

**IS SOUTH AFRICA'S HEADQUARTER REGIME  
SUCCESSFUL AND DOES IT GO AGAINST  
NATIONAL LEGISLATION.**

University of Cape Town

**NAME:** ISMAIL MOHAMED CA (SA)  
**STUDENT NUMBER:** MHMISM004  
**DEGREE:** MASTERS IN PHILOSOPHY – TAX LAW  
**SUPERVISOR:** JUDGE DENNIS DAVIS  
**WORD COUNT:** 8 818 WORDS

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

**TABLE OF CONTENTS**

1. Introduction .....	3
2. Prior barriers that resulted in the insertion of Section I .....	7
3. Details behind Section 9I – Headquarter companies .....	11
4. Amendment to address the barriers previously faced by the South African legislation .....	15
5. A comparison between South African and Mauritian headquarter regimes .....	21
6. What extent is a headquarter regime in South Africa considered to be treaty shopping .....	32
7. Impact of anti-avoidance and treaty shopping .....	34
8. Conclusion .....	37
9. Biography .....	38

## 1. INTRODUCTION

In 2010, all eyes were on South Africa as it hosted the 19<sup>th</sup> FIFA Soccer World Cup. The World Cup demonstrated South Africa's ability to construct and improve infrastructure through building world class stadiums, improving our public transportation systems and our ability to organise and manage a tournament of this magnitude.

Despite the fact that South Africa was selected to host the 19th FIFA World Cup, the country was emerging from the worst global economic recession experienced in seven years and the country's first recession in 17 years.<sup>1</sup> According to the 2010 National Budget Review, the global economic recession resulted in large-scale job losses, with unemployment on the rise. In light of this, job creation was a high priority on the government's agenda to combat the ever increasing poverty and to address the debris of the recession.

On 17 February 2010, the National Treasury of the Republic of South Africa released its 2010 Budget Review which stated that South Africa was coming out of a deep global economic recession in seven decades, and South Africa's first recession in 17 years.<sup>2</sup> Many South Africans lost their jobs as a result of the recession and unemployment was on the rise. Job creation was high on the government's agenda in which to combat poverty and to address the debris of the recession.

The strength of the South African public finance provided a concrete response to the economic crisis; strengthened the county's social security safety net, as well as increased investment in key infrastructural projects, which also served as a stimulus for growth. Adding to this, the 2010 National Budget Review indicates that South Africa's fiscal stance will continue to

---

<sup>1</sup> National Treasury, 2010 Budget Review, Foreword paragraph 1

<sup>2</sup> National Treasury, 2010 Budget Review, Foreword paragraph 1

support economic recovery, while gradually reducing the deficit to bring the budget back into a sustainable position.<sup>3</sup>

The 2010 Budget Review further promoted “South Africa as a gateway to Africa”. In line with this, findings from investigations conducted by National Treasury to make South African an attractive destination for countries wanting to extend their operations in Africa<sup>4</sup>. To this end, South Africa has amended its Income Tax Act to provide relief to those wanting to do so by means of a headquarter company in located in South Africa. Currently monies coming into South Africa from non-residents require exchange control approval.<sup>5</sup> This is viewed as a barrier and in light of these barriers, certain tax rules was to be reviewed.<sup>6</sup> These restrictions are further discussed in this paper.

In the 2010 Budget Review, one of the tax proposals on the National Budget Revenue was the promotion of “South Africa as a gateway into Africa”.

“South Africa’s location, its strength in financial services and its banking infrastructure makes it a potential gateway into Africa. Government proposed measures to enhance this role. In 2010/11, further investigations were to be done to enhance our attractiveness as a viable and effective location from which businesses can extend their African operations. Relief from exchange control and taxation for various types of headquarter companies located in South Africa was to be considered<sup>7</sup>.”

At an international level, individuals and companies are trading and investing with each other. This results in large amounts of money moving between the different countries. Through this process countries are trying to attract

---

<sup>3</sup> National Treasury, 2010 Budget Review, Foreword paragraph 2

<sup>4</sup> National Treasury, 2010 Budget Review

<sup>5</sup> National Treasury, 2010 Budget Review

<sup>6</sup> National Treasury, 2010 Budget Review, Chapter 5, Revenue trends and tax proposals

<sup>7</sup> National Treasury, 2010 Budget Review, Chapter 5, Revenue trends and tax proposals

multinational companies to invest in them by creating head quarter regimes. The most common and well-known 'tax havens' are Mauritius and Bermuda.

Legwaila describes that a holding company investment can be in any of the following three forms dependant on the investors, namely,

*“An international holding company is created to control the companies in the group; it would hold and manage intellectual property rights via this holding company in the group of companies. An international headquarter company is where a multinational group of companies have significant economic interests in a region which is distant from its head office to oversee and co-ordinate the group’s business interests in a particular region. An intermediary holding company is to acquire, manage and sell investments in group companies, mainly its subsidiaries and in general to provide transactional and organisational flexibility in a group of companies.”<sup>8</sup>*

These holding companies are the connection between the shareholder (investor) and operating companies. In most instances the holding companies are also set up in jurisdictions which provide the best tax relief and therefore it is in a different jurisdiction from the shareholder.

The Katz Commission report encouraged the formation of headquarter companies located in South Africa. This will benefit the South African economy by encouraging South African to invest out of South Africa without South African human capital leaving the country and to allow foreign investors to invest in Africa through South Africa.<sup>9</sup>

Both of these factors would lead to both the retention and importation of skills, and a subsequent contribution to overall economic activity in the

---

<sup>8</sup> Legwaila “Intermediary Holding Companies and Group Taxation” 2010 *De Jure* 308 313 – 315

<sup>9</sup> Katz Commission. ‘*Aspects of the Tax Structure of South Africa*’, 1997, 5<sup>th</sup> edition, paragraph 7.1.1 (i) and (ii)

country.<sup>10</sup> The potential increase economic activities in South Africa will result in job creation which was highlighted as a major concern during the global economic recession.

Research indicates that due to where South Africa is located, the infrastructure that the country possesses in terms of being a supplier of resources and its developing economy, this making South Africa an viable option to set up a headquarter company to do business in the rest of Africa.<sup>11</sup> Furthermore, South Africa has the largest amount of treaties, 74 treaties, compared to other countries in Africa.<sup>12</sup>

It is within this framework that this minor dissertation identifies why South Africa's headquarter regime has never taken off, given that it is going into its fifth year of existence (the effective date was 1 January 2011). What should we have done or should do to make this piece of legislation a viable option to multinational companies.

---

<sup>10</sup> Katz Commission. *Aspects of the Tax Structure of South Africa*, 1997, 5<sup>th</sup> edition, paragraph 7.1.1 (i) and (ii)

<sup>11</sup> Grant Ward "Investing into Africa: Comparison between South Africa headquarter company and Mauritian GBC1 regime" 10 February 2014, page 6 paragraph 3

<sup>12</sup> [http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-\(Rest-of-the-World\).aspx](http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Rest-of-the-World).aspx) (accessed on 23 July 2015)

## 2. PRIOR BARRIERS THAT RESULTED IN THE INSERTION OF SECTION 9I OF THE INCOME TAX ACT NO.58 OF 1962

South Africa charges tax on income for residents on a worldwide basis compared to non-residents on a source basis. As a result of a resident company, the resident company will be taxed on its worldwide income which includes a controlled foreign company (“CFC”) which is defined as a foreign company where more than 50 per cent owned by South African residents<sup>13</sup>. One of the issues that this is likely to lead to is transfer pricing.

Dividend taxation is charged on dividend declared to shareholders. Previously, the dividend taxation was charged to the company and the expense born to them. The various tax treaties that countries have will be available to reduce the dividends taxation paid.

If a company’s foreign debt in relation to its equity is excessive<sup>14</sup>, thin capitalisation rules would apply. This will restrict the outflow of profits from South African companies. Thin capitalisation may even apply if the foreign debt that is immediately on-lent to foreign operations.

For South Africa to become an attractive headquarter company regime, four tax rules in the South African Income Tax Act needed to be addressed as they were identified as barriers to a headquarter company regime set up:

- CFC rules
- Dividend tax on outgoing dividends
- Thin Capitalisation rules
- Withholding tax on royalties

---

<sup>13</sup> Income Tax Act No 58 of 1962, Section 9D, definition of “controlled foreign company”

<sup>14</sup> OECD “Thin capitalisation legislation: Background paper for tax administration” August 2012

## 2.1 CFC rules

Section 9D of the Income Tax Act is applicable section to CFC's.

The Income Tax Act defines a foreign company.

*“a foreign company is where South African residents directly or indirectly hold more than 50% of rights to participate in the share capital / profit of the foreign company or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents is considered to be a CFC.”<sup>15</sup>*

Treatment of the foreign company's income “shall include for the year of assessment of any resident who directly or indirectly holds participating rights in a CFC.”<sup>16</sup> There however is an exclusion, “where a resident, together with any connected person in relation to that resident, in aggregate hold less than 10 per cent of the participating rights or may not exercise at least 10 per cent in that CFC, the net income of the CFC is calculated as if the CFC was a taxpayer and was a resident for the purposes of the definition of gross income”<sup>17</sup>

## 2.2 Dividends tax on dividends leaving South Africa

Section 64D to Section 64N of the Income Tax Act, is the applicable sections for all dividends.

Pre 1 April 2012, a Secondary Tax on Companies was levied at 10 per cent and payable by the company on dividend declared and in 2007 the Minister of Finance announced that this would be replaced by dividends withholding tax. The dividend withholding tax would be levied at 15 per cent effective 1 April 2012. The Dividends Tax legislation (as amended by the Taxation Laws

---

<sup>15</sup> <https://sataxguide.wordpress.com/tax-implications-of-controlled-foreign-companies-cfc/> (accessed on 12 June 2015)

<sup>16</sup> Income Tax Act No. 58 of 1962, Section 9D(2)

<sup>17</sup> Income Tax Act No. 58 of 1962, Section 9D(2A)

Amendment Act, 2011, promulgated on 10 January 2012) became effective on 1 April 2012 (see notice in the Government Gazette on 20 December 2011).

This resulted in the same monies being taxed twice. Firstly in the foreign company that the monies come from and passes to the headquarter company and secondly when the same monies pass to the investor via the STC or dividends withholding tax applicable in South Africa.

### **2.3 Thin capitalisation rules**

Thin capitalisation is found in Section 31 of the Income Tax Act, and would be applicable to all debt financed transactions with connected persons.

Companies are financed in one of two ways, namely through funds from shareholders which is “equity” or by “debt”, which is borrowed money which needs to be repaid. The dividends on equity or the interest paid on debt are treated differently for tax purposes. Interest payments on debt borrowed are deductible as it is incurred in the production of income by a person carrying on a trade<sup>18</sup> while dividends are not deductible. Therefore the finance structure of a company will have a direct impact on the company’s taxable income. A company which is considered to have too little equity when the debt is two times its equity is said to be thinly capitalised for tax purposes.<sup>19</sup>

The issue arises when South African companies are funded either directly or indirectly by non-resident connect persons. The typical transactions between the non-resident company and South African companies are their excessive intercompany loan accounts which may result in interest payments based on

---

<sup>18</sup> Income Tax Act No. 58 of 1962, section 11 (a)

<sup>19</sup> OECD “Thin capitalisation legislation: Background paper for tax administration” August 2012

higher normal, not at an arm's length interest rate, therefore reducing the South African company's tax base.<sup>20</sup>

## **2.4 Withholding tax on royalties**

This critical barrier was not dealt as yet and should be considered as critical as multinational companies use their headquarter companies as conduits for their intellectual property and charge royalties to subsidiaries all around the world. An example would be Coca Cola recipe and brand. South Africa levies a withholding tax of 15 per cent on all royalty payments to foreign companies.

Section 49A to Section 49H of the Income Tax Act, would be applicable to all withholding tax on royalties.

---

<sup>20</sup> SARS Interpretation Note on Section 31 "Determination of the taxable income of certain persons from international transactions: Thin Capitalisation" 2013

### 3. SECTION 9I – HEADQUARTER COMPANIES

As a result of these barriers South Africa faced in encouraging foreign investment, it inserted into the Income Tax Act No.58 of 1962 section 9I specifically for headquarter companies.

