

Investigating the role of VAT in the changing landscape of Educational Services: A case study of a digital educational services provider



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1. Abstract

Given the funding crisis in South African universities, investigation was carried out with respect to the role which Value Added Tax (VAT) plays in the educational services sector. It was found that there are difficulties in accounting for and apportioning VAT due to the diversification of revenue streams, especially with historically government-funded institutions. Furthermore, it was found that the application of current VAT legislation can face difficulties in regards to application of legislation with the move towards digital educational services providers, especially when looking at the role of agency through providing digital educational services on behalf of another institution. Lastly, the role of the VAT exempt status of educational services was seen to be one which can be improved upon so as to remove inefficiencies in the funding process of governmentally funded institutions, and to possibly remove the benefit afforded to privately owned institutions.

2. Introduction to VAT in the education sector in South Africa

2.1 Background.

“Education is the most powerful weapon which you can use to change the world” was a famous statement made by Nelson Mandela in 2003. He realised that in the South African context, education was key to redressing the inequalities of the past. In 2018 however the South African educational system finds itself undergoing a number of crises.

Tertiary education in South Africa is currently experiencing a “funding crisis”¹, South African primary education is currently sliding in the global rankings in terms of competitiveness² and student unrest has caused massive emotional and monetary damages to both students and staff.³

Given the financial state of many of South African public universities as well as general mismanagement in both primary and secondary schooling⁴, it is not unexpected to see that the private educational sector has been on the rise in recent times with the two largest private educational groups in South Africa, Curro and ADVtech having grown to combined market capitalisations in excess of R28 Billion rand⁵.

While these figures pale in comparison to the R792 billion and R324 billion budgeted by government as spending on basic and higher education respectively in 2018⁶, private education is definitely on the rise. The future expected growth in public education is required to be linked to the proposed increase in government spending for this sector, but this has been met with a coupled uncertainty about the existence of the tax base to fund this desired increase⁷.

1PwC, 2016. Funding of public higher education institutions in South Africa, s.l.: PwC.

2 Mbiza, M., 2018. The Issues with South Africa’s Education System. [Online]
Available at: <https://educonnect.co.za/the-issues-with-south-africas-education-system/>

3 Dandara, C., Chimusa, E. & Wonkam, A., 2017. South African student protests, 2015 -2016: The aftermath viewed through Medical Science Honours students at the University of Cape Town. *South African Medical Journal*, 107(9), pp. 723-723.

4 Rangongo, P., Mohlakwana, M. & Beckmann, J., 2016. Causes of financial mismanagement in South African public schools: The views of role players. *SA Journal of Education*, 36(3).

5 BusinessTech, 2017. Why private schools are an excellent investment opportunity in SA. [Online]
Available at: <https://businesstech.co.za/news/business/189369/why-private-schools-are-an-excellent-investment-opportunity-in-sa/>

6 National Treasury, 2018. Budget Review 2018, s.l.: National Treasury.

7 Luescher, T., Loader, L. & Mugume, T., 2017. #FeesMustFall: An Internet-Age Student Movement in South Africa and the Case of the University of the Free State. *Politikon*, 44(2), pp. 231-245.

VAT was a 25.3% contributor to the revenue of the country in 2017¹ and given that educational services are currently classified as an exempt supply, it would be wise to investigate whether there exists a more efficient and equitable role for VAT in the context of educational services in South Africa moving forward.

The aim of this paper is to investigate: the role of VAT in the context of both public and private education from a historical, current as well as forward looking perspective; the role of VAT as a funding method for public educational institutes; and finally the role of VAT in a changing educational landscape where digital and online education is quickly becoming a dominant force in the tertiary education space². This will be done through the use of an analysis of the current, as well as possible future legislative reforms and a fictional case study of a digital educational services provider in the context of the current VAT legislation.

As a point to note, the inspiration for this investigation is taken from an exam question posed by a professional accountancy body in South Africa whereby the VAT consequences of a transaction involving a purely digital educational provider was posed as a question in a qualifying exam³. While the question was limited in scope, it raised many questions as to what the current status of a purely digital educational service provider is in terms of the Value-Added Tax Act of 1991, which is to be examined by this paper.

¹ National Treasury and the South African Revenue Service, 2017. 2017 Tax Statistics, s.l.: National Treasury and the South African Revenue Service.

