is the beneficiary of a trust that carries on trading activities and the trustees exercise their discretion to distribute an amount in accordance with section 25B(2) of the Act, such amount will be deemed to be from a business undertaking or trading activity in the hands of the PBO. This distribution will be taken into account in the determination of the basic exemption of the PBO (see also paragraph 10).

6. Exempt trading activities

6.1 Integral and directly related trade [item (aa) of section 10(1)(cN)(ii)]

The undertaking or activity is –

- *integral and directly related to the sole or principal object of the PBO as contemplated in paragraph (b) of the definition of “public benefit organisation” in section 30;*
- *is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost; and*
- *does not result in unfair competition in relation to taxable entities.*

In terms of the above legislation all three of the following requirements must be complied with:

- The trading or business activity must be integral and directly related to the approved public benefit activity carried on by the PBO.
- Substantially the whole of the trading activity must be conducted on a cost recovery basis. It is accepted that it is not always possible to base trading activities on a 100% cost recovery basis and it is for this reason that the legislation requires that substantially the whole of the trading activity must be based on recovery of cost. The concepts “recovery of cost” and “substantially the whole” are explained in 4.5 and 4.8.
- The trading activity should not be seen as being in unfair competition with other taxable entities. This means that the PBO should not be in a more favourable position or have an unfair advantage over a taxable entity conducting the same trading activity, in that it is not required to sacrifice a portion of the profit in the form of tax. Each case would be considered on its own merits and various factors could possibly be taken into account, such as, active advertising or marketing, whether or not the activity is conducted on a competitive basis with the intention of maximising profits, whether the income received is market related or not.

Example 11

Facts:

A PBO engages in PBAs of caring for adult persons with severe mental disabilities on an agricultural smallholding. The residents are not capable of obtaining work in

either the open labour market or protected workshop facilities. Residents are placed in various groups with house parents and each group is assigned to a particular farming activity. The residents are responsible for the household chores as well as being involved in the particular farming activity. The mechanical labour as well as veterinary services are provided at no cost by a nearby agricultural college. The farming activities are conducted for self sufficiency and own consumption and the produce, in excess of their needs, is sold to a nearby farmers market. In addition, certain of the residents, who are unable to take part in the manual farming activities, have been taught to knead and bake bread which is supplied to a nearby supermarket. No commercial ovens or baking processes are used. Both the farming and baking activities are regarded as being of therapeutic benefit for the residents.

Determine: Whether the trading activities conducted by the PBO (farming operations and the sale of bread) fall within the ambit of section 10(1)(cN)(ii)(aa).

Result:

- The trading activities are integral and directly related to the sole object of the PBO, namely, caring for persons suffering from a severe mental disability. The primary purpose of the activities is to provide for own consumption (self sustaining) and only the excess being sold. Secondly, the activities are regarded as being of therapeutic benefit to the residents who are unable to find employment in the open labour market.
- Substantially the whole of the trading activities are conducted on a cost recovery basis. The main purpose of conducting the trading activities, is not to sell the goods at a profit, but for own consumption and to sell excess produce in order to recover certain costs. If it were not for the donated services or if external labour had been hired, a profit would not have been realised.
- The activities do not result in unfair competition with other taxpaying entities. The primary purpose is for own consumption and therapeutic benefit for the residents and only the excess to their own needs being sold.

Note: Where assets are used to generate income, for example, the letting of parking facilities, a hall, tennis courts, etc to members of the public, this will not be regarded as a related trading activity, but as income from a taxable trading activity.

6.2 Occasional trade [item (bb) of section 10(1)(cN)(ii)]

The undertaking or activity is of an occasional nature and undertaken substantially with assistance on a voluntary basis without compensation.

To qualify under this item the trading activity must –

- take place on an occasional or infrequent basis; and
- be undertaken substantially with assistance on a voluntary basis without compensation, other than the *bona fide* reimbursement of reasonable and necessary out of pocket expenditure.