The first step is to ascertain whether a company qualifies as a headquarter company, we need to determine if it is a headquarter company as defined by section 1 and section 9I(1):<sup>21</sup>

1. Resident
2. Complies with the requirements of section 9I(2)
3. Makes an election to be a headquarter company

#### 3.1 A resident

- To be resident of South Africa there is a need to look at the definition in section 1 of the Income Tax Act which is defined as “person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic”<sup>22</sup>
- As “Place of effective management” is not defined in the Act, South African Revenue Services (SARS) has issued an interpretation note on this, Interpretation Note 6 of 2011. It interprets “place of effective management” as the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made.<sup>23</sup>

---

<sup>21</sup> Income Tax Act No. 58 of 1962, section 1 and section 9I(1)

<sup>22</sup> Income Tax Act No. 58 of 1962, section 1, “resident”, (b)

<sup>23</sup> SARS Interpretation Note 6 of 2011 and 2015, page 4

### 3.2 Complies with the requirements in Section 91(2)

- a) *“During the year of assessment each holder of the headquarter company, whether alone or together with other companies forming part of the same group of companies) held 10 per cent or more of the equity shares and voting rights of the company.”<sup>24</sup>*

Interpretation Note on Headquarter Companies issued in 2015 provides guidance in the form of examples on the 10 per cent criteria.<sup>25</sup>

The guidance relates to the words “during the year of assessment”, which means that throughout the entire year of assessment, the shareholders alone or together with other companies should hold 10 per cent in the headquarter company. Therefore, if at any point in the year, any shareholder whether alone or together with other companies, shareholding drops below the 10 per cent criteria even for a day, would fall outside the criteria, “during the year of assessment hold 10 per cent” and this section would not be available for the company to use.

The Interpretation Note provides clarity that the “holder” does not have to be resident. It includes both resident and non-resident.

The Interpretation note emphasises that the 10 per cent holding rule is for both equity shareholding and voting rights and is not an either or requirement.

- b) *“At the end of the year of assessments and all previous years of assessments 80 per cent or more of the cost of the total assets of the company was attributed to one or more of the following:*
- i. Any interest in equity shares in;*
  - ii. Any debt owed by; or*
  - iii. Any intellectual property that is licensed by the company to any foreign company in which that company (alone or together with*

<sup>24</sup> Income Tax Act No. 58 of 1962, section 91(2)(a)

<sup>25</sup> SARS Interpretation Note 6 of 2015, pages 7 – page 10

*other companies forming part of the same group of companies) held at least 10 per cent of the equity shares or voting rights.*<sup>26</sup>

This criterion reveals that the majority (being 80 per cent or more) of the company's earning must be in relation to 'passive income' instead of 'active income'.

Active income is income received for which services have been performed and includes income such as salary, wages or commission from employment, tips or gratuities and income from business activities.<sup>27</sup> Passive income is received on a regular basis, with little effort required to maintain it.<sup>28</sup> Examples of passive income include dividends, interest or royalties.

Interpretation Note on Headquarter Companies issued in 2015 provides clarity on the foreign company the "potential headquarter company" derives passive income from.<sup>29</sup> The potential headquarter company must hold at least 10 per cent of the equity shares and voting rights of the foreign company. If the 10 per cent criteria is met the potential headquarter company the cost of that asset would form part of the cost of total assets.

The cost relates to actual cost paid for the equity shares, debt forwarded or intellectual property bought and not the impaired or revalued amount.

A major drawback of this requirement is to be found in the words "all previous years of assessment". If in any previous years of assessment the company does not meet this requirement, the company will be unable to become a headquarter company in any future years of assessments.

---

<sup>26</sup> Income Tax Act No. 58 of 1962, section 9I(2)(b)

<sup>27</sup> <http://www.investopedia.com/terms/a/activeincome.asp> (accessed 22 June 2015)

<sup>28</sup> [http://en.wikipedia.org/wiki/Passive\\_income](http://en.wikipedia.org/wiki/Passive_income) (accessed 22 June 2015)

<sup>29</sup> SARS Interpretation Note 6 of 2015 pages 10 to 16 which includes examples of this requirement.

Another problem is that if a company has total assets with market value of less than R50,000 in any year of assessment, that year of assessment is disregarded. The ripple effects of these requirements are that if they do not meet the requirement once, they will be unable to meet it in any future years of assessments as it states “all previous years of assessment”.

- c) *“Where the gross income of the company for the year of assessment exceeds R5 million, 50 per cent or more of this gross income consists of amounts in the form of one or more of the following:*
- I. any rental, dividends, interest, royalties or service fees paid or payable by any foreign company contemplated by section 9I(2)(b)*
  - II. Any proceeds from the disposal of any interest in equity shares or of any intellectual property.*
  - III. No exchange differences should be taken into account.”<sup>30</sup>*

To determine whether 50 per cent of gross income includes income stated in Section 9I(2)(c), we first need to determine the scope of “gross income”.

*“Gross income includes items of revenue nature unless specifically included in terms of section 1, “gross income” (a) to (n)”.*

In most cases, “the proceeds from the disposal of an interest in equity shares or intellectual property” would be of a capital nature.<sup>31</sup>

Subsection 9I(2)(c) requirement does not give the user an indication to what happens when gross income is equal or less than R5 million. However, the section does state that gross income should exceed R5 million, of which 50 per cent must be specific income, as listed in the section, else the subsection is not met.

### **3.3 Make an election to be a headquarter company**

Once the requirements of Section 9I(1) and 9I(2) are met, the company may elect to become a headquarter company in terms of Section 9I(3).

---

<sup>30</sup> Income Tax Act No 58 of 1962, section 9I(2)(c)

<sup>31</sup> SARS Interpretation Note 6 of 2015, page 17 including examples on pages 17 to 19

## 4. AMENDMENTS TO ADDRESS THE BARRIERS PREVIOUSLY FACED BY SOUTH AFRICA'S LEGISLATION

### 4.1 Dividends and foreign dividends received by or accrued to a headquarter company

The headquarter company is a resident and therefore taxed on its worldwide income. Both local dividends and foreign dividends received or accrued should therefore be included into gross income in terms of paragraph (k) in the definition of "gross income" in section 1 of the Income Tax Act No. 58 of 1962.

Section 10(1)(k) exempts the local dividends received by or accrued to headquarter company from gross income. Section 10B exempts the entire foreign dividends received by or accrued to headquarter company from gross income, if it meets the requirements of section 10B(2).<sup>32</sup>

- Section 10B(2)(a), *"if that person, whether alone or together with any other company forming part of the same group of companies as that person, holds at least 10 per cent of the equity shares and voting rights in the company declaring the section 10B foreign dividend"*;
- Section 10B(2)(b), *"if the person is a foreign company and the foreign dividend is paid or declared by another foreign company that is a resident in the same country as that person"*;
- Section 10B(2)(c), *"if the person is a resident then, under certain circumstances, to the extent that the foreign dividend does not exceed the aggregate of all amounts previously attributed from the company which is a CFC"*;
- Section 10B(2)(d), *"to the extent that the foreign dividend is received by or accrues to that person on a listed share and does not consist of the distribution of an asset in specie"*; or

---

<sup>32</sup> Income Tax Act No 58 of 1962, section 10B(2)

- Section 10B(2)(e), *“to the extent that the foreign dividend is received by or accrues to a company that is a resident in respect of a listed share and consists of the distribution of an asset in specie.”*<sup>33</sup>

#### **4.2 Interest incurred by a headquarter company payable to foreign companies**

Interest is incurred by the headquarter company on debt that is made available to the headquarter company by foreign companies. As a result of this transaction two possible deductions are available, namely,

- Section 31 would apply first, “Tax payable in respect of international transactions to be based on arm’s length principles”<sup>34</sup>
- Section 20C(2) would apply second, “Ring-fencing of interest and royalties incurred by headquarter companies”<sup>35</sup>

*Section 31* defines the borrowing of money (debt) and security or guarantee as financial assistance. Therefore, when a headquarter company borrows money from a foreign company, section 31 should be applied. However, section 31(5)(a) states that “where a transaction has been entered into between the headquarter company and a non-resident and that transaction is considered to be financial assistance to the headquarter company, this section would not apply if the headquarter company is a connected person” as interpreted in Section 9I of Income Tax Act. This section is to be analysed comprehensively later in this paper.

Section 20C applies if a headquarter company incurred any interest in respect of financial assistance granted to the headquarter company that is non-resident and a connected person. The amount of the deduction allowable to the headquarter company is limited to the amount of interest received by or accrued to the headquarter company that the headquarter

---

<sup>33</sup> Income Tax Act No 58 of 1962, section 10B(2)

<sup>34</sup> Section 31 of Income Tax Act

<sup>35</sup> Section 20C(2) of Income Tax Act

company onward provided as financial assistance to connected foreign companies.

### **4.3 Royalties incurred by headquarter companies**

Royalty payments are made for the use of a third parties intellectual property.<sup>36</sup> When a company makes a royalty payment to a person who is non-resident in South Africa, a withholding tax of 15 per cent, since 1 January 2015, is withheld from the royalty payment paid to the non-resident and thereafter the non-resident can rely on a Double Tax Agreement.<sup>37</sup>

However, if a headquarter company pays royalties to a non-resident, the royalty is exempt from withholding tax in terms of Section 49D(c) to the extent that Section 31 does not apply.

In most cases, headquarter companies will be paying the holding company or Intellectual Property Holding Company royalties.<sup>38</sup> Therefore, this exemption would be beneficial to the headquarter company and group of companies as no withholding tax would be payable in South Africa at a rate of 15 per cent.

### **4.4 Transfer Pricing and thin capitalisation**

Transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities within an enterprise.<sup>39</sup>

Therefore, all transaction between connected persons should be assessed for transfer pricing. This is to determine whether the price charged between

---

<sup>36</sup> <http://www.investopedia.com/terms/r/royalty.asp> (accessed on 19 June 2015) and Section 49A under definition of royalty as well as Section 23I

<sup>37</sup> <http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2013-01%20-%20Status%20Overview%20of%20All%20DTAs%20and%20Protocols.pdf> (accessed on 19 June 2015)

<sup>38</sup> Legwaila, T --- The nature of a headquarter company: a comparative analysis De Jure 377

<sup>39</sup> [https://en.wikipedia.org/?title=Transfer\\_pricing](https://en.wikipedia.org/?title=Transfer_pricing) (accessed on 19 June 2015)

the connected persons are charged at an arm's length price.<sup>40</sup> An arm's length price is the price a willing buyer would pay a seller on the open market for the goods and service offered. Therefore, when a headquarter company renders managerial services to a connected person who is a non-resident, the transfer pricing principle of Section 31 would apply.

However, there are 2 specific exclusions to Section 31:

- *“By a non-resident to a headquarter company, Section 31 will not apply to so much of the financial assistance as is directly applied or to so much of the use, right of use or permission to use the intellectual property as is granted to any foreign company in which the headquarter company directly or indirectly whether alone or together with any other company forming part of the same group of companies holds at least 10 per cent of the equity shares and voting rights and in the case of an intellectual property, the headquarter company does not use it otherwise”; or*
- *“By headquarter company to a foreign company in which the headquarter company directly or indirectly, whether alone or together with any other company forming part of the same group of companies hold at least 10 per cent of the equity shares and voting rights, Section 31 would not apply to the financial assistance or granting of use, right of use or permission to use that intellectual property”*

#### 4.5 Capital gains

A capital gain is derived when a capital asset is sold for a profit. For a headquarter company this could be a sale of foreign company that the headquarter company held. This is assuming that it was the headquarter company's intention to hold the foreign company as an investment for a substantial period of time and sold the investment for best advantage.<sup>41</sup>

In terms of Section 64B(2) of the Eighth Schedule,

---

<sup>40</sup>

[http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer\\_pricing:\\_Keeping\\_it\\_at\\_arms\\_length.html](http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html) (accessed on 19 June 2015)

<sup>41</sup> Case Law: Stott Case (Revenue versus Capital)

*“a headquarter company must disregard a capital gain or capital loss on the disposal of equity shares in a foreign company if the headquarter company, whether alone or together with any other person forming part of the same group of companies as the headquarter company, immediately before the disposal held at least 10 per cent of the equity shares and voting rights in the foreign company.”<sup>42</sup>*

The Section 64b(2) exemption will not apply when:

*“80 per cent or more of the market value of the equity shares in a foreign company is directly or indirectly attributed to immovable property in South Africa held otherwise than as trading stock and the headquarter company (whether alone or together with any other connected person in relation to that headquarter company), directly or indirectly, holds at least 20 per cent of the equity shares in that company.”*

#### **4.6 Exchange Control**

For exchange control purposes, South African Reserve Bank (“SARB”) has classified headquarter companies as non-resident companies, other than for reporting purposes.<sup>43</sup> The focus of these provisions in the Exchange Control Rulings issued by Authorised Dealers are made so that headquarter companies can transact, either by way of offshore investment or offshore borrows with foreign companies without any exchange control restrictions as both headquarter company and foreign company are non-resident companies.<sup>44</sup> However, transactions between South African resident companies and headquarter companies would be viewed as transactions with a non-resident company.