² Du Plessis, L. & Lodewyckx, E., 2007. Crossing the Rubicon in higher education. *South African Journal of Higher Education* Volume 21 Issues 7, p. 842.

³ SAICA, 2017. Assessment of Professional Competence (Part II – Qualifying Examination). [Online] Available at:

<https://www.saica.co.za/LearnersStudents/Examinations/ExamInformation/PastExamPapers/AssessmentofProfessionalCompetencePartIIQ/tabid/3629/language/en-ZA/Default.aspx>

2.2 Problem Statement

Owing to the funding crisis experienced by higher education¹ and the mismanagements of primary education², it needs to be examined whether potential changes to the classification of educational service as exempt items for VAT purposes, or other changes to the manner in which resources are collected and subsequently redistributed can assist in improving the efficiencies in regards to funding of government education. Linked to this, it needs to be examined whether the current and proposed VAT legislation is having the desired effect with regards to the services offered by privately owned providers of educational services and government's role in respect of funding towards these institutes.

Furthermore, given the changing nature of the educational sphere³ it needs to be examined whether VAT legislation has provisions for the changing methods of delivery of educational series. In particular it needs to be examined whether the current VAT legislation makes provision for providers of digital educational services, and the possibility that they may be presenting the content on behalf of another institution.

2.3 Research Objectives

This research aims to achieve the following objectives;

- To explain the role of Value Added Tax (VAT) in the context of both public and private education from a historical, current and forward looking perspective.
- To explore the role of VAT as a funding method for public educational institutes.
- To explore the effects VAT has on private education institutions and whether this effect is desired.
- To explore the role of VAT in a changing educational space which is moving towards the provision of digital educational services.

1 PwC, 2016. Funding of public higher education institutions in South Africa, s.l.: PwC.

2 Rangongo, P., Mohlakwana, M. & Beckmann, J., 2016. Causes of financial mismanagement in South African public schools: The views of role players. *SA Journal of Education*, 36(3).

³ Vaughn, N., Reali, A., Stenbom, S. & Jansen van Vuuren, M., 2017. Blended Learning from Design to Evaluation: International Case Studies of Evidence-Based Practice. *Online Learning* vol 21 no 3, pp. 103-114.

- To discuss the challenges and relevant decisions which need to be made in applying current legislation to a fictional provider of digital educational services.

2.4 Importance and benefit of this study

This study aims to provide recommendations about taxation in an area which directly affects any person who is currently, or plans to in the future receive the provision of educational services. Furthermore, it also affects those who may be paying for such educational services even if they are not the consumer of such services. Lastly, it affects all taxpayers in South Africa as any changes to the composition of tax revenue will indirectly affect other taxes and sources of income for the fiscus.

The Benefits of this study aim to include;

- To provide greater explanation in regards to the role of VAT in the context of both public and private education from both a historical, current and forward looking perspective.
- To provide greater explanation of the role of VAT as a funding method for public educational institutes.
- To provide greater explanation on the effects VAT has on private education institutions and whether this effect is desired.
- To provide greater explanation and examples of the role of VAT in a changing educational space moving towards the provision of digital educational services.
- To highlight the challenges and relevant decisions which need to be made in applying current legislation to a fictional provider of digital educational services so as to provide guidance to those in similar circumstances.

2.5 Definitions of key terms and abbreviations

Term/Abbreviation	Explanation
Basic Education	Primary and secondary schools which are registered in terms of South African Schools Act, 1996(Act No. 84 of 1996)
Digital education services provider	A provider of educational services through a digital form such as through pre-recorded lectures, live webcasts of lectures or through video based online interactions.
Educational Acts	The relevant act under which the educational service provider needs to be registered for accreditation within their country of operation.
Educational services	The provision of teaching content to students in any format, being of a digital nature or traditional face to face or correspondence services.
Higher education	Public and private universities and colleges which are registered in terms of the Higher Education Act, 1997 (Act No. 101 of 1997),
IFRS	International financial reporting standards, being the guidance used for financial reporting across the majority of the world.
Legislation	Primarily the contents of Value-Added Tax Act 89 of 1991 but also included is all other applicable laws relevant to the topic.
Private education provider	A provider of education which is run with profit motives and which is not owned by governmental or similar public parties.
SAICA	The South African Institute of Chartered Accountants, a professional body of South African Chartered Accountants.