Example 12

- Fundraising activities such as fêtes, cake sales, raffles and jumble sales which usually take place on an annual basis and with the assistance of helpers or volunteers who are not remunerated for their services.
- The sale of Christmas cards which have been reconditioned by volunteers.

6.3 Ministerial approval [item (cc) of section 10(1)(cN)(ii)]

The undertaking or activity is approved by the Minister by notice in the Gazette having regard to –

- *the scope and benevolent nature of the undertaking or activity;*
- *the direct connection and interrelationship of the undertaking or activity with the sole or principal object of the PBO;*
- *the profitability of the undertaking or activity; and*
- *the level of economic distortion that will be caused by the tax exempt status of the PBO carrying out the undertaking or activity .*

Any submissions in this regard will have to clearly demonstrate and motivate the benefits of the activity for the general public, together with reasons why it will not result in unfair competition with other taxpayers, or erode the tax base. To date, no such activities have been approved by the Minister.

The submission together with fully motivated representations must be sent to:

The General Manager
Legal and Policy Division: Interpretation and Rulings
South African Revenue Service
P.O. Box 402
PRETORIA
0001

6.4 Basic exemption [item (dd) of section 10(1)(cN)(ii)]

Other than an undertaking or activity in respect of which item (aa), (bb) or (cc) applies and do not exceed the greater of –

- (i) *5% of the total receipts and accruals of that public benefit organisation during the relevant year of assessment; or*
- (ii) *R100 000.*

Where a PBO carries on trading activities which do not fall within the ambit of the exemptions set out in items (aa), (bb) or (cc) of section 10(1)(cN)(ii), the PBO will be taxable on the taxable income derived from all such other business or trading activities. The greater of 5% of the total receipts and accruals of the organisation or R100 000 will not be subject to tax.

Example 13

Facts: A PBO conducting religious PBAs operates a book shop in a shopping mall. An analysis of the gross receipts as reflected in the income statement:

Donations from members	R 850 000
Interest	R 60 000
Bequest	R 40 000
Letting of parking during week days	R 35 000
Gross receipts from book shop	R 480 000
Annual fête	<u>R 140 000</u>
Total receipts and accruals	<u>R1 605 000</u>

Determine: The basic exemption of trading income which will not be taxable.

Result:

- An amount not exceeding the greater of R100 000 or 5% of the total receipts and accruals will be exempt from tax.
- 5% of the total receipts of R1 605 000 amounts to R80 250. This means that R100 000 of the total receipts and accruals derived from the taxable trading activities (parking R35 000 and R480 000 book shop) will be excluded from calculating the taxable income derived from the trading activities.
- The total gross receipts which will be taxable amount to R415 000 (R35 000 + R480 000 = R515 000 – R100 000 = R415 000).
- The “exempt” portion (R100 000) must be allocated on a *pro rata* basis to the taxable trading income, namely the letting of parking and the income from the bookshop (see example 15).

7. Practical application of the basic exemption trading rule [item (dd) of section 10(1)(cN)]

7.1 Determination of the threshold

Where the PBO makes use of the basic exemption provision set out in section 10(1)(cN)(ii)(dd), the gross receipts of all the trading activities that do not qualify in terms of items (aa), (bb) or (cc) must be utilised to determine the threshold of receipts derived from trading activities that will be exempt. The exempt amount must be determined in relation to all commercial trading activities and not individually to each trading activity.

7.2 Apportionment of expenditure

Expenditure incurred in the production of income will be apportioned *pro rata* between the exempt and the taxable amounts. General expenditure, such as administration and overhead costs must be allocated *pro rata* to total receipts. Where a PBO has retained accurate records relating to the expenditure incurred in the production of the different sources of income, this computation will be accepted.

7.3 Step by step calculation

The following examples are a step by step guide for the calculation of taxable income by applying the basic exemption rule.

Example 14

Facts:

- An approved PBO conducts religious PBAs and reflects the following information in its financial statements for the year of assessment ended 30 June 2007.
- The resident minister does not occupy the manse and the congregation has let it to a third party at market related rates for the full year.