---

<sup>42</sup> Income Tax Act No.58 of 1962 of 1962, Eighth Schedule, Section 64B(2)

<sup>43</sup> South African Reserve Bank, Exchange Control Manual, Section O10, para 6.1.4.5

<sup>44</sup> South African Reserve Bank, Exchange Control Manual, Section O9, para 6.1.4.5

To apply the provisions of the above following shareholding and asset criteria are met.<sup>45</sup>

- *“The shares or debt of the headquarter company is not listed on the Johannesburg Stock Exchange (“JSE”), nor may the shares in the headquarter company be directly or indirectly held by a shareholder with shares or debt listed on the JSE. (Different rules apply to such companies)”*,
- *“Each shareholder (whether alone or together with any other company forming part of the same group of companies) must hold at least 10 per cent of the equity shares and voting rights in that headquarter company”*,
- *“Not more than 20 per cent of the equity shares in the headquarter company may directly or indirectly be held by South African residents”*,
- *“At the end of each financial year, at least 80 per cent of the assets of the headquarter company must consist of foreign assets.”*

The registration of the headquarter company with the Financial Surveillance Department will stand provided that the requirements mentioned above continue to be met.<sup>46</sup> There would still be reporting requirements for the headquarter company which will be used for statistical purposes. This report must include but not limited to source of the headquarter companies funding, which includes additional and existing funding and funding from a South African source.<sup>47</sup>

#### **4.7 Controlled Foreign Company**

The criteria to classify a foreign company as a CFC has previously been discussed under the barriers the headquarter regime faced and therefore not discussed again. As the headquarter company will be classified as a non-resident company in terms of exchange control rules, the headquarter company will not be classified as a CFC.

---

<sup>45</sup> South African Reserve Bank, Exchange Control Manual, Section O10, para 6.1.4.5

<sup>46</sup> South African Reserve Bank, Exchange Control Manual, Section O10, para 6.1.4.5

<sup>47</sup> South African Reserve Bank, Exchange Control Manual, Section O10, para 6.1.4.5

## 5. A COMPARISON OF SOUTH AFRICA AND MAURITIAN HEADQUARTER REGIMES

### 5.1 Introduction

For many years, Mauritius has always been viewed as a “tax haven” for foreign investors with its favourable tax incentives. Investors also used Mauritius as a gateway into Africa for its investments. Over the past few years, South Africa has established itself in the business community outside Africa and therefore wanted to create a headquarter regime that could be an alternative to Mauritius for foreigners investments into Africa.

The question is, why are foreign investors still using Mauritius instead of South Africa? Even after South Africa made amendments to the South African Income Tax Act and Exchange Control Rulings that was supposed to break the barriers previous encountered.

### 5.2 Comparison between South Africa and Mauritius

#### *Location of country*

The Republic of South Africa is a country and is situated at the southernmost tip of Africa.<sup>48</sup> The Republic of Mauritius is an island nation situated in the Indian Oceans off the south east coast of Africa.

#### *Population*

South Africa’s population based on Statistics South Africa 2014 estimates is 54,002,000 people<sup>49</sup> compared to Mauritius based on Mauritian Statistic 2014 estimates is 1,261,208.<sup>50</sup>

---

<sup>48</sup> South African Maritime Safety Authority ([www.sama.org.za](http://www.sama.org.za)) (accessed on 22 June 2015) <https://www.cia.gov/library/publications/the-world-factbook/geos/sf.html> (accessed on 22 June 2015)

<sup>49</sup> Statistics South Africa. (accessed on 22 June 2015)

<sup>50</sup> Statistics Mauritius ([https://en.wikipedia.org/wiki/Statistics\\_Mauritius](https://en.wikipedia.org/wiki/Statistics_Mauritius)) (accessed on 22 June 2015)

### *Language*

South Africa has eleven official languages namely, Afrikaans, English, Ndebele, Northern Sotho, Sotho, Swazi, Tswana, Tsonga, Venda, Xhosa, and Zulu. Mauritius is both an English-speaking and French-speaking nation.

### *Legal System*

South Africa has a mixed legal system, comprising of both Dutch and British legal systems.<sup>51</sup> Mauritius has a hybrid legal system; however comprises of the principles governed by both from the French Code Napoleon and the British common law.<sup>52</sup>

### *Economy and ease of doing business*

The economy of South Africa is the second largest in Africa, behind Nigeria.<sup>53</sup> Mauritius economy is based on “tourism, textiles, sugar, and financial services and in recent years, information and communication technology, seafood, hospitality and property development, healthcare, renewable energy, and education and training,” attracting substantial investment from both local and foreign investors.<sup>54</sup>

Mauritius is ranked 28th out of 189 countries surveyed for the ease of doing business and is ranked the highest in Africa followed closely by South Africa who is ranked 45<sup>th</sup> out of the 189 countries.<sup>55</sup>

---

<sup>51</sup> Du Bois, F (ed) "Wille's Principles of South African Law" 9th ed. Cape Town, Juta & Co, 2007

<sup>52</sup> [http://www.calaw.mu/en/mauritian\\_legal\\_system.html](http://www.calaw.mu/en/mauritian_legal_system.html) (accessed on 22 June 2015)

<sup>53</sup> <http://data.worldbank.org/country/south-africa>, (accessed on 22 June 2015)

<sup>54</sup> <https://www.cia.gov/library/publications/the-world-factbook/geos/mp.html> CIA – The World Factbook. (accessed on 22 June 2015)

<sup>55</sup> <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB15-Chapters/DB15-Report-Overview.pdf> (accessed on 22 June 2015)

### *Tax System*

In South Africa, a taxpayer is taxed on his worldwide income as well as in Mauritius. Both countries tax systems are governed by the Income Tax Act. Headquarter companies in Mauritius is classified as a Global Business Companies 1 (“GBC”) which is structured as a collective investment scheme, global fund, protected cell company or an investment holding company; trusts are also eligible to qualify for this scheme or as a GBC2 is eligible to carry out most business activities however with the caveat that it can only do so with non-residents and not using the Mauritian rupee. As a GBC2 it is not a tax resident and therefore cannot benefit from the numerous double tax agreements. It is however completely exempt from paying taxes in Mauritius. It can take advantage of the flexible legal regime. This structure is suited to companies that are engaged in invoicing, marketing and international trading activities.<sup>56</sup>

### *Double Tax Agreements (“DTA”)*

South Africa has 72 signed DTAs around the world compared to Mauritius’s 42 signed DTAs. South Africa has 21 signed DTAs with other African countries compared to Mauritius’s 16 signed DTAs.<sup>57</sup>

Provided that the Company holding a GBC1 licence owns at least 5% of an underlying company, credit will be available on foreign tax paid on the income out of which the dividend was paid (“underlying foreign tax credit”).<sup>58</sup> Section 77 of the Mauritian Income Tax Act states “that where a taxpayer derives income on which he paid foreign tax, the amount of foreign tax paid

---

<sup>56</sup> [http://mitco.mu/index.php?option=com\\_content&view=article&id=108&Itemid=94](http://mitco.mu/index.php?option=com_content&view=article&id=108&Itemid=94) (Accessed on 14 September 2015).

<sup>57</sup> [http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-\(Rest-of-the-World\).aspx](http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Rest-of-the-World).aspx) (accessed on 23 July 2015)  
[http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-\(Africa\).aspx](http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Africa).aspx) (accessed on 23 July 2015)  
<http://www.mra.mu/index.php/taxes-duties/double-taxation-agreements> (accessed on 23 July 2015)  
<http://www.africaranking.com/largest-economies-in-africa/> (accessed on 23 July 2015)

<sup>58</sup> <http://www.ocra-mauritius.com/offshore/mauritius01.asp> (accessed on 23 June 2015)

will be set off as a credit against the income tax payable in Mauritius<sup>59</sup>. This includes profits for which foreign tax was paid relating directly or indirectly to the dividends paid.

A company holding a GBC1 licence can apply for a foreign tax credit or a presumed foreign tax credit in terms of the Mauritian Tax Act. A presumed tax credit is not based on actual foreign taxes paid. It is used by GBC1 companies that have no supporting documentation. As a result, 80 per cent of their foreign tax credits are based on a presumed foreign tax credit and 20 per cent of the income is taxable at 15 per cent, resulting in an effective tax rate of 3 per cent.<sup>60</sup>

---

<sup>59</sup> Mauritian Income Tax Act 1995, Section 77

<sup>60</sup> Kross Border: Mauritius tax credit, <http://krossborder.com/mauritius/tax.html> (Accessed on 26 August 2015)

A high level comparison based on the key indicators as discussed above between South African and Mauritius headquarter regimes was conducted by Grant Ward and will be further examined by indicating the preferred headquarter regimes.<sup>61</sup>

<b>Key indicators of comparison</b>	<b>South African headquarter regime</b>	<b>Mauritius GBC1</b>	<b>Preferable</b>
Ease of qualification as a headquarter company	<ul style="list-style-type: none"> <li>• “must be resident in South Africa”</li> <li>• “Each shareholder of the headquarter company must hold at least 10 per cent of equity shares and voting rights in foreign company”</li> <li>• “At the end of each year, 80 per cent or more of the cost of the total assets of the headquarter company must comprise of equity in, debt against, or investment property licensed to, foreign companies in which the</li> </ul>	<ul style="list-style-type: none"> <li>• “must be resident in Mauritius”</li> <li>• “The company must have at least two Mauritian directors who attend all directors meetings”</li> <li>• “The company must have a Mauritian bank account.”</li> <li>• “Its accounting records must be kept in Mauritius”</li> <li>• “Financial statements for the company must be audited in Mauritius”</li> <li>• “A tax residence certificate must be applied for annually.”</li> </ul>	<p><b>Mauritius</b></p> <p>The ease of qualifying as a headquarter company is straight forward and achievable.</p> <p>The qualification criteria also allows for the local businesses to benefit from the creation of such company. The following are a few that directly benefit from the qualification criteria, the banks as you need to open a Mauritian bank account, accounting practices as accounting records</p>

<sup>61</sup> Grant Ward, Investment into Africa: Comparison between South Africa headquarter company and Mauritian GBC1 regime, (Amended)

	<p>headquarter company holds at least 10 per cent of equity shares and voting rights”</p> <ul style="list-style-type: none"> <li>• “50 per cent of the headquarter company’s gross income must comprise income from foreign subsidiaries if the gross income of the headquarter company exceeds R5 million”</li> <li>• “An annual election to be treated as a headquarter company is required”</li> <li>• “Annual reporting is required.”</li> </ul>		<p>must be kept in Mauritius and audit firms as the financial statements must be audited in Mauritius.</p> <p>Theses qualification criteria encourage employment which is great if a country wants to decrease its unemployment rates.</p>
Corporate tax rate	Corporate tax rate of 28 per cent.	Corporate tax rate of 15% GBC1 tax rate ranges from 0% – 3% depending on foreign tax credits.	<p><b>Mauritius</b></p> <p>The corporate tax on remaining taxable income after deductions and exemptions is between nil and 3 per cent which is lower than the South African tax rate which</p>

			does not alter even if you are a headquarter company.
Capital gains tax on disposal of equity shares in foreign companies	CGT are disregarded on gains and losses from the sale of any equity shares in a foreign company if the shareholding in the foreign company before disposal was at least 10 per cent.	CGT is not payable.	<b>Mauritius</b> Investors would prefer to invest in countries with no or very low tax levied on capital disposals, however this alone is not the only reason why a company would have its headquarters in a certain jurisdiction, in particular when in most instances capital is not frequently disposed of. <sup>62</sup>
Foreign dividends received from foreign companies	Exempt from tax.	GBC1 is tax rate is a maximum of 3 per cent which can be reduced to nil depending on foreign withholding taxes levied.	<b>South Africa</b> Headquarter companies purpose is to hold interests in other foreign companies which will distribute a dividend. If the dividends are

<sup>62</sup> Phumaphi "Do the South African Headquarters Provisions provide for a Competitive Alternative for a Gateway into Africa for International Companies" 2014 pages 40 – 41

			exempt, it would be better than a chance of being taxed between 0% – 3% depending on foreign tax credits.
Dividends declared to shareholders of headquarter company	Exempt from withholding tax.	No such thing as withholding tax on dividends.	<b>Mauritius</b> Even though both would not levy tax on dividends declared, South Africa still has a withholding tax model on dividends declared.
Interest received on borrowings	Taxable at corporate tax rate of 28 per cent.	GBC1 is tax rate between 0% – 3% depending on foreign tax credits received.	<b>Mauritius</b> Mauritius charges a corporate tax rate of maximum 3 per cent compared to South Africa's corporate tax rate of 28 per cent.
Interest paid on loans	Exempt from interest withholding tax and interest paid on money borrowed to on lend to foreign subsidiaries can be set off against the interest received from those	Interest paid is fully deductible for GBC1 companies.	<b>Mauritius</b> Mauritius is fully deductible with underlying criteria to be met.

	subsidiaries.		
Transfer pricing and thin capitalisation	Applies except for funding transactions with foreign subsidiaries.	No transfer pricing and thin capitalisation rules.	<b>Mauritius</b>  No rules outweigh a possible exception.
Exchange control	Does not apply.	Does not have exchange control.	<b>Mauritius</b>  No rules outweigh a possible exception as it could be reinstated or the requirements could change.
CFC rules	Apply to the shareholders of the headquarter company if "SA residents collectively hold more than 50% of the equity shares in the headquarter company."	Does not have CFC rules.	<b>Mauritius</b>  No rules outweigh a possible application of CFC rules.
DTAs and foreign tax credits or presumed tax	Total DTAs: 74 sign treaties <sup>63</sup> African DTAs: 21 treaties <sup>64</sup>	Total DTAs: 42 sign treaties Pending: 9 treaties Negotiating: 15 treaties	<b>South Africa</b> South Africa holds DTA with Nigeria, Egypt and Algeria which