South African Public universities	26 institutions within South Africa including traditional, comprehensive and universities of technology.
Technical vocational education and training	TVET and other similar colleges which are registered in terms of the Further Education and Training Colleges Act, 2006 (Act No. 16 of 2006)
VAT	Value Added Tax as envisioned by the Value-Added Tax Act 89 of 1991

2.6 Research design and methodology

The design of this paper is that of an analysis of current legislative requirements and guidance surrounding VAT in the context of educational services, along with an analysis of surrounding literature in terms of the past, current and future state of educational services and the associated VAT effect of those states.

Certain possible amendments to current legislation will be suggested and the effect of these changes will then be discussed and evaluated in terms of the desired effect of the amendments.

A case study will be conducted to highlight the challenges and provide possible answers to the difficulties which exist in applying the current legislation to a provider of digital educational services

2.7 Limitations

This study only undertakes to look at the VAT consequences of a single sector, and does not aim to extrapolate the results to any other goods or service which are exempt supplies for VAT purposes. This study only examines a single sector, being that of educational services, and is only examined in a single country being South Africa. This study also only aims to provide a qualitative approach to understanding the VAT effect on the educational services sector. While some quantitative aspects are considered, this study does not aim to definitively quantify the effect of any suggested policy or legislative changes.

2.8 Possibilities of future research

This study could be extended to look at the VAT consequences of a multiple sectors, which contain other goods or services which are exempt supplies for VAT purposes. This study could also be extended to countries other than South Africa both as an analysis of the legislation in said country and as a comparison to the South African context. Lastly this study could be extended to attempt to quantify the effects of any proposed changes to policy or legislation.

3. The historical landscape of VAT in the education sector in South Africa

When Value-Added Tax (VAT) was introduced to South African taxpayers in 1991, providers of educational services were mostly public institutions which were state funded¹. Furthermore, most research undertakings were funded by the Foundation for Research Development (FRD) or other subject specific councils. Legislation at the time did not specify the boundaries of primary, secondary and tertiary education and it was difficult to distinguish between the various educational levels in terms of legislated offerings.²

As a result, the Value-Added Tax Committee (VATCOM), appointed by the Minister of Finance, recommended that the supply of educational services should be exempt from VAT. This was similar to the previous sales tax treatment under which it was also exempted. The exemption aimed to alleviate the financial burden on universities by not having an additional tax on any value added through their offering, and through this, doing away with the additional risks and compliance costs associated with VAT accounting and compliance.

In the twenty seven years which followed there was little to no change in the VAT treatment of educational services. However, other legislation had now evolved to categorise education into 3 categories, namely: Basic education (schools); technical vocational education and training (colleges); and higher education (universities).

Research activities conducted mostly by public universities has also changed over this period, with private entities engaging to a much larger level in various types of research and consulting services in collaboration with public universities.

From the perspective of VAT, the emergence of the privately funded research output as well as the increase in additional income streams such as income from parking or gym facilities³, required many of the tertiary as well as some primary and secondary institutions were required to begin to register for VAT. As a result of these institutions providing both exempt and taxable supplies, they faced large difficulties in managing their VAT risk in a very complex environment⁴.

1 PwC, 2016. Funding of public higher education institutions in South Africa, s.l.: PwC.

2 PwC, 2016. Funding of public higher education institutions in South Africa, s.l.: PwC.

3 Dajee, Y. & Muthayan, S., 2018. VAT and Private Schools?, s.l.: BDO South Africa.

4 PwC South Africa, 2016. Recent tax developments in the higher education sector, s.l.: PwC.

In terms of these complexities, a Value-Added Tax Class Ruling (VCR) by SARS was introduced, dated 12 March 2015, to provide guidance on the apportionment of input VAT (VAT which has been incurred and can be “claimed back” from SARS) when a university had multiple income streams, in particular for instances whereby the primary supply being educational services are exempt, and the secondary supply of commercial research which would constitute a taxable supply were rendered. The VCR outlined the process to follow in terms of apportionment between taxable and non-taxable supplies in a tertiary education institute. While this policy was renewed beyond the initial 9 months of applicability, its status moving forward was never certain, and universities faced many issues in terms of identifying the required inputs into the calculations of their net VAT position.