Determine: Taxable portion of trading income not exempt in terms of section 10(1)(cN).

Result:

Income	R	R
<u>Total receipts other than from trading:</u>		720 000
Donations and tithes from members	660 000	
Bequest	40 000	
Interest on investment of surplus funds	<u>20 000</u>	
<u>Add: Total receipts from trading activities:</u>		<u>200 600</u>
Proceeds from annual fete	32 600	
Rental income from letting of manse	<u>168 000</u>	
Total gross receipts		<u>920 600</u>
Expenditure		
PBA expenses		324 000
Manse (rates, repairs, garden services)		<u>52 000</u>
Total expenses		<u>376 000</u>

Step 1

Total receipts not subject to tax

Income applicable to PBAs:

Donations and tithes	660 000	
Bequest	40 000	
Interest on investments	<u>20 000</u>	720 000
<u>Add: Income exempt in terms of item (bb)</u>		32 600
Proceeds annual fete	<u>32 600</u>	
Total receipts exempt from tax		<u>752 600</u>

Step 2

Total receipts from trading subject to tax

Rental income from manse		168 000
Total receipts from trading activities subject to tax		<u>168 000</u>

Step 3

Calculation of basic exemption – item (dd)

Greater of -

- (a) R100 000; or
- (b) 5% of total receipts and accruals (R920 600) = R46 030

Basic exemption = Exempt portion of total trading receipts = R100 000

Step 4

Allocation of basic exemption (R100 000) to taxable trading receipts

	Rental
	R
Total receipts	168 000
<u>Less: Exempt</u>	<u>100 000</u>
Total taxable receipts	<u>68 000</u>

Step 5

Direct expenditure (R52 000) incurred in respect of taxable trading activities attributable to “exempt” and “taxable” total receipts

Expenditure incurred in the production of total taxable receipts from trading activities to be apportioned between the “exempt” and “taxable” portion.

Formula:

$$\frac{\text{Total taxable receipts from specific trade}}{\text{Total receipts from the taxable trade}} \times \frac{\text{Expenditure}}{1}$$

Application: Rental income from manse (R168 000)

1. Calculate expenditure to be allocated in order to calculate the taxable portion of the rental income from the manse:

$$\begin{aligned} & \frac{\text{Total taxable receipts from the manse}}{\text{Total receipts from manse}} \times \frac{\text{Expenditure}}{1} \\ = & \frac{68\,000}{168\,000} \times \frac{52\,000}{1} \\ = & \text{R21 048} \end{aligned}$$

2. Expenditure applicable to “taxable” portion of rental income = R21 048
3. Expenditure applicable to “exempt” portion of rental income = R39 952
4. Calculate taxable receipts from the letting of manse:

$$\begin{aligned} \text{Taxable receipts} &= (\text{Total receipts} - \text{exempt portion}) - \text{allowable expenditure} \\ &= (168\,000 - 100\,000) - 21\,048 \\ &= 68\,000 - 21\,048 \\ &= \text{R46 952} \end{aligned}$$

Step 6

Calculation of tax payable

The PBO will pay normal tax at the flat rate applicable to PBOs, namely 29%. Tax on the taxable income of R46 952 will, therefore, be R13 616.08 (R46 952 x 29%).

Example 15

A company incorporated under section 21 of the Companies Act 1973, conducts a PBA of caring for abandoned children and has been approved as a PBO in terms of section 30 of the Act. The following receipts and expenditure are reflected for the year of assessment:

Income	R	R
<u>Total receipts other than from trading:</u>		1 833 000
Donations	165 000	
Government subsidy	1100 000	
Grants	550 000	
Interest on investments	<u>18 000</u>	
<u>Add: Total receipts from trading activities:</u>		377 000
Bookshop sales	227 400	
Royalties distribution from trust	132 600	
Sale of Christmas cards	4 000	
Sale of concert tickets	<u>13 000</u>	
Total gross receipts		<u>2 210 000</u>
Expenditure		
PBA expenses		724 000
Bookshop trading expenses		48 000
Accounting fees		<u>16 900</u>
Total expenses		<u>788 900</u>