<sup>63</sup> [http://www.sars.gov.za/legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-\(Rest-of-the-World\).aspx](http://www.sars.gov.za/legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Rest-of-the-World).aspx) (accessed on 23 July 2015)

<sup>64</sup> [http://www.sars.gov.za/legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-\(Africa\).aspx](http://www.sars.gov.za/legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Africa).aspx) (accessed on 23 July 2015)

credits		<p>African DTAs: 16 treaties<sup>65</sup></p> <p>Foreign tax credits or presumed tax credits available.</p>	<p>are 3 of the largest economies over \$200 billion other than itself. Mauritius holds South Africa and Egypt. Nigeria has become the biggest economy in early 2014 and therefore a great DTA to have when viewed as a gateway into Africa.<sup>66</sup> Mauritius treaty with Nigeria has been pending ratification by Nigeria since 2012.<sup>67</sup></p>
---------	--	---	---

<sup>65</sup> <http://www.mra.mu/index.php/taxes-duties/double-taxation-agreements> (accessed on 23 July 2015)

<sup>66</sup> <http://www.africaranking.com/largest-economies-in-africa/> (accessed on 23 July 2015)

<sup>67</sup> <https://www.kpmg.com/MU/en/issuesAndInsights/ArticlesPublications/Documents/Highlights%20of%20Mauritius%20-%20Nigeria%20Tax%20Treaty.pdf> (accessed on 23 July 2015)

### 5.3 Conclusion

After comparing South Africa and Mauritius headquarter regimes in this table, it is clear that Mauritius provides a more favourable environment for the establishment of a headquarter regime based on the following:

- It is easier to qualify as a headquarter company as the criteria to qualify as headquarter company is attainable. The criteria are clear and direct with no additional pre-conditions.
- The corporate tax rate is 3 per cent for GBC1 licence headquarter companies which can be reduced to nil depending to foreign withholding taxes levied.
- It has no CGT, dividends withholding tax, and interest withholding tax, transfer pricing and thin capitalisation, exchange control and finally CFC rules.

South Africa might have exempted or disregarded the majority of taxes but headquarter companies still need to meet certain criteria before the exemption or disregarded capital profit or capital loss can be received. If criteria are not met, the headquarter company is taxed at the corporate rate of 28 per cent compared to the 3 per cent in Mauritius.

The advantage that South Africa holds is that it has concluded DTA's with Nigeria and Algeria. These are treaties that Mauritius does not have in Africa and constitute 2 of the largest economies in Africa. Multinationals wanting to invest into these countries would be interested in setting up headquarter company in South Africa.

## 6. WHAT EXTENT IS A HEADQUARTER REGIME IN SOUTH AFRICA CONSIDERED TREATY SHOPPING

Treaty shopping has over the last few years become an important topic of discussion as companies continue to grow, and at the same time wanting to earn more profits to distribute to its shareholders. One of the ways to achieve this is to pay less tax. Before determining whether headquarter companies in South Africa are considered to be treaty shopping, we need to first define what exactly is meant by treaty shopping.

OECD Glossary of Tax Terms defines treaty shopping as:

*“An analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of a particular tax treaty. The term is normally applied to a situation where a person not resident of either the treaty countries establishes an entity in one of the treaty countries in order to obtain treaty benefits.”<sup>68</sup>*

IBFD International Tax Glossary defines treaty shopping as:

*“Treaty shopping refers to a situation where a person who is not entitled to the benefits of a tax treaty makes use of another person in order to indirectly obtain treaty benefits that are not available directly.”<sup>69</sup>*

In essence treaty shopping means that when a company structures an international transaction with countries that it would not have transacted in order to obtain a tax benefit from the use of the tax treaties that those countries have with each other.

A headquarter company generally will have as its sole business the performance of management functions and services, intra-group shared services, and intellectual property management to affiliate companies. In the light of the provision of these services it is likely that a large proportion of the income derived will be in the form of management fees, technical fees, and interest paid by its off-shore subsidiaries.<sup>70</sup> The main functions of a headquarter company is to manage investments and to centralise the income

<sup>68</sup> <http://www.oecd.org/ctp/glossaryoftaxterms.htm#T> (accessed on 23 June 2015)

<sup>69</sup> IBFD International Tax Glossary definition of treaty shopping

<sup>70</sup> Honnibal. M and Killoran. R, “The New South African Headquarter Regime doesn’t quite cut it” Without Prejudice February 2011 29

of the subsidiaries before they are to be distributed either back to the ultimate holding company or to their investors. The rationale behind setting up a headquarter company somewhat varies between companies, but usually one of the reasons would be for tax purposes, therefore it was imperative when South Africa made the decision to make provision for headquarter companies within its jurisdiction that the legislation paid particular notice of the tax implications for companies and investors.<sup>71</sup>

For example, before a headquarter regime was available, if an Indian company wanted to invest in a Nigerian company, the Indian company would have to transact directly with the Nigerian company. This would result in exchange control between the two countries and no tax benefits when the rewards of the investment, for example dividends, are distributed by the Nigerian company to the Indian company. Through the creation of a South African headquarter regime, the Indian company would create a headquarter company in South Africa, ensuring that it meets all the requirements as started in section above in terms of section 9I. The South African headquarter company will be used to invest in the Nigerian company. The headquarter company can make use of South Africa's DTA with Nigeria when it receives the dividends from its investment between the headquarter company and the Nigerian company. The passive income can then be sent onwards to the Indian company, of which South Africa also has a DTA with India therefore again making use of the DTA.

By applying the definitions of treaty shopping on the purpose of the establishment of a headquarter company, the South African legislation has invited multinational companies to establish headquarter companies in South Africa so that they would be able to transact with other countries within Africa (termed "Gateway into Africa" as noted in the National Treasury Budget Review 2010) through the South Africa headquarter company thereby benefiting from South Africa's many DTAs. If companies accept the invitation and establish headquarter companies in South Africa they would be

---

<sup>71</sup> Legwaila. T, "Tax reasons for establishing a Headquarter Company"

considered to be treaty shopping. The paper further looks at the impact of our anti-avoidance rules. Therefore, who is guilty, the company accepting the offer of creating a headquarter company or would it be South Africa legislator for inviting and setting up Income Tax Act to facilitate this.

## 7. IMPACT OF ANTI AVOIDANCE AND TREATY SHOPPING

The South African legislation deals with a concept similar to treaty shopping in the Income Tax Act under Section 80A, Impermissible tax avoidance arrangements. This section unpacks whether the transactions that the headquarter company transact in are arrangements which sole and main purpose is to obtain a tax benefit which is similar to the concept of treaty shopping where an international transaction is structured for the purposes of obtaining a tax benefit through the DTAs.

Section 80A states that:

*“an avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and –<sup>72</sup>*

*(a) In the context of business–*

- (i) It was entered into or carried out by means or in a manner which would not normally be employed for bone fide business purposes, other than obtaining a tax benefit; or*
- (ii) It lacks commercial substance, in whole or in part, taking in account the provisions of section 80C;<sup>73</sup>*

*(b) In context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for bone fide purpose, other than obtaining a tax benefit; or<sup>74</sup>*

*(c) In any context–*

- (i) It has created rights or obligations that would not normally be created between persons dealing at arm’s length; or*

<sup>72</sup> Income Tax Act No 58 of 1962, Section 80A

<sup>73</sup> Income Tax Act No 58 of 1962, Section 80A(a)

<sup>74</sup> Income Tax Act No 58 of 1962, Section 80A(b)

- (ii) *It would result directly or indirectly in the use or misuse of the provisions of this Act (including the provisions of this Part).*<sup>75</sup>

By using the simulated headquarter transaction example from the previous section between the Indian investor, South African headquarter company and the Nigerian investment company to the provisions of section 80A we would identify whether the transaction would equate to an arrangement which sole or main purpose is to obtain tax benefit. It is clear from the simulated example before a headquarter company is available the Indian investor would have invested directly with the Nigerian company. But with the headquarter company available, a simulated or disguised transaction has been created. It is created for the sole purpose of obtaining a tax benefit. It obtains this benefit by making use of the numerous DTA available in South Africa.

The current simulated example can be closely linked to the CSARS v NWK Ltd 2011 (2) SA 67 (SCA), 73 SATC 55, 2010 Tax Payer 203 (“NWK”). In this case, the taxpayer met with representatives of First National Bank (“FNB”) with the view to update its existing banking facilities with an addition of a term finance facility of R50 million<sup>76</sup>. Pursuant to a proposed lending structure conceived of by FNB, the taxpayer then entered into an elaborate agreement with loans would be forwarded via subsidiary companies, promissory notes issued and paid, delivery of maize, derivatives on the maize, etc. Lewis JA held that “where parties structure a transaction to achieve an objective other than the one ostensibly achieved they would intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial substance of the transaction: of its real substance and purpose. If the purpose of the transaction was only to achieve an object that allows the ‘evasion’ of tax, or of a peremptory law, then it would be regarded as simulated. And the mere fact that parties did perform in the terms of the contract did not show that it

---

<sup>75</sup> Income Tax Act No 58 of 1962, Section 80A(c)

<sup>76</sup> Income Tax: Cases and Material by Emslie and Davis, fourth edition

was not a simulated: the charade of performance was generally meant to give credence to their simulation.”<sup>77</sup>

By applying the principles of NWK case to the simulated example, we will be able to identify whether the facts are similar and what the possible outcome for the simulated example transaction would be. In NWK, the taxpayer came to FNB to obtain a loan of R50 million this is similar to the simulated example where the Indian investor wanted to make an investment in the Nigerian company. In both cases those were their ultimate purpose between the two parties. However, the taxpayer in NWK came out of FNB with an intricate agreement for the loan that it went in for. In the simulated example, the creation of the headquarter company in South Africa as a gateway into Africa is creating something similar to an intricate arrangement between the Indian investor and the Nigerian company which deviates from its initial purpose of its investment. In this case, we are creating a third party, namely South African headquarter company through which the investment will flow to receive a tax benefit. For NWK, the taxpayer entered into this arrangement to obtain excessive deductions to its taxable income in excess of the initial arrangement that he intended entering into. In the case of the simulated example, the Indian company would make use of the favourable tax relief from the DTA between South Africa and India which Nigeria and India do not have.

---

<sup>77</sup> CSARS v NWK Ltd 2011 (2) SA 67 (SCA), 73 SATC 55

## 8. CONCLUSION

As demonstrated with the use of the simulated example, the creation of a headquarter regime would create impermissible tax avoidance transactions in South Africa in terms of section 80A of the Income Tax Act No. 52 of 1962 and on the bases of the NWK case which is the leading anti-avoidance case in South Africa and which set a precedence for future cases.

In spite of this, the question begs, “Upon which entity would the South African Revenue Service impose the provisions of Section 80A?” Logically, attention would be focused on the entity which established the headquarter company, in the simulated example it would be the Indian investor. However, it could be argued that the South African legislation created an environment which encourages headquarter regimes which includes associated tax benefits. Based on legislation, this would be a sound argument.

For the purposes of the above dilemma involving the South African Revenue Service (“SARS”) and to get around the provisions of section 80A, the legislator should insert into the legislation a provision that will exclude specifically headquarter companies from the provisions of section 80A as majority of their transactions would be simulated transactions as demonstrated in the simulated example.

It can also be seen from the application of the legislation and case law that the anti-avoidance rule is similar to the concept of treaty shopping thereby utilises South Africa’s can be held accountable for the creation of a platform where companies wanting to invest into Africa could be treaty shopping and make use of our headquarter regime in this regard.

## **9. Biography**

### **9.1 Primary Sources**

#### **9.1.1 South African Statutes**

Income Tax Act No. 50 of 1962

South African Reserve Bank, Exchange Control Manual

Taxation Laws Amendments Act No. 24 of 2011

#### **10.1.2 Foreign Statutes**

Mauritian Companies Act 2011

Mauritian Income Tax Act of 1995

### **9.2 Secondary Sources**

#### **9.2.1 Books and journals**

Du Bois. *Wille's Principles of South African Law*. 9ed. Cape Town, Juta & Co, 2007

Emslie & Davis *Income Tax Cases & Material* 4ed (2014) The Taxpayer.

Haupt, P. *Notes on South African Income Tax* 33ed (2014) H & H Publications.

Legwaila, T. *Tax characteristics of an ideal holding company location* 2012 De Jure.

### 9.2.2 Cases

*CSARS v NWK Ltd* 2011 (2) SA 67 (SCA).

*CIR v Stott* 1928 AD 252, 3 SATC 253

### 9.2.3 Dissertations

S Phumaphi *Do the South African Headquarters Provisions provide a Competitive Alternative for a Gateway into Africa for International Companies?* LLM (UCT) 2014.