It must be noted that this VCR was only binding on the applicable member of the HESA (At the time HESA, now US (“Universities South Africa”)), its existence served to indicate that the changing nature of universities and education as a whole in South Africa, needed to be met with a changing approach to their taxation, and in particular their treatment in terms of VAT.¹

4. The current Position of VAT in relation to the education sector in South Africa.

4.1 Applicability of the exemption of Educational Services from Output Vat

The provision of Educational Services as envisaged in s12(h) (i) & (ii) of the Value-Added Tax act of 1991 states as follows²:

Section 12: The supply of any of the following goods or services shall be exempt from the tax imposed under section 7 (1) (a):

12(h) (i) the supply of educational services-

¹ Nelson, L., 2016. Value-Added Tax apportionment methodology applied in the higher education sector, Cape Town: University of Cape Town.

² SAICA, 2018. SAICA Student Handbook Volume 3. s.l.:Lexis Nexis.

- (aa) Provided by the State or a school registered under the South African Schools Act, 1996(Act No. 84 of 1996), or a public college or private college established, declared or registered as such under the Further Education and Training Colleges Act, 2006 (Act No. 16 of 2006);
- (bb) By an institution that provides higher education on a full time, part-time or distance basis and which is established or deemed to be established as a public higher education institution under the Higher Education Act, 1997 (Act No. 101 of 1997), or is declared as a public higher education institution under that Act, or is registered or conditionally registered as a private higher education institution under that Act; or
- (cc) By any public benefit organisation as contemplated in paragraph (a) of the definition of “public benefit organisation” contained in section 30 (1) of the Income Tax Act that has been approved by the Commissioner in terms of section 30 (3) of that Act and which has been formed for—
 - (A) adult basic education and training including literacy and numeracy education, registered under the Adult Basic Education and Training Act, 2000 (Act No. 52 of 2000), vocational training or technical education;
 - (B) Education and training of religious or social workers;
 - (C) Training or education of persons with a permanent physical or mental impairment;
 - (E) Provision of bridging courses to enable indigent persons to enter a higher education Institution as envisaged in subparagraph (bb);
- (ii) The supply by a school, university, technikon or college solely or mainly for the benefit of its learners or students of goods or services (including domestic goods and services) necessary for and subordinate and incidental to the supply of services referred to in subparagraph (i) of this paragraph, if such goods or services are supplied for a consideration in the form of school fees, tuition fees or payment for lodging or board and lodging; or
- (iii) the supply of services to learners or students or intended learners or students by the Joint Matriculation Board referred to in section 15 of the Universities Act, 1955 (Act No. 61 of 1955): Provided that vocational or technical training provided by an employer

to his employees and employees of an employer who is a connected person in relation to that employer does not constitute the supply of an educational service for the purposes of this paragraph;

Paragraph (aa) outlines the type of institutions which would be exempt from output tax as levied by section 7(1)(a). The key requirement is to be either a state owned institution or a private institution being registered under the South African Schools Act, 1996(Act No. 84 of 1996) or Further Education and Training Colleges Act, 2006 (Act No. 16 of 2006). The crux of the matter at point here is that any institution wishing to issue any form of recognised qualification, such as a certificate or diploma or offering registered primary or secondary school education must be registered in terms of the Further Education and Training Colleges Act, 2006 (Act No. 16 of 2006). This would mean that public colleges such as Further Education and Training colleges (FET Colleges) as well as public and private primary and secondary schools would fall into the ambit of providing educational services as defined.

Paragraph (bb) outlines the type of institutions which would be exempt from output tax as levied by section 7(1)(a). It requires that an institution which provides higher education on a full time, part-time or distance basis and which is established or deemed to be established as a public higher education institution under the Higher Education Act, 1997 (Act No. 101 of 1997), or is declared as a public higher education institution under that Act, or is registered or conditionally registered as a private higher education institution under that Act. The key issue here once again is the requirement to be registered in order to be able to issue formal qualifications, and as such all public universities, and most private institutes of higher learning will meet this definition and would fall into the ambit of providing educational services as defined.

Paragraph (cc) is in reference to approved public benefit organisations being exempt from output tax as levied by section 7(1)(a). This application is made to the commissioner and if approved the institution would be deemed to be supplying educational services as defined. No further explanation of this paragraph will be examined by this research.

s12(h)(ii) refers to the fact that goods or services which are “necessary for and subordinate and incidental to the supply” of any educational services can also be exempt from output tax provided those goods or services are supplied for a consideration in the form of school fees, tuition fees or payment for board and lodging. The effect of this is that any ancillary

services provided by a supplier of educational services can be exempted from output VAT if they are charged in the form of fees or as payment for board and lodging while receiving educational services. The largest and perhaps most pertinent issues here is that of the payment of residence fees levied by the institution, those fees are deemed to be a supply of educational services provided they are “necessary for and subordinate and incidental to the supply” which if they are for *Bona Fide* students would meet the requirements for the exemption as educational services.