Step 1

Total receipts not subject to tax

Income applicable to PBAs:

Donations	165 000	
Government subsidy	1100 000	
Grants	550 000	
Interest on investments	<u>18 000</u>	1 833 000

Add: Income exempt in terms of item (bb)

Sale of Christmas cards	4 000	
Sale of concert tickets	<u>13000</u>	<u>17 000</u>
Total receipts not subject to tax		<u>1 850 000</u>

Step 2

Total receipts from trading subject to tax

Bookshop sales	227 400	
Royalties distribution	<u>132 600</u>	<u>360 000</u>
Gross receipts from trading subject to tax		<u>360 000</u>

Step 3

Calculation of basic exemption – item (dd)

Greater of -

- (a) R100 000; or
- (b) 5% of total receipts and accruals (R2 210 000) = R110 500

Basic exemption = exempt portion of total trading receipts = R110 500

Step 4

Allocation of basic exemption (R110 500) to taxable trading receipts

The allocation is done on a *pro rata* basis in relation to the total receipts from the trading activities.

	Bookshop	Royalty	Total
	R	R	R
Total receipts	227 400	132 600	360 000
Exempt (<i>pro rata</i>)	<u>69 800</u>	<u>40 700</u>	<u>110 500</u>
Gross taxable receipts	<u>157 600</u>	<u>91 900</u>	<u>249 500</u>

Step 5

Allocation of direct expenditure

Expenditure directly incurred in the production of a specific category of income will be allocated to such income. Expenditure that is directly related to income producing activities as well as PBAs, but is paid as a single expense, for example rent paid, the basis of apportioning the expense will depend on the nature of the expense. In the case of rent paid the appropriate method would be the m² for the bookshop in relation to the m² of the whole area that is rented. In the example, the gross receipt from the bookshop as well as the PBAs had expenditure that could be allocated directly to the activities, namely:

1. Bookshop incurred expenditure of R48 000.
2. PBAs (income from donations, subsidy and grants) incurred expenditure of R724 000.

Step 6

Allocate direct expenditure incurred in respect of taxable trading activities to “exempt” and “taxable” total receipts.

Expenditure incurred in the production of taxable total receipts from trading activities will be apportioned between the exempt and taxable portion.

Formula:

$$\frac{\text{Total taxable receipts from specific trade}}{\text{Total receipts from the taxable trade}} \times \frac{\text{Expenditure}}{1}$$

Application: Bookshop

Calculate expenditure to be allocated in order to calculate the taxable portion of the income from the bookshop:

$$\begin{aligned} & \frac{\text{Total taxable receipts from the bookshop}}{\text{Total receipts from bookshop}} \times \frac{\text{Expenditure}}{1} \\ = & \frac{157\,600}{227\,400} \times \frac{48\,000}{1} \\ = & \text{R}33\,266 \end{aligned}$$

Calculate taxable receipts from the bookshop before allowable general expenditure:

$$\begin{aligned} \text{Taxable receipts} &= (\text{Total receipts} - \text{exempt portion}) - \text{allowable expenditure} \\ &= (227\,400 - 69\,800) - 33\,266 \\ &= 157\,600 - 33\,266 \\ &= \text{R}124\,334 \end{aligned}$$

Step 7

General (indirect) expenditure

Where expenditure, such as accounting fees, audit fees, bank charges or overhead expenses, is incurred which does not specifically relate to a particular source of income but which can be attributed to various sources, such costs will be apportioned on a *pro rata* basis.

Depreciation in respect of dual purpose assets (assets used for trade and PBAs, such as a motor vehicle), should also be apportioned *pro rata*.

Basis on which general expenditure may be apportioned

The expenditure will be apportioned based on the total receipts.