G Ward *Investing into South Africa: Comparison between South Africa headquarter company and Mauritian GBC1 regime* PGDip Tax Law (UCT) (2014).

### 9.2.4 Government Publications

Draft Interpretation Note *Section 9I Headquarter companies*, 2015.

Draft Interpretation Note No.6 (Issue 2) *Resident – Place of effective management (Companies)*. 2015.

Public Discussion Draft BEPS Action 6: *Preventing the granting of treaty benefits in inappropriate circumstances*. 2014

National Treasury Budget Review (2010).

Interpretation Note on *Section 31 Determination of the taxable income of certain persons from international transactions: Thin Capitalisation*. 2013

Katz Commission. Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa. *'Basing the South*

*African Income Tax system on the source or residency principle – options and recommendations*, 1997, ISBN 0-621-17706-7

### 9.2.5 Articles

Doing Business. 2015. *Going beyond efficiency*. [Online].

<http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB15-Chapters/DB15-Report-Overview.pdf>

(accessed on 22 June 2015)

The SA Institute for Tax Professionals. 2011. *The New Headquarter Company Regime*. [Online]. Available at

<http://www.thesait.org.za/news/96607/The-New-Headquarter-Company-Regime.htm>. [24 April 2015].

ENSAfrica. 2011. *The headquarter tax regime*. [Online].

<https://www.ensafrika.com/news/The-headquarter-tax-regime?Id=1146&STitle=tax%20ENSight>. [22 April 2015].

Hofmeyer, CD. 2011. *International 2041. Headquarter companies*. [Online].

[https://www.saica.co.za/integritax/2012/2041.Headquarter\\_companies.htm](https://www.saica.co.za/integritax/2012/2041.Headquarter_companies.htm)  
. [22 April 2015].

Honnibal, M and Killoran, R. *The New South African Headquarter Regime just does not cut it*. 2011

IBFD International Tax Glossary definition of treat shopping

KPMG. *Practical Guide to South African headquarter regime*. 2011.

Lessing, D and Malan, D 2011. *Private equity investments: SA headquarter company vs Mauritius GBC1 regime*. [Online].

<http://www.werksmans.com/legal-briefs-view/private-equity-investments-sa-headquarter-company-vs-mauritius-gbc1-regime/>. [22 April 2015].

Legwaila, T. *Taxation of Holding Companies in the Netherlands: A South African observation* 2012.

Legwaila, T. *Commercial Law reasons (other than tax) for setting up a headquarter company: A South African observation* 2013.

Legwaila, T. *The nature of a headquarter company: a comparative analysis*. 2012 De Jure

Legwaila, T. *Intermediary Holding Companies and Group Taxation*. 2010 De Jure

Legwaila, T. *Tax characteristics of an ideal holding company location*. 2012 De Jure

OECD, "Thin capitalisation legislation: Background paper for tax administration" 2012 [Online]

### 9.2.6 Websites

African ranking <http://www.africaranking.com/largest-economies-in-africa/> (accessed on 23 July 2015).

C & A Law. [http://www.calaw.mu/en/mauritian\\_legal\\_system.html](http://www.calaw.mu/en/mauritian_legal_system.html) (accessed on 22 June 2015).

Central Intelligence Agency <https://www.cia.gov/library/publications/the-world-factbook/geos/sf.html> (accessed on 22 June 2015).

Central Intelligence Agency. <https://www.cia.gov/library/publications/the-world-factbook/geos/mp.html> CIA – The World Factbook. (accessed on 22 June 2015).

Investopedia. <http://www.investopedia.com/terms/a/activeincome.asp> (accessed 22 June 2015).

Investopedia. <http://www.investopedia.com/terms/r/royalty.asp> (accessed on 19 June 2015)

Kross Border: Mauritius tax credit, <http://krossborder.com/mauritius/tax.html> (accessed on 26 August 2015)

KPMG.

<https://www.kpmg.com/MU/en/IssuesAndInsights/ArticlesPublications/Documents/Highlights%20of%20Mauritius%20-%20Nigeria%20Tax%20Treaty.pdf> (accessed on 23 July 2015).

Mauritius Revenue Authority. <http://www.mra.mu/index.php/taxes-duties/double-taxation-agreements> (accessed on 23 July 2015).

Mitco.

[http://mitco.mu/index.php?option=com\\_content&view=article&id=108&Itemid=94](http://mitco.mu/index.php?option=com_content&view=article&id=108&Itemid=94) (Accessed on 14 September 2015).

OCRA Worldwide. <http://www.ocra-mauritius.com/offshore/mauritius01.asp> (accessed on 23 June 2015).

OECD. <http://www.oecd.org/ctp/glossaryoftaxterms.htm#T> (accessed on 23 June 2015).

OECD

[http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer\\_pricing:\\_Keeping\\_it\\_at\\_arms\\_length.html](http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html) (accessed on 19 June 2015).

Popular Sports. [www.mostpopularsports.net](http://www.mostpopularsports.net) (accessed on 14 June 2015).

South African Maritime Safety Authority ([www.sama.org.za](http://www.sama.org.za)) (accessed on 22 June 2015).

SARS. <http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2013-01%20-%20Status%20Overview%20of%20All%20DTAs%20and%20Protocols.pdf> (accessed on 19 June 2015).

SARS. [http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-\(Africa\).aspx](http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Africa).aspx) (accessed on 23 July 2015).

SARS. [http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-\(Rest-of-the-World\).aspx](http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Rest-of-the-World).aspx) (accessed on 23 July 2015).

SA Tax Guide. <https://sataxguide.wordpress.com/tax-implications-of-controlled-foreign-companies-cfc/> (accessed on 12 June 2015).

Statistics Mauritius. ([https://en.wikipedia.org/wiki/Statistics\\_Mauritius](https://en.wikipedia.org/wiki/Statistics_Mauritius) ) (accessed on 22 June 2015).

Statistics South Africa. (accessed on 22 June 2015).

Wikipedia. <https://en.wikipedia.org/?title=Mauritius>, About Mauritius (accessed on 22 June 2015).

Wikipedia. [http://en.wikipedia.org/wiki/Passive\\_income](http://en.wikipedia.org/wiki/Passive_income) (accessed 22 June 2015).

Wikipedia. [https://en.wikipedia.org/?title=Transfer\\_pricing](https://en.wikipedia.org/?title=Transfer_pricing) (accessed on 19 June 2015).

Wikipedia. [https://en.wikipedia.org/wiki/National\\_Assembly\\_\(Mauritius\)](https://en.wikipedia.org/wiki/National_Assembly_(Mauritius)) (accessed on 22 June 2015).

Worldbank. <http://data.worldbank.org/country/south-africa>, (accessed on 22 June 2015).

**ARE REWARDS FROM A CUSTOMER LOYALTY  
PROGRAMME CAPITAL OR REVENUE IN  
NATURE?**

**NAME:** ISMAIL MOHAMED CA (SA)  
**STUDENT NUMBER:** MHMISM004  
**DEGREE:** MASTERS IN PHILOSOPHY – TAX LAW  
**SUPERVISOR:** JUDGE DENNIS DAVIS  
**WORD COUNT:** 8 317 WORDS

**TABLE OF CONTENTS**

Introduction .....	3
Chapters	
1. How a typical customer loyalty programme functions .....	10
2. The issues relating to a customer loyalty programme .....	14
3. Elements of the general gross income definition .....	16
4. The laws to be addressed regarding customer loyalty programmes.....	22
5. Conclusion .....	30
Biography .....	32

## Introduction

*‘During the first few days of the new calendar month, I receive my bank statement. As I review the contents thereof, I notice my healthy accumulated loyalty point balance. I think to myself, should I exchange my loyalty points for a reward, or should I just let it accumulate further? I decide to exchange it for a reward after checking whether I have the required loyalty points. At this time I think to myself, will I be taxed on this reward I receive?’*

Customer loyalty programmes are incentive schemes used by businesses as diverse as coffee shops, supermarkets, hotels, airlines, movie theatres, music stores, pharmacies, banks and even your local salon. It is used to increase sales by awarding customer with rewards with the aim of maintaining its customer base and attracting potential customer wanting to be rewarded for purchasing from a particular company. At the same time companies gather information about its customer base which will result in the availability of required stock and assisting with pricing and specials and we would know what the customer is willing to pay.<sup>1</sup>

The Consumer Protection Act defines a ‘loyalty programme’ as:

*‘any arrangement or scheme in the ordinary course of business, in terms of which a supplier of goods or services, association of such suppliers, or other person on behalf of or in association with any such suppliers, offers or grants to a consumer any loyalty credit or award in connection with a transaction or an agreement.’<sup>2</sup>*

Customer loyalty programmes provide customers with rewards when they buy or make use of the company’s products or services. As they buy and make use of the company’s products or services, the customer accumulates loyalty points provided by the customer loyalty programme. These loyalty points can be redeemed for a reward by the company. Rewards can be in

---

<sup>1</sup> South African Revenue Services ‘Discussion paper on VAT treatment of customer loyalty programmes’ April 2014

<sup>2</sup> Consumer Protection Act No.68 of 2008, Section 1

the form of the company's own goods or services, prizes, shopping vouchers or discounts.

A loyalty point awarded by a customer loyalty programme has no commercial value; it's not a form of money and cannot be used as a means of tender therefore cannot be traded with. However, accumulated loyalty point provides the customer with an expectation that he can use the loyalty points as payment against a future good or service in the form of a reward. In many instances, customer loyalty programmes requires the customer to accumulate an amount of loyalty points before it can be redeemed for a reward.

Loyalty points are is a virtual currency unlike banknotes or coins. The loyalty points accumulate that the customer is entitled to is virtual. The accumulated loyalty point's balance can be obtained electronically (Pick 'n Pay has terminals or via the company website) or printed on a company document (your statement or an invoice).

Loyalty point does not fully adhere to the definition of a "voucher"<sup>3</sup>, but both accumulated loyalty points and a voucher allow the customer to claim a reward. Once a predetermined accumulated loyalty point balance is reached, it entitles the customer to that reward just like a voucher which entitles you to what is prescribed thereon. As a result, the company has a responsibility towards the customer which creates a liability for accounting purposes to provide the reward, whether on its own or through a redemption partner.<sup>4</sup>

---

<sup>3</sup> The Oxford Dictionary Online <http://oxforddictionaries.com/definition/english/voucher?q=voucher> (Accessed on 8 July 2015) defines a voucher as "a small printed piece of paper that entitles the holder to a discount, or that may be exchanged for goods or services".

<sup>4</sup> South African Revenue Services 'Discussion paper on VAT treatment of customer loyalty programmes' April 2014

## **Types of customer loyalty programmes**

As previously mentioned customer loyalty programmes are used by a diverse variety of businesses and therefore the characteristics, terms and conditions and structures vary between one customer loyalty programmes to the next.

There are three types of loyalty programmes, namely:

- Customer loyalty programmes where a monetary value is attached to the accumulated loyalty points and/or reward
- Customer loyalty programmes where no monetary value can be attached to accumulated loyalty points and/or reward until the time the loyalty points are redeemed and
- Customer loyalty programmes where customers receive a discount as a means of reward.

### **Customer loyalty programmes where a monetary value is attached to the accumulated loyalty points and/or reward**

For customer loyalty programme where a monetary value is attached to the accumulated loyalty points, a monetary value can be calculated for the accumulated loyalty point balance. All the variables used to recalculate the monetary value are available.

A simple example of how a monetary value can be attached to accumulated loyalty points can be explained. In the Edgars Thank U customer loyalty programme offered by Edgars, a big fashion retailer in South Africa, 10 Thank U points is earned for every R1 you spend at participating store.<sup>5</sup> Edgars Thank U offers customer 10 times their participating spent as loyalty points. When spending the Thank U points, 10 000 points can be exchanged for a reward of R10. This means that R1 000 spend equates to 10 000 Thank U points (R1 000 spend multiplied by 10 times) and those 10 000 Thank U points provides the customer with a R10 reward. This shows that 1 per cent (R10 as a percentage of R1 000) is the percentage marketing spend, as the

---

<sup>5</sup> <https://www.thanku.co.za/getting-points/> (Accessed on 8 July 2015)

customer loyalty programme is classified as a marketing cost, on all Edgars customer loyalty programme spend and also means that each loyalty points equates to 10 cents. Therefore, at the end of the financial year Edgars can calculate its liability to the customer on the accumulated loyalty points for all participants of the customer loyalty programme multiplied by 10 cents. 10 cents is the monetary value attached to the accumulated loyalty point.

For customer loyalty programme where a monetary value is attached to the reward, the market value of the reward received by the customer can be used as the monetary value for the reward.

An example of this type of customer loyalty programme, the customer's local salon has a loyalty programme that after the customers tenth haircut the customer will receive the next one free. The free haircut after the tenth is a reward for being a loyal customer. A value can be attached to this reward. The value equates to the market value of the haircut received.