S12(h)(iii) is a specific provision applying to the services of the Joint Matriculation Board referred to in section 15 of the Universities Act, 1955 (Act No. 61 of 1955) and shall not be analysed further.

The summation of the above is that generally an institution which supplies educational services as defined, will not be subject to the output tax as mentioned in by section 7(1)(a). As a consequence of this, these educational service would not constitute a “taxable supply” as defined, meaning that based on the provision of educational services alone, no person would meet the requirements to register, either under voluntary or compulsory registration as a VAT vendor. A person who is not a registered VAT vendor is not entitled to claim any VAT incurred by them (Commonly referred to as Input VAT) and would not levy output VAT on supplies made by themselves.

4.2 Effects of supplying taxable and non-taxable supplies.

If a person is supplying both taxable and non-taxable (exempt) supplies, they are required to apportion any VAT incurred (Input VAT), and claim it only to the extent to which they make taxable supplies. As discussed previously in the case of an educational institute this can prove to be difficult given the nature of the services offered and the diversity of means by which those service are paid for. Nelson, 2016¹ suggests that while a calculation based on the composition of taxable and non-taxable supplies in respect of turnover is possible, for a higher education insitute, the guidance offered by the applicable VCR simplifies the process.

¹ Nelson, L., 2016. Value-Added Tax apportionment methodology applied in the higher education sector, Cape Town: University of Cape Town.

The status and applicability of the VCR mentioned before is currently not certain and it would thus be appropriate for higher educational institutes and other educational service providers to account for any inputs they wish to claim based on the percentage turnover composition method.

5. Challenges Faced due to the changing nature of the educational sector.

5.1 The role of Exemption from VAT as a funding mechanism

Since VAT was introduced to South Africa in 1991, Educational services have been classified as being an “exempt supply”, one which is by design not supposed to be subject to output VAT. The irony of the term “Exempt” is not lost on those with insight into the VAT framework, even if others, usually consumers, can be misled by the terminology. From the perspective of the vendor or suppliers an “exempt” supply for VAT is actually in theory a taxable supply for the consumer, while a “taxable” supply is actually an exempt supply for the consumer, as there is no recovery of input tax embedded in the price of exempt supplies. The cost of the tax included in the price must be carried by the supplier that acquires the exempt supply and can only be recovered if the tax cost is passed on to customers. A taxable supply, on the other hand, is theoretically tax-free to a registered vendor’s customers as the VAT can be recovered through the input tax credit system. Ultimately both taxable and exempt supplies are taxed supplies from the perspective of the final consumers – albeit at different levels – with an explicit tax levied on the first type of supply, and a (smaller) embedded tax included in the cost of the second¹.

The reasoning for having educational services as an exempt supply is generally seen to be two-fold. Firstly, it is simply an exercise of the difficulty in calculating the “Value Added” in the process stream of an educational service. While it might be possible to calculate a gross income vs. expenditure of an educational institution, there exists difficulties owing to not having uniform tangible products or services being offered, having to work with areas such as

¹ De La Feria, R. & Krever, R., 2013. Ending VAT Exemptions: Towards A Post-Modern VAT, Oxford: Oxford University Centre for Business Taxation.

allocation of staff members to work performed, cross subsidisation of departments and faculties etc.¹. The same thought is often given as a reason for the exemption of financial services².

The second reason, which will be discussed in more detail is one of funding, and rests in the context that in 1991 most providers of education services in South Africa, were government funded institutions³. The logic applied here is that as a government funded institution, there would ideally be no effect of VAT levied on an institution which relies on government funding as its main source of funding. This would be counter intuitive, as you would be collecting tax revenue from an institute which is funded mostly from that tax revenue. This would be inefficient, as in that method there would be large administration costs involved with little benefit, and ultimately it is the goal of any tax system to be as efficient as possible⁴.

The thinking here is that any revenue lost from the non-levying of output VAT on educational services might be a loss for the fiscus, but that money would most likely have been re-fed to the universities as government funding in some form, so that was not a problem. By having educational institutes not levy VAT, and thus also not claim an input VAT, the effect on their operations due to VAT should be very limited.