Formula:

$$\frac{\text{Specific income to which allocated}}{\text{Total receipts from taxable activities}} \times \frac{\text{Expenditure}}{1}$$

Source of receipts to which general expenditure is to be apportioned

Application:

Source	Total receipts (R)
PBAs (Donations + grants + subsidy)	1 815 000
Bookshop	227 400
Sale of Christmas cards	4 000
Sale of concert tickets	<u>13 000</u>
Total	<u>2 059 400</u>

Proportionate administration and overheads to be deducted based on the above formula (R16 900)

Source	Total receipts (R)	Allocation (R)
PBAs (Donations + grants + subsidy)	1 815 000	14 894
Bookshop	227 400	1 866
Sale of Christmas cards	4 000	33
Sale of concert tickets	<u>13 000</u>	<u>107</u>
Total	<u>2 059 400</u>	<u>16 900</u>

Note: The PBO has confirmed that no portion of the general expenditure has been incurred in the production of the investment income or the income received as distribution from the trust.

Step 8

Allocation of administration/overhead expenditure between taxable and exempt portion of bookshop trading –

$$\begin{aligned} & \frac{\text{Total taxable receipts from the bookshop}}{\text{Total receipts from bookshop}} \quad \times \quad \frac{\text{Expenditure}}{1} \\ = & \frac{124\,334}{227\,400} \times \frac{1866}{1} \\ = & \text{R1020} \end{aligned}$$

The allowable portion of the general or indirect expenditure must now be deducted from the taxable receipts determined in Step 6, namely R124 334 in the case of the bookshop.

Taxable income from the bookshop will, therefore, amount to:
= R124 334 – R1 020
= R123 314

Step 9

Add all the amounts representing taxable income from the various sources together in order to calculate the taxable income for the year of assessment.

Source	Amount
	R
Taxable income from the bookshop (Step 8)	123 314
Taxable income from trust distribution (Step 4)	<u>91 900</u>
Total taxable income from trading activities	<u>215 214</u>

Step 10

Calculation of tax payable

The PBO will pay normal tax at the flat rate applicable to PBOs, namely 29%. Tax on the taxable income of R215 214 will, therefore, be R62 412,06 (R215 214 x 29%).

8. Effective date of implementation

The amendment to section 10(1)(cN) relating to the partial taxation came into operation on 1 April 2006 and is applicable to a PBO as from its first year of assessment commencing on or after that date.

Note: Reference should be made to paragraph 14 for an explanation of “year of assessment” and “financial year end”.

Example 16

The financial year end of a PBO, which is incorporated under section 21 of the Companies Act, 1973 is 31 December. The year of assessment for the company will coincide with its financial year, namely 1 January to 31 December. The new provision relating to partial taxation will be applicable as from the year of assessment commencing 1 January 2007, namely its 2007 year of assessment.

A PBO which is a trust, will always have a year of assessment ending 28 February and will be subject to the new provisions with effect from the year of assessment commencing 1 March 2007, namely the 2008 year of assessment.

9. Allowable deductions

Expenditure incurred in the production of income is generally allowable in determining taxable income. The exception is expenditure which is of a capital nature (such as the cost of acquiring the business) and expenditure incurred which produces exempt income (interest incurred to buy shares that will produce exempt dividends). Where expenditure is incurred with a dual intent, namely for purposes of trade as well as for PBAs, an equitable allocation must be made as expenditure incurred not for the purpose of trade is not allowable as a deduction.

10. Income from a trust where the PBO is the beneficiary

In terms of the provisions of section 25B(2) of the Act, where the trustees exercise their discretion to distribute an amount to the beneficiaries of the trust, the beneficiaries obtain a vested right to the amount which is deemed to accrue to the beneficiaries. The beneficiaries will then be taxable on the amount so distributed. However, where the trust is taxed on the amount, the deeming provision will not apply.

Section 10(1)(cN)(i) has been amended to provide that any receipts and accruals derived from any business undertaking or trading activity will not be exempt from normal tax other than to the extent that they qualify in terms of the rules in section 10(1)(cN)(ii). Where a PBO is a beneficiary of a trust and the trustees exercise their discretion to distribute the income in accordance with section 25B and such receipts constitute receipts derived from trading activities, such as rental income or profit on a commercial bookshop, the receipts will be regarded to be business or trade in the hands of the PBO, which will qualify to be taken into account in terms of section 10(1)(cN)(ii)(*dd*).