### **Customer loyalty programmes where no monetary value can be attached to accumulated loyalty points and/or rewards**

For a customer loyalty programme where no monetary value can be attached to accumulated loyalty points and/or rewards, there are both accumulated loyalty points earned by customers and there are rewards received by the customers. As demonstrated in the example where a monetary value can be attached to the accumulated loyalty points and/or rewards, the cost per loyalty point can be recalculated using the value of the reward and the market value of the reward is a known factor. But in this case, the value of the reward is unknown as it changes consistently. The value of the reward is based on demand for the goods or services.

In most cases, customer loyalty programmes where no monetary value can be attached to accumulated loyalty points and/or rewards is found in service providing industries like airlines, car hire or accommodation. The value of these services changes based on demand. An example of this would be that the price of accommodation would be R1000 per night today, but when the

hotel is almost full, the price increases to R1500 per night for the same room type.

As no monetary value can be attached to the reward we are also unable to recalculate the value of the accumulated loyalty points. Today 5000 accumulated loyalty points equates to R1000 and tomorrow 5000 equates to R1500 as per the example above.

### **Customer loyalty programmes where customers receive a discount as a means of reward**

This type of customer loyalty programme is different to the previous two which have been described. With this type of programme, the customer does not receive or accumulate loyalty points. The customer would receive discounts or vouchers for being part of the loyalty programme. An example of this type of programme would be the WRewards loyalty programme by Woolworths<sup>6</sup>, where the customer will obtain 10 per cent discount for being part of the customer loyalty programme.

### **Research problem**

This research paper aims to address whether rewards received by a customer loyalty programme are of a revenue or capital nature. The answer to this question will assist in determining whether the reward received by a customer loyalty programme should be included into the gross income of an individual or company participating in customer loyalty programmes.

Currently, customer loyalty programmes are not included under the specific inclusions in the definition of the gross income in the Income Tax Act<sup>7</sup> found in Section 1. Therefore, it is necessary to examine the general gross income formula to determine whether a reward will be included in gross income.

---

<sup>6</sup> [http://www.woolworths.co.za/store/fragments/wrewards/wrewards-index.jsp;jsessionid=zOohfHBU7D22SY4o0ZzzhbNDMsBN-4GMaYTFuGQ5OB\\_fvEQ0dJtt!-955816874](http://www.woolworths.co.za/store/fragments/wrewards/wrewards-index.jsp;jsessionid=zOohfHBU7D22SY4o0ZzzhbNDMsBN-4GMaYTFuGQ5OB_fvEQ0dJtt!-955816874) (Accessed on 12 August 2015)

<sup>7</sup> Income Tax Act No. 58 of 1962, section 1, gross income

Gross income is defined in Section 1 of the Income Tax Act as:

*“in relation to any year or period of assessment, means –*

- (i) In the case of any resident, the total amount, in cash or otherwise, received by or accrued to in favour of such resident; or*
- (ii) In the case of any other than a resident, the total amount, in cash or otherwise, received by or accrued to in favour of such person from a source within the Republic,*

*During such year or period of assessment, excluding receipts or accruals of a capital nature, but including....”*

The gross income definition, contains four elements to be considered to determine whether rewards received from a customer loyalty programme should be included in the gross income of an individual or company:

1. total amount in cash or otherwise
2. received by or accrued to
3. a resident or a South African source
4. excluding capital receipts

This research paper addresses, whether the first three elements are met, and then proceeds to focus on whether a receipt in the form of a reward from a customer loyalty programme is of a revenue or capital nature.

The chapter outline is as follows:

### **Chapter 1 – How a typical customer loyalty programme functions**

This chapter demonstrates how an actual customer loyalty programme functions by means of an actual customer loyalty programme and, due to the fact that every customer loyalty programme functions differently, we conceptualise the customer loyalty programme into a conceptual framework which will be used to assess whether rewards received from a customer loyalty programme should be classified as revenue or capital in nature.

## **Chapter 2 – The issues relating to a customer loyalty programme**

In this chapter we identify the issues in the conceptual framework that will cause doubt as to whether the rewards received from a customer loyalty programme is of a revenue or a capital nature.

## **Chapter 3 – Elements of the general gross income definition**

This chapter discusses whether a reward received by a customer loyalty programme meets the criteria of the first 3 elements of the gross income definition, namely; (1) total amount in cash or otherwise, (2) received by or accrued, (3) to a resident.

## **Chapter 4 – The laws to be addressed regarding customer loyalty programmes**

This chapter cite court cases that are relevant to the issues identified in the conceptual framework of a customer loyalty programme.

## **Chapter 5 – Conclusion of research problem**

This chapter aims to conclude on whether a reward received as part of a customer loyalty programme is revenue or capital in nature, and also whether it meets the general gross income definition, which would result into a reward received as part of customer loyalty programme to be included in an individual or company's gross income for tax purposes.

## **Chapter 1**

### **How a typical customer loyalty programme functions**

#### **Introduction**

This chapter demonstrates how a typical loyalty programme functions by means of a real life example. This example will help construct a customer loyalty programme conceptual framework that will be used throughout this paper.

The Investec Dividend Reward Programme will be used to explain how a customer loyalty programme functions and a conceptual framework will be constructed from there.

#### **Belonging to a customer loyalty programme**

Customer loyalty programmes exist for the purpose of rewarding customers that make use of the company's products. The company's products are defined as both goods and services. Therefore, a customer loyalty programme would always be a supplementary product to an existing product used or held with the company by a customer. For example, a customer can only belong to the Investec Dividend Reward Programme if the customer holds an Investec Private Bank banking account. If the customer does not have an Investec Private Bank banking account, the customer would be eligible to partake in the Investec Dividend Reward Programme.<sup>8</sup> This would encourage customers to open a banking account if it feels that the customer loyalty programme is beneficial to the customer or least make the offering competitive.

The customer loyalty programme is in essence a marketing tool used by companies to encourage customers to purchase the company's products.

---

<sup>8</sup> <https://www.investec.co.za/products-and-services/banking-services/rewards-programme.html> (Accessed on 10 July 2015)

The customer loyalty programme would be the same, for example, if the company gave you a laptop bag when you bought a laptop. These are all marketing tools which companies have used for generations but have now decided to introduce a customer loyalty programme as this type of marketing is more structured and would have long term benefit. Example, if a customer is unhappy with the service at a particular point in time, the customer will not hastily close his / her account as they might have large quantities of rewards due to him / her. Instead he / she will wait till it can claim the rewards and by that time the storm would have passed and the customer would feel differently about closing his / her account. Therefore, the structure of the customer loyalty programme is beneficial to both the customer and the company.

### **Accumulation of loyalty points**

The Investec Dividend Reward Programme is stated to demonstrate how loyalty points are accumulated. As noted above, to partake in the Investec Dividends Reward Programme, the customer must hold a bank account with Investec Private Bank. This would make the customer eligible to partake in the customer loyalty programme. The customer has to make use of his Investec Visa card in order to accumulate dividend points. The Investec Visa card holder can earn bonus and additional points by purchasing at partner companies or making use of exclusive Investec services, for example Investec Foreign Exchange.<sup>9</sup> Below is a table representation of the amount of dividends points are earning.

---

<sup>9</sup> <https://www.investec.co.za/products-and-services/banking-services/rewards-programme.html> (Accessed on 10 July 2015)

<b>Type of transaction</b>	<b>Number of points</b>	<b>How it is earned</b>
<b>Investec Visa card</b>	One point	Earn 1 Dividends point for every R5 spent on purchases made with your Visa Platinum card
<b>Travel Latitude</b>	One and a half points	Earn 1.5 Dividends points for every R5 spent on purchases made through Travel Latitude
<b>McCarthy Call-a-Car</b>	One point	Earn 1 Dividends point, up to a maximum of 200 000 Dividends points, for every R5 spent on a vehicle sourced through McCarthy Call-a-Car and financed through Investec Private Bank
<b>Dividends Partners</b>	Double points	Earn double Dividends points for purchases at select partners (The Pro Shop, Europcar, Camelot Spa, Cape Union Mart including Poetry and Old Khaki, NetFlorist, Spas of Distinction)
<b>Investec Foreign Exchange</b>	One point	Earn 1 Dividends point for every R35 of foreign currency purchased through Investec Foreign Exchange, including fees.

### **Redeeming loyalty points**

Over time, a number of loyalty points are accumulated as customers make use of the company's products. Customers are entitled to the points when they meet the predetermined conditions set out by the company. Refer to Investec dividend schedule above. Customers can redeem or exchange these accumulated loyalty points for predetermined goods or services offered by the company when the customer obtain the right to redeem or exchange the loyalty points.

The customer is able to do three things with its loyalty points, firstly, redeem or exchange loyalty points for the companies' products or products offered by the company. Example; Investec Rewards Programme offers customer to

redeem dividend points for their own products, unit trusts, or purchased in products, mall vouchers or donations to charities.<sup>10</sup>

Secondly, if the customer does not have sufficient loyalty points, the customer can purchase the additional loyalty points from the customer loyalty programme. This would mean that loyalty points have a monetary value. Investec Rewards Programme does not offer purchasing of additional loyalty points. In most cases, the purchase of additional loyalty points is common within the airline industry as the quantity of miles is greater. Example; South African Airways Voyager programme allows customer to purchase up to 50% of the miles required at a cost of R250 for 1000 miles.<sup>11</sup>

Lastly, the customer has the option to transfer the loyalty points to someone else. Example; Investec Reward Programme allows dividend points to be transferred to a family member who is linked to the same banking account.<sup>12</sup>

## Conclusion

To conceptualise the functioning of a customer loyalty programme. It is a value added service offered by companies to attract customers to increase its revenue base. The customers increase the company's revenue base by making use of the company's products or services. The customer is then rewarded with loyalty points which it can exchange for a reward. The reward granted by the company is something that the customer did not previously have and therefore in a better advantage if the customer did not offer a customer loyalty programme. The following key words: (1) participate in customer loyalty programme; (2) accumulate loyalty points; (3) exchange loyalty points for a reward, are used as a basis of the conceptual framework.

---

<sup>10</sup> <https://www.investec.co.za/products-and-services/banking-services/rewards-programme/rewards-by-charities.html> (Accessed on 22 July 2015)

<sup>11</sup>

[https://www.flysaa.com/za/en/voyager/AboutVoyager/flysaa\\_VoyagerTermsAndConditions.html](https://www.flysaa.com/za/en/voyager/AboutVoyager/flysaa_VoyagerTermsAndConditions.html) (Accessed on 22 July 2015)

<sup>12</sup> <https://www.investec.co.za/products-and-services/banking-services/rewards-programme/rewards-terms-and-conditions.html> (Accessed on 22 July 2015)

## **Chapter 2**

### **The issues relating to customer loyalty programme**

#### **Identifying issues in conceptual framework of a customer loyalty programme**

The key areas for analysis in respect of the application of the gross income definition: (1) participating in customer loyalty programme; (2) accumulating of loyalty points and (3) exchange of loyalty points for a reward.

##### **(i) Participate in customer loyalty programme**

In most cases, the customer loyalty programme is a value added product that the company offers the customer for being a client. It is a supplementary service that the customer receives. The customer does not necessarily pay for the service but from time to time, some companies will charge a nominal fee. The fee could also be hidden in the primary charge that customer pays, therefore the by-product, the customer loyalty programme, seem to be free. This fee is immaterial and is there to only cover the administrative expenses of running such a programme. Therefore, if an individual physically goes out into the market to seek the best possible customer loyalty programmes and rearranges his affairs, for example, the customer changes his bank account to obtain rewards, could we possible consider this to be revenue of nature and not capital.

##### **(ii) Accumulate loyalty points**

Customers will accumulate loyalty points as they make use of the company's products; this is in essence what the purpose of the customer loyalty programme. Some customers will rearrange their affairs so that they accumulate the maximum amount of loyalty points as they could possible obtain. For example, instead of paying by electronic funds transfer ("EFT"),

they will swipe their card as swiping your card get loyalty points where as EFT's does not.

**(iii) Exchange loyalty points for a reward**

When a customer exchanges loyalty points for a reward, he is receiving something that he did not previously have. This would be similar to a fringe benefit, but the section is only applicable if you are in employment or holding office.<sup>13</sup> Therefore, is the reward received revenue in nature and should be accounted for in the same way as we would a fringe benefit, or would it be capital in nature?

Another concern would be the transferability of the loyalty points. Is the customer able to transfer the loyalty points from himself to another person? If this is the case, it would feel as if the loyalty points are a means of tender.

**Conclusion**

After conceptualising the customer loyalty programme and identifying issues in the key areas of the conceptual framework, we can now address these issues which will better assist us in deciding whether customer loyalty programmes are revenue or capital in nature and whether it should be included in gross income or not.

---

<sup>13</sup> Income Tax Act No.58 of 1962 of 1962, Seventh Schedule

## Chapter 3

### Elements of general gross income definition

#### Introduction

Before a receipt or accrual can be included in gross income, taking into account that there are no special inclusions in terms of Section 1 of the gross income definition, the general gross income formula needs to be met,

*‘the total amount, in cash or otherwise, received by or accrued to in favour of such resident’*

This chapter addresses these three elements and determines whether these elements are met. After which we address the fourth element of which this research paper is about, whether the reward received as part of a customer loyalty programme is of a revenue or capital nature.