The question then needs to be asked, why educational services were not zero rated at inception of VAT in South Africa. This would have had the effect of allowing institutions to claim a VAT refund on any VAT they incurred through the purchase of goods or the use of services from VAT registered vendors. While the effect would be somewhat dampened by the fact that the major cost of educational institutions being staff costs⁵, which do not attract VAT, it would still have been a source of financial funding to an institution through the refunds it could claim.

1 Nelson, L., 2016. Value-Added Tax apportionment methodology applied in the higher education sector, Cape Town: University of Cape Town.

2 The Tax Policy Center, 2018. The Tax Policy Centre's Briefing Book. [Online] Available at: <https://www.taxpolicycenter.org/briefing-book/what-difference-between-zero-rating-and-exempting-good-vat>

3 PwC South Africa, 2016. Recent tax developments in the higher education sector, s.l.: PwC.

4 Mclean, I., 2018. Classical Justifications of Taxing Land Values.. *Taxation: Philosophical Perspectives*, 10(1), p. 185.

5 Nelson, L., 2016. Value-Added Tax apportionment methodology applied in the higher education sector, Cape Town: University of Cape Town.

In the context of 2018 South Africa, it would seem logical to find any reasonable way to funnel funding to an education institution given the funding deficits experienced at all levels of education¹, but on a purely theoretical level it doesn't make sense to claim back funds (In the form of Input VAT) from the institution (The fiscus) which is providing the majority of your funding anyway. That would be inefficient as discussed above, to have to calculate your VAT rebate when that revenue would be provided back to the institutions as required in any regards.

A good comparison to examine whether this change might be effective is that of the outcome of zero-rating property rates levied by municipalities in South Africa. Prior to the amendment property rates were, as in the case of educational services currently, exempt from VAT. The zero-rating of the property rates was designed to release previously denied input tax credits to replace funding provided by Regional Services Councils before RSC levies were scrapped².

In practice, very little additional input tax credits were released, due to high levels of recoveries by municipalities before the amendment, so the desired outcome was limited.

On the face of it all from the above two reasons, it would make no sense to zero-rate educational services as a means of funding educational institutions. Other than the additional VAT compliance burden it would place on educational institutions, it would also infringe on and frustrate the general process of South African tax reform.

Furthermore, this option would only be viable in a growing economy if the void created in the coffers of the fiscus was replaced by additional VAT generated by consumption in the general economy, and given the current state of the South African economy this is unlikely³.

1 Rangongo, P., Mohlakwana, M. & Beckmann, J., 2016. Causes of financial mismanagement in South African public schools: The views of role players. *SA Journal of Education*, 36(3).

2 Theron, C., 2017. #VatMustRise. [Online]
Available at: <https://www.theteacher.co.za/2017/03/vatmustrise/>

³ Theron, C., 2017. #VatMustRise. [Online]
Available at: <https://www.theteacher.co.za/2017/03/vatmustrise/>

5.2 The effect of Privatization of educational services and VAT in South Africa.

In 2001 the presence of privately owned educational facilities was much smaller than it is today¹. This means that if the government were to decide to zero rate all educational services despite the concerns raised above, a large number of privately owned institutions would benefit from this decision. This goes against the general reasoning for zero rating an item; being to lower the tax burden on low-income households by zero-rating essential goods, of which private education is not one².

It would thus seem as though the most applicable approach going forward would be to leave educational services as exempt supplies.

This leaves us with two key issues, Firstly; the benefits of this exemption clearly also still extend to private education, and at least part of the purpose of exempting educational services which relates to the funding aspects, would not appear to be meant for private institutions.

The second issue is that the desired principle of not needing to claim back input VAT, because the funding is already coming from the Fiscus, doesn't seem to hold true given the funding crisis³. Given the vast deficiencies and lack of funds flowing through to educational facilities in the past, there appears to be a flow-through problem, which is littered with inefficiencies and agency costs along the path back to the institution from the fiscus.

Thus if leaving educational services as an exempt good, can be seem to be equitable but perhaps inefficient, and changing it to a zero rated goods can be seen as more efficient, but perhaps less equitable, then there is only one option left. Perhaps a solution can be found in making educational series a standard rated supply and levying VAT on it.

1 Verger, A., Novelli, M. & Altiyelken, H. K., 2018. Global education policy and international development: New agendas, issues and policies.. 2nd ed. s.l.:Bloomsbury Publishing.