11. Losses incurred

A profit/loss arises from the final result of a trading operation after allowable expenditure has been deducted. In terms of section 11(a) of the Act expenditure and losses which are not of a capital nature and which have been actually incurred in the production of income, may be deducted in the determination of taxable income. An “assessed loss” which is defined in section 20(2) of the Act, arises when the deductions allowable in terms of the Act exceed the income in respect of which they are admissible. An assessed loss will be allowed to be carried forward and deducted from income in a subsequent year of assessment.

11.1 Years of assessment prior to implementation of the system of partial taxation

Where an entity is exempt from the payment of normal tax, the income received is not subject to tax and the expenditure incurred is not allowed as a deduction. It follows therefore that where an exempt PBO has conducted trading activities, the profits of which were not subject to tax and, such activities resulted in a loss in the year prior to such PBO becoming taxable on the profit derived from trading activities, the loss incurred in the previous year may not be carried forward. This loss is not an “assessed loss” as it has not been allowed in the determination of taxable income.

11.2 Years of assessment subsequent to implementation of the system of partial taxation

Losses incurred in years of assessment as from the first year of assessment during which the partial taxation is applicable to a PBO, may be carried forward to subsequent years of assessment.

Note: It must be noted that in the case of a company, an assessed loss may not be carried forward for set off in the next succeeding year of assessment unless the company has carried on a “trade” as defined in section 1 of the Act.

For further information relating to assessed losses refer to Interpretation Note No. 33 dated 4 July 2005, available on the SARS website. It must be noted that Interpretation Note No. 33 is only applicable to PBOs that are companies and not to PBOs that are registered as trusts.

Example 17

A PBO which is exempt from income tax in terms of section 10(1)(cN) of the Act, conducts trading as a bookshop. During the year of assessment ending 30 June 2006 a loss on this trading activity of R7 800 was incurred. This loss was not reflected on the assessment notice as the PBO was exempt from income tax on all its receipts and accruals. As from the year of assessment commencing 1 July 2006 the PBO will be taxable on this trading activity. The taxable income, after taking into account the allowable expenditure as well as the basic exclusion, amounts to R12 000. The loss of R7 800 incurred in the previous tax year will not be allowed to be set off against this taxable income.

12. Rate of tax applicable to taxable trading receipts

A PBO which has been approved in terms of section 30 of the Act and which is liable to tax on trading income, will pay tax at a single flat rate of 29%, irrespective whether it is established as a trust, company incorporated under section 21 of the Companies Act, 1973 or as an association of persons.

13. Valuation of assets for purposes of depreciation

Where any assets, such as machinery, plant, implements, utensils or articles were used by a PBO during any previous financial year for purposes of any trade carried on, the receipts and accruals of which were not included in the income of the PBO, the period of use of such asset during such previous years will be taken into account in determining the amount by which the asset may still be written off. For further details refer to Practice Notes No. 19 (dated 30 April 1993) and 39 (dated 10 May 1995), which are available on the SARS website.

Where an asset is used partly for trade and partly for conducting approved PBOs, depreciation may be claimed proportionately.

Example 18

An exempt PBO conducts a car wash as a business activity in order to augment its PBAs. Up until the year of assessment ended 30 June 2006 the PBO was exempt from income tax on all its receipts and accruals, including the taxable income derived from the car wash. As from the year of assessment commencing 1 July 2006 the PBO will be taxable on the receipts derived from the carrying on of this business activity. The machinery is depreciated over a

period of 5 years (in accordance with Practice Note No.19).