#### Element 1 – “Total amount in cash or otherwise”

The word “amount” is not defined in the Income Tax Act, but is given meaning by way of relevant case law. In this regard the decision in *Stander v CIR*<sup>14</sup> and *CSARS v Brummeria Renaissance*<sup>15</sup> cases is of considerable assistance.

In *Standers* case, the taxpayer worked as a bookkeeper for a dealership, Frank Vos (Proprietary) Limited. He received an award from Delta Motor Corporation (Proprietary) Limited, a manufacturer and distributor of motor vehicles. The manufacturer and distributor used dealerships to market their products. The award was given to the bookkeeper for excellent service. In this case the award was a seven-day overseas holiday. The Commissioner included the cost of the holiday in the taxpayer’s returns.

---

<sup>14</sup> *Stander v CIR* 1997 (3) SA 617 (C)

<sup>15</sup> *CSARS v Brummeria Renaissance (Pty) Ltd* 2007 (6) SA (SCA) 69 SATC 205

The taxpayer, appeal successfully in the Cape Provisional Division, Special Court. Friedman JP said that the question was whether the award was constituted 'property' which had a money value in the hands of the taxpayer or whether the taxpayer by being given the trip, had acquired a right that could be 'turned into money'. At no stage did the taxpayer receive any 'property' on which a monetary value could be placed. The award did not consist of 'money's worth' and therefore it does not matter what Delta paid for the award or what a person who wished to go on that trip would have paid, it did not constitute an amount in the hands of the taxpayer.

In the *Brummeria Renaissance* case, the taxpayer obtained an interest free loan to finance the construction of units in a retirement villages as a quid pro quo for granting the lenders life occupation rights to the units. The Commissioner included in the taxpayer's gross income the amounts representing the value of the rights to use the loans interest free.

Cloete JA said, "Whether the rights to use the loans interest free constituted 'amounts' which 'accrued to' the company. The word 'amount' and phrase 'accrued to' were interpreted by Watermeyer J writing for a Full Court of the Cape Provisional Division in *Lategan v CIR*<sup>16</sup> and both interpretations were approved by the court in *CIR v Peoples Stores*."<sup>17</sup> The law was restated by the court in *Cactus Investments*<sup>18</sup>. Hefer JA, "who wrote both judgements in the court, summed up the law set out in *Cactus Investments* by saying that the definition of gross income:"

'includes, as explained in *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), not only income actually received, but also rights of a non-capital nature which accrued during the relevant year and are capable of being valued in money.....The judgement in *Peoples Stores* case tells us that no more is required for an accrual than that the person concerned has become entitled to the right in question'

---

<sup>16</sup>*Lategan v CIR* 1926 CPD 203

<sup>17</sup> *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A)

<sup>18</sup> *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA)

After this case was appealed in the Supreme Court by the Commissioner and allowed, the South African Revenue Services (“SARS”) issued an Interpretation note where it addresses the principles of the case and also the application of the principles thereon.<sup>19</sup> The main principles highlighted from the Interpretation note are as follows:

- *“The word “amount” in the definition of the term “gross income” is to be interpreted widely.”*
- *“The right to use a loan interest free has a monetary value”*
- *“Even though the receipt or accrual is in the form of other money, which cannot be alienated or turned into money, it does not mean that the receipt of the right has no monetary value”*
- *“The test to determine whether the receipt or accrual has a monetary value is an objective test and not subjective test.”<sup>20</sup>*
- *“The value of the receipt or accrual in a form other than money (in casu, the right to use an interest-free loan) constitutes an “amount” that “accrues” to the taxpayer and should be included in the gross income of the taxpayer for the year of assessment in which the right is received by or accrued to the taxpayer”*

Based on the principles of *Brummeria Renaissance*, the rewards received as part of the customer loyalty programme have a monetary value.

For customer loyalty programme where a monetary value is attached to the accumulated loyalty points and/or reward, the taxpayer has a right to the loyalty points and for that right, a monetary value can be attached. For example, at Edgars, the 10 000 Edgars Thank U points equate to R10.<sup>21</sup>

For customer loyalty programme where no monetary value can be attached to the accumulated loyalty points and/or reward and where customers receive a discount as a means of reward, the taxpayer has a right to the loyalty points or discount but the monetary value can be determined only when the reward is exercised as this will provide the customer with a monetary value that can be attached to the reward.

---

<sup>19</sup> South African Revenue Services, *The Brummeria case and the right to use loan capital interest free*, Interpretation Note 58, October 2012

<sup>20</sup> *Stander v CIR* 1997 (3) SA 617 (C), 59 SATC 21 was found to incorrectly reflect the law on this point.

<sup>21</sup> <https://www.thanku.co.za/spending-points/> (Accessed on 9 September 2015)

## Element 2 – Received by or accrued to

Similar to element 1, “total amount in cash or otherwise”, the words “received by or accrued to” are not defined in the Income Tax Act. The use of the words “received by” or “accrued to” suggests that there is two ways in which income may arise. Either upon receipt of an amount or as it accrues to the taxpayer.<sup>22</sup> Therefore, “upon receipt of an amount” would mean when you actually received the money and “upon accrual of an amount” would mean that the money is due and payable but did not receive the money as yet.

The courts held in the *Delfos*<sup>23</sup> case that income, which is referred to as the amount above, should not be included in the taxpayers’ income twice. It is either on receipt of the monies or as it accrues, which ever arises first.

The principle of entitlement of an unconditional right to an amount only accrues to a taxpayer when he possesses the right to claim payment was the basis of *Peoples Stores*<sup>24</sup> case. In the case of a customer loyalty programme, the accumulation of loyalty points provides the customer with a right to exchange accumulated loyalty points for a reward in the future, this is referred to as the condition. A condition is an uncertain event that needs to occur before the taxpayer can receive anything.

In terms of a customer loyalty programme where a monetary value is attached or not attached to the accumulated loyalty points and/or reward, the customer accumulates loyalty points as he makes use of goods or services, this would constitute an accrual as he is unconditionally entitled to the accumulated loyalty points which is exchanged for a reward which is the receipt. A monetary value can be attached to the accumulated loyalty points up until that time the customer exchanges the accumulated loyalty points for a reward for customer loyalty programmes where a monetary value can be

---

<sup>22</sup> T Calvert Pidduck and k Odendaal ‘Customer Loyalty Programmes: The loss to the fiscus in South Africa’ (2013) 12 IBERJ 1521 at 1525

<sup>23</sup> *CIR v Delfos* 1933 (6) SATC 92

<sup>24</sup> *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A)

attached. However, for customer loyalty programmes where no monetary can be attached or where a discount is received, an amount can only be attached once the reward is received.

For customer loyalty programmes where the customer receives a discount as a reward, the reward is conditional and if not used within the prescribed timeframe, the customer forfeits the reward. Therefore, when the customer exercises his right to his reward, which will be the time of receipt.

### **Element 3 – Resident or South African source**

A customer is a resident, if he is ordinary resident in the Republic, or meets the criteria set out in section 1 of the Income Tax Act<sup>25</sup>, he will be taxed on his world-wide income therefore any customer loyalty programmes could possibly be taxed.

For non-residents, anyone not classified as resident as per above, they are taxed on South African source income. Therefore, if a reward is received as a result of actions taken in South Africa that will constitute a South African source, based on the *Millin*<sup>26</sup> case. This would mean that when a non-resident accumulates loyalty points, the accumulation of loyalty points are from a South African source.

### **Conclusion**

In this chapter, the first three elements of the general gross income definition has been discussed and validated in terms of a customer loyalty programme.

The rewards and accumulated loyalty points have a monetary value and which constitute a “total amount in cash or otherwise”. The customer is entitled to the accumulated loyalty points as loyalty points are earned which constitutes an accrual and generally occurs before the receipt of the reward

---

<sup>25</sup> Income Tax Act No. 58 of 1962, Section 1, “resident”

<sup>26</sup> *Millin v CIR* 1928 AD 207, 2 SATC 170

for which the accumulated loyalty points are exchanged for. Therefore, there the customer loyalty programme is “received by or accrued to”. The last element being residency, this needs to be assessed on a case by case basis. In most cases we are discussing South African based customer loyalty programmes and therefore the source is South Africa.

## **Chapter 4**

### **The laws to be addressed regarding customer loyalty programmes**

#### **Introduction**

In the previous chapters, we described a typical customer loyalty programme and conceptualised key areas thereof namely participate in customer loyalty programme; accumulate loyalty points and exchange loyalty points for a reward which formed the basis for our conceptual framework. Thereafter we identified issues that would cause doubt to whether the customer loyalty programme would be revenue or capital of nature. This chapter addresses the applicable laws that would shed some light on the issues identified.

As the Income Tax Act does not provide definitions of what revenue and capital means, we need to rely on case law to decide on the nature of every transaction.

The courts have provided taxpayers with guidance that will assist in determining whether income received would be revenue or capital in nature by applying the following tests:

- a) The intention of the taxpayer
- b) The duration of the investment
- c) The nature of the business
- d) The frequency of transactions

#### **The customers' intention in a customer loyalty programme**

This is one of the key tests that courts will rely upon regarding whether a customer is involved in a scheme of making profit, in our case, exchanging loyalty points for rewards or exchanging the loyalty points for best advantage. If it is found that it was the intention of the customer for taking out loyalty points to receive the rewards, then the reward will be revenue in nature. However, if the customer exchanged the loyalty points for best

advantage, then the reward would be of a capital nature. There are a few leading cases that will be discussed which relate to the principle of intention, namely *Natal Estates*<sup>27</sup>, *Nussbaum*<sup>28</sup> and *Pick 'n Pay Employee Share Purchase Trust*<sup>29</sup>.

In *Natal Estates* case, the taxpayer acquired a business with 21 000 acres of land which was suitable for cultivation of sugar cane and it was the taxpayers intention to use the land for that purpose. With the increase pressure and demand for the land to be converted to residential developments, the taxpayer decided to actively develop the land by sourcing architects and engineers and engaging with the local town planner. The taxpayer also subsequently bought and sold land in the Umhlanga Rocks and Lu Lucia areas.

Holmes JA found that the taxpayer was no longer realising the sale of the sugar cane for best advantage but instead the taxpayer was engaged in a scheme of making profit.<sup>30</sup> The taxpayer changed his intention from a capital nature, using the land for farming activities, to that of a revenue nature, actively developing the land and selling it at a profit.

In terms of a customer loyalty programme, when the customer starts participating in the customer loyalty programme, the intention of the customer is not to receive a reward but to make use of the company's services. For example, Investec Private Bank has a better private banking service which was the intention of opening the bank account with them. The customer loyalty programme was fortuitous to opening the banking account. The intention of opening the banking account would therefore be of a capital nature and the customer will realise the rewards offered for best advantage, meaning that the customer will cash in the loyalty points when he has accumulated the required amount of loyalty points. However, if the customer actively went looking out for the best customer loyalty programme in the

---

<sup>27</sup> *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A)

<sup>28</sup> *CIR v Nussbaun* 1996 (4) SA 1156 (A)

<sup>29</sup> *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A)

<sup>30</sup> *CIR v Stott* 1928 AD 252, 3 SATC 253

market, then his intention for opening the banking account would be of a revenue nature as he entered into the customer loyalty programme with the intention of making money therefrom in terms of the rewards he would be able to receive.

The major issue is thus, how would SARS prove that the customer changed banks because of the customer loyalty programme and not just because the bank provides a better service'.

### **The duration of the accumulated loyalty points held before exchanged for a reward**

The duration between acquisition and disposal must be considered in determining the nature of a transaction to whether it is revenue or capital. The intention between acquisition and disposal would be the determinant which was discussed in *Natal Estates* above. Whether there was a change in intention and whether the taxpayer "crossed the Rubicon".

In *ITC 1185*<sup>31</sup> case, the taxpayer acquired three properties, one property which was zoned as a residential site, was selected for a development scheme by an industrial organisation. Within a short period of time the value of the property increased. The taxpayer was approached with an offer for the purchase of its residential property and it was duly accepted. The taxpayer made a considerable profit on the sale of its residential property.

Miller J held that the taxpayer purchased the properties for investment purposes and that the profits should be of a capital nature. He stated that with the announcement of the industrial development both investors who held those properties for a long period of time and those who held it for a short period, might be tempted to sell it in light of the highly enhanced values which were attached to the properties after the announcement of the selected properties.

---

<sup>31</sup> *ITC 1185* 35 SATC 122, 1974

In terms of the loyalty points held by the customer, the duration that the accumulated loyalty points are held by the customer will not determine whether it is of revenue or capital in nature.