Wear and tear has been calculated as follows:

	R
Cost of machinery 1 August 2003	100 000
Depreciation 30 June 2004	20 000
Depreciation 30 June 2005	20 000
Depreciation 30 June 2006	<u>20 000</u> 60 000
Book value as at 1 July 2006	<u>40 000</u>

Depreciation to be claimed by the PBO as deduction in the determination of taxable receipts:

Depreciation 30 June 2007	R20 000
Depreciation 30 June 2008	R20 000

14. Period for which accounts are to be submitted

A year of assessment is the period of twelve months which commences on 1 March of a specific year and ends on the last day of February the following year. A financial year is the twelve month period, as determined in the founding document, as the fixed period for which annual financial statements are drawn up.

A PBO that is registered as a trust will have a year of assessment ending on the last day of February. Relief provisions are, however, available to trusts in circumstances where it is not convenient to render financial statements to the end of February. For more information in this regard see Interpretation Note No. 19 (Issue 2) available on the SARS website.

On the other hand, PBOs that are registered in terms of section 21 of the Companies Act, 1973 as well as association of persons are permitted to have a year of assessment ending on the date that coincides with their financial year end.

15. Provisional Tax – Fourth Schedule to the Act

A PBO which has been approved by the Commissioner in terms of section 30(3) of the Act are exempt from making provisional tax payments for a three year transitional period as from its first year of assessment commencing on or after 1 April 2006. This three year transitional period may be extended by the Minister by notice in the *Gazette*.

16. Capital Gains Tax (CGT) – Eighth Schedule to the Act

Amendments to the Eighth Schedule relating to CGT implications for PBOs have been introduced by the RLAA 31 of 2005 and the RLAA 20 of 2006. A separate Interpretation Note No. 44 dated 31 August 2007 has been issued providing clarity for PBOs with regard to the disposal of capital assets and the CGT

implications. This aspect will therefore not be discussed in detail in this Note. However, the following salient points should be noted:

16.1 Effective date

As from a PBOs first year of assessment commencing on or after 1 April 2006, any capital gain or loss made on the disposal of an asset which has not been solely used to produce amounts which are exempt from tax or, substantially the whole of the use of the asset from the valuation date has not been in the carrying on of a PBA, will be taken into account for CGT purposes.

16.2 Valuation date

The valuation date for a PBO in existence on 1 April 2006 on which the base cost of an asset is to be determined, is the first day of its first year of assessment commencing on or after 1 April 2006.

16.3 Base cost

The methods available for determining the base cost of an asset on valuation date, is fully discussed in the Interpretation Note No. 44 dealing with CGT implications for PBOs.

16.4 Capital gains and losses which must be disregarded

Any capital gain or loss made in respect of the disposal of following categories of assets must be disregarded:

- Non-trading assets. This category refers to assets used exclusively for non-trade purposes such as carrying on PBAs and assets held as investment.
- Minimal trading assets. This category includes assets, where substantially the whole of the use of the asset by the PBO, on or after valuation date was directed at a purpose other than carrying on a business undertaking or trading activity. (An asset used 90% of the time for PBAs and 10% of the time for trading purposes.)
- Permissible trading assets. This category applies to assets where substantially the whole of the use of the asset was directed at carrying on a business undertaking or trading activity which qualifies for exemption in terms of items (aa), (bb) or (cc) of section 10(1)(cN)(ii).

16.5 Donations and bequests to PBOs

Any capital gain or capital loss made by a person on the disposal of an asset which has been donated or bequeathed to an approved PBO will be disregarded in the hands of the donor.

16.6 Transfer duty implications

A consequential effect on PBOs having to determine capital gains and capital losses on the disposal of fixed assets is the transfer duty implication. Where the asset (which qualified for transfer duty exemption) is subsequently not substantially used for PBA purposes, transfer duty becomes payable at the time the property is used for any purpose other than for the purpose of carrying on one or more PBAs.

For further information in this regard see Interpretation Note No. 22 dated 11 March 2004.

17. Conclusion

The information contained in this Interpretation Note discusses only the broad principles in interpreting the legislation. As the facts and circumstances pertaining to each PBO may differ, each case must be considered in the light of its own merits.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

Date of first issue: 19 March 2004