### **The nature of a customers' loyalty points in a customer loyalty programme**

The fundamental inquiry is whether the loyalty points which results into a receipt or an accrual which is subject to the inquiry, whether the customer is engaged in carrying on a trade or business or profit making scheme. If this is what the customer is doing, the loyalty points would be considered income and taxable in the hands of the customer. If not, the realisation of the loyalty points into a reward would be a conversion of a capital asset into cash, which would be considered capital in nature.

In *Pick 'n Pay Employee Share Purchase Trust*<sup>32</sup> case, the "Trust" was created to benefit qualifying employees in the Pick 'n Pay group. The Trust acquired shares in Pick 'n Pay by initial allotment and subsequently thereafter through the various methods available. Shares were sold at middle market price. In the Trust years of assessments, it made profits and losses.

Nicholas AJA held that the shares were acquired were not fixed capital and that the proceeds on their realisation could therefore not be capital. Although the intention of the Trust was not to make a profit and the shares were not bought and sold in a scheme of making profits, it was the nature of the business to trade in shares as opposed to realising capital investments at enhanced values. Therefore, the profits from the Trust was not of a capital nature and the profits were taxable while losses deductible.

In the *George Forest Timber*<sup>33</sup> case, the taxpayer, a company carrying on business as a timber merchant, had purchased 600 morgen of indigenous forest land. In the subsequent year of assessment, the taxpayer claimed a

---

<sup>32</sup> *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A)

<sup>33</sup> *CIR v George Forest Timber Co Ltd* 1924 AD 516, 1 SATC 20

deduction from his taxable income an amount which representing a proportionate share of the purchase price of the timber sold by it. The Commissioner disallowed the deduction on the grounds that “the transaction incurred was of a capital nature.”

Innes CJ held that “acquiring an income producing concern or source of future profits instead of money spent working on it would be considered to be capital in nature”. The land in questioned, which includes the trees stood in a different position from its trading stock, it was bought for the purpose of producing revenue and not the source of revenue. As the expenditure was incurred in the acquisition of the revenue producing asset to be worked for future profits, “the expenditure is of a capital nature.”

In *Samril Investments*<sup>34</sup> case, which looks at “the frequency as well, the taxpayer was an owner of a farm, and for many years its income consisted solely of proceeds of the sale of farming products and rental received from an associate company for the grazing on the farm”. Between January 1994 and February 1996, it received income from third party for the removal of building sand from the farm.

Hefer JA held “the usual test of determining the true nature of an accrual or receipt was whether it was not fortuitous but rather designedly sought and worked for.” He also mentions that “profit making is an element of capital accumulation as we dispose of capital assets for best advantage.” “The income was generated by exploiting the resources of what was admittedly a capital asset and was plainly designedly sought and worked for, therefore being revenue of nature.” “If this was done in a single transaction then the taxpayers claims of merely sought to improve the company’s land by removing an unwanted subsoil layer of sand would have been more convincing.”

In terms of a customer loyalty programme, loyalty points are accumulated when making use of the company’s products. The accumulation of loyalty

---

<sup>34</sup> *Samril Investments (Pty) Ltd v CSARS* 2003 (1) SA 659 (SCA), 65 SATC 1

points happens simultaneously and not separately. Therefore, the accumulation of loyalty points would be part of transacting with the company.

In relation to *Pick 'n Pay Employee Share Purchase Trust*, it is not the nature of the customers' business to trade in loyalty points therefore the exchange of accumulated loyalty points for a reward is of a capital nature. In relation to *George Forest Timber*, the customer loyalty programme is not a source of income but a source of future income for the company and not the customer therefore the customer loyalty programme would be of a capital nature. For example, customer can make use of Investec Dividend Reward Programme if the customer has an Investec private banking account, therefore Investec Private Bank sources future income from the use of the banking accounts. In relation to *Samril Investments*, the loyalty points were not designedly sought or worked for and therefore, the loyalty points would be of a capital nature unless the customer actively rearranged his affairs so that he could benefit from the customer loyalty programme. For example, by the customer swiping his Investec card, he would accumulate dividend points; the customer did not work for the loyalty points therefore will be of a capital nature.

### **The frequency of transactions of which loyalty points is derived**

In the *Nussbaum* case, a retired school teacher inherited a substantial number of portfolios in listed shares. He kept a constant watch on his portfolios, effecting switches between counters on a regular basis in accordance with his investment strategy. The taxpayer held that it was his intentions to sell the shares for best advantage by deriving maximum dividend income from his investment.

Howie JA held that due to the scale of transactions and the frequency of the transactions of which the taxpayer was involved in, the taxpayer had manifested a secondary purpose of dealing in shares, and that it was for a profit and that it was not incidental to its investment, and therefore he was engaged in a scheme of making profit.

For customer loyalty programmes, when a customer actively rearranges his affairs to accumulate the maximum amount of loyalty points, for example, making all payments using his visa card instead of EFT, he is using the customer loyalty programme for the purposes of making a profit. The customer loyalty programme would be considered to be of a revenue nature as the intention is to make a profit and the frequency of the transactions would result in both a primary purpose, being to exchange the loyalty points for a reward and a secondary purpose being have maximised his loyalty points to receive more rewards than he would if he carried on his affairs as he would ordinarily have done instead of rearranging it to maximise his loyalty points.

However, in today's environment that we live in, with the increase in crime, customers prefer making use of their bank cards instead of handling cash, therefore making it very hard to proof that a move away from cash to bank card or the frequency of the use of your bank card compared to before will constitute the actions being revenue of nature.

## **Conclusion**

The courts have provided the customer with case law that will guide and assist him in determining the nature of the loyalty points and rewards in the customer loyalty programme.

The first test identified was the intention. The guidance lay down in case law all based its judgements as to whether the transaction was a scheme of making profit or the profit was as a result of a realisation of capital asset for best advantage. When the transaction is a scheme of making profit, this also includes if the profits were designedly sought and worked for, the nature of the transaction is revenue. And when the profits were as a result of a realisation of capital asset for best advantage, the nature of the transaction is capital. In my opinion, the initial intention of a customer loyalty programme is that of a capital nature as the customer loyalty programme is embarked on incidentally and the customer did not go out and look for the best possible

customer loyalty programme. In most cases, the customer is offered the customer loyalty programme with the company's main product or by the cashier at check out.

The second test identified is duration of the investment. For a customer loyalty programme, the period of time is irrelevant as the rewards can only be exchanged once the predetermined amount of loyalty points are accumulated or the period the discount voucher offered.

The third test identified is the nature of the transaction. In most cases the customer loyalty programmes are part and parcel of the company's main product or services and the cost thereof is incorporated in therein. In rare scenarios, the customer needs to apply to participate in the customer loyalty programme.

The last test is the frequency of transactions. Customer behaviour changes throughout time and therefore this is not a good indication of whether a customer has crossed the Rubicon<sup>35</sup> from exchanging loyalty points for best advantage to a scheme of making profit.

Therefore, based on the above, the rewards received from a customer loyalty programme would be of a capital nature and excluded from gross income. In terms of the Tax Administration Act, the onus is on the taxpayer to prove that a transaction is of capital nature and not of revenue nature.

---

<sup>35</sup> *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A)

## Chapter 5

### Conclusion

From the discussion in the case of *Brummeria Renaissance* the element of the total amount, in cash or otherwise was addressed. The issue of a right to something, in this case, the right to receive a reward after the customer accumulated the required loyalty points, can be valued in money's worth. This is why the decision in *Standers* case was correct, as the taxpayer did not have 'money worth' for the award received. In all the types of loyalty programmes, money worth can be attached. In some cases, the monetary value is known as the loyalty points accumulate and in other cases when the customer exercises his loyalty points or discounts.

From the discussion in the case of *People Stores* the element of received or accrued to was addressed. The principle of unconditional entitlement was discussed. As the customer becomes unconditionally entitled to the loyalty points that accumulate, but for some cases, a monetary value can only be placed on either an accrual or receipt basis. For customer loyalty programmes where a monetary value can be attached to a reward and/or accumulated loyalty points, this will be on the accrual basis. Where no monetary value can be attached to the reward and/or accumulated loyalty points, it is only when the customer receives the reward can we attach a monetary value and would therefore be on receipt of the reward.

In terms of residence, the source of the customer loyalty programme for non-resident customers is the test as resident customers are taxed on their world-wide income.

In formulating an answer to our research problem, being the last element of the general gross income definition, we look at case law handling the test applied by courts on revenue versus capital applications. The test laid down, deals with the intention, duration, nature and frequency of the customer

loyalty programme being of a revenue or capital nature. Due to the changes in people's behaviour and changes in times, we do things differently today as we did 10 years ago, it will be hard to prove that the customer loyalty programme is of a revenue nature. One of the main reasons is the increase in crime, unemployment, higher cost of living but to name a few and another reason being that the customer loyalty programme service is offered fortuitously, it comes hand in hand with the main product or service purchased.

### **Recommendations**

In terms of the general gross income definition, all elements except the last element, the transaction must be of a capital nature, is met. As all the elements of the general gross income definition are not met, the rewards from a customer loyalty programme should not be taxable in the hands of the customer.

However, capital gains tax consequences can be dealt with as the reward received as part of the customer loyalty programme is of a capital nature. But this question needs further research as the capital gains tax rules need to be determined.

If for some reason, SARS proves that a customer embarked in a customer loyalty programme as part of a scheme to make profits and therefore he should be taxed on the reward, the onus SARS having to collect monies from taxpayers would far exceed the monies received. And in most cases, majority of the active users of a customer loyalty programme would be below the submission of tax return threshold. With this said, we are assuming that due to the changes in economic climate the majority of the users would be from a low income background.

## **BIOGRAPHY**

### **Primary Sources**

#### **South African Statutes**

Consumer Protection Act No. 68 of 2008

Income Tax Act No. 58 of 1962

Taxation Laws Amendments Act No. 24 of 2011

### **Secondary Sources**

#### **Journals**

Calvert Pidduck T and Odendaal K, *Customer Loyalty Programmes: The Loss To The Fiscus In South Africa*, 12 (2013) Volume 12, International Business & Economics Research Journal

#### **Cases**

*Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA)

*CIR v Delfos* 1933 (6) SATC 92

*CIR v George Forest Timber Co Ltd* 1924 AD 516, 1 SATC 20

*CIR v Nussbaun* 1996 (4) SA 1156 (A)

*CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A)

*CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A)

*CIR v Stott* 1928 AD 252, 3 SATC 253

*CSARS v Brummeria Renaissance (Pty) Ltd* 2007 (6) SA (SCA) 69 SATC 205

*ITC 1185* 35 SATC 122, 1974

*Lategan v CIR* 1926 CPD 203

*Millin v CIR* 1928 AD 207, 2 SATC 170

*Natal Estates Ltd v SIR* 1975 (4) SA 177 (A)

*Samril Investments (Pty) Ltd v CSARS* 2003 (1) SA 659 (SCA), 65 SATC 1

*Stander v CIR* 1997 (3) SA 617 (C), 59 SATC 21

### **Dissertations**

D Marais, *An analysis of the taxability of customer loyalty rewards in South Africa* LLM (UJ) (2010)

### **Government Publications**

SARS, Discussion Paper *Discussion Paper on the VAT treatment of loyalty programmes*, 2014

National Treasury, *Budget Speech 2013*

### **Articles**

Ernest and Young, *A closer look at the new revenue recognition statement* (2014)

Ernest and Young, *Frequent flyer program: Ready for take-off* (2014)

## Websites

Edgars, <https://www.thanku.co.za/getting-points/> (Accessed on 8 July 2015)

Investec Private Bank, <https://www.investec.co.za/products-and-services/banking-services/rewards-programme.html> (Accessed on 10 July 2015)

Investec Private Bank, <https://www.investec.co.za/products-and-services/banking-services/rewards-programme.html> (Accessed on 10 July 2015)

Investec Private Bank, <https://www.investec.co.za/products-and-services/banking-services/rewards-programme/rewards-by-charities.html> (Accessed on 22 July 2015)

Investec Private Bank, <https://www.investec.co.za/products-and-services/banking-services/rewards-programme/rewards-terms-and-conditions.html> (Accessed on 22 July 2015)

Oxford Dictionary,  
<http://oxforddictionaries.com/definition/english/voucher?q=voucher>  
(Accessed on 8 July 2015)

South African Airways,  
[https://www.flysaa.com/za/en/voyager/AboutVoyager/flysaa\\_VoyagerTermsAndConditions.html](https://www.flysaa.com/za/en/voyager/AboutVoyager/flysaa_VoyagerTermsAndConditions.html) (Accessed on 22 July 2015)

Woolworths,

[http://www.woolworths.co.za/store/fragments/wrewards/wrewards-index.jsp;jsessionid=zOohfHBU7D22SY4o0ZzzhbNDMsBN-4GMaYTfuGQ5OB\\_fvEQ0dJtt!-955816874](http://www.woolworths.co.za/store/fragments/wrewards/wrewards-index.jsp;jsessionid=zOohfHBU7D22SY4o0ZzzhbNDMsBN-4GMaYTfuGQ5OB_fvEQ0dJtt!-955816874) (Accessed on 12 August 2015)