2 The Tax Policy Center, 2018. The Tax Policy Centre's Breifing Book. [Online]
Available at: <https://www.taxpolicycenter.org/briefing-book/what-difference-between-zero-rating-and-exempting-good-vat>

3 Mbiza, M., 2018. The Issues with South Africa's Education System. [Online]
Available at: <https://educonnect.co.za/the-issues-with-south-africas-education-system/>

This possible change would entail the following:

If the exemption found in s12 was to be removed, then educational services would be a standard rated supply. As such any supplies made by an educational institute would attract VAT at 15%, which would be collected and paid over to SARS based on the standard VAT regulations. This would alleviate the need to apportion input VAT claimable, as all of the educational institute's supplies would now be taxable supplies. This would alleviate the administrative burden of the current situation, as there would not need to be allocation of costs to specific outputs¹.

This change would theoretically increase the price of both private and public education by 15%. However, this would certainly not be welcomed by the general public who would be assumed to be calling for the lowering of the costs of education². As such while it may be possible to minimise the impact of the increase of the cost of education through government subsidies or rebates for government funded studies, it would seem that this would add another level of administrative burden as well as negative public reactions which might not outweigh the additional possible benefit.

Taking all of the above considerations into account, it may be conceivable that public education be zero rated and education services provided by private institutions be standard rated. This would enable an increase in input VAT claimable, and an eased administrative burden for public institutions, coupled with the same decrease in administration for private institutions without the implied funding. However, there would be an increase in the VAT revenue from the output levied on the supplies from private institutes. An increase in the cost of private education, with an increase in funding (through a claimable VAT Input) to public institutions would seem to meet the desire of governmental goal for educational growth as perhaps should be considered as a possible approach to moving forward³.

1 Nelson, L., 2016. Value-Added Tax apportionment methodology applied in the higher education sector, Cape Town: University of Cape Town.

2 Luescher, T., Loader, L. & Mugume, T., 2017. #FeesMustFall: An Internet-Age Student Movement in South Africa and the Case of the University of the Free State. *Politikon*, 44(2), pp. 231-245.

3 Boughey, C., 2002. From Equity to Efficiency: Access to higher education in South Africa. *Arts & Humanities in Higher Education* vol 2(1), pp. 65-71.

5.3 The evolving nature of digital educational services

The provision of educational services in the digital space, particularly in the higher education sector has been viewed as the future of learning, with some 95% of educators believing it positively impacts student achievement, and 92% of educators believing it positively impacts teaching effectiveness¹.

In the South African context, many students experience the use of computers or other ICT services for the first time in their 1st year of university². It is also argued that despite this historical deprivation of learning in conjunction with the digital space, education providers in all aspects of education, being primary, secondary and tertiary have increased in their use of computer or technology based teaching.³

In the higher education sphere in South Africa this has mostly taken the form of blended learning (BL)⁴. The most widely accepted basic position is that effective BL environments are a combination of F2F(Face to face) learning with technology-mediated instruction⁵. While challenges have been faced in the South African context⁶, there also exists a number of partially successful implementations such as one at North-West University(NWU)⁷.

1 Schoology, 2017. The Global State of Digital Learning in K-12 Education. s.l.:Schoology.

2 Galpin, V. & Sanders, I., 2007. Perceptions of computer science at a South African university. *Computers and Education*, 49, pp. 1330-1356.

3 Galpin, V. & Sanders, I., 2007. Perceptions of computer science at a South African university. *Computers and Education*, 49, pp. 1330-1356.

4 Du Plessis, L. & Lodewyckx, E., 2007. Crossing the Rubicon in higher education. *South African Journal of Higher Education* Volume 21 Issues 7, p. 842.

5 Graham, M., 2013. Emerging practice and research in blended learning. In: *Handbook of Distance Education*. New York: Routledge, pp. 333-350.

6 Mabusela, M. & Adams, J., 2017. STUDENTS' EXPERIENCE OF E-LEARNING AT A RURAL-UNIVERSITY IN. *Gender & Behaviour* 2017, Volume 15 Issue 4, pp. 10221-10235.

7 Vaughn, N., Reali, A., Stenbom, S. & Jansen van Vuuren, M., 2017. Blended Learning from Design to Evaluation: International Case Studies of Evidence-Based Practice. *Online Learning* vol 21 no 3, pp. 103-114.

The future trend of growth in blended learning combined with the lack of access to traditional higher education in South Africa¹, created a market for, not only the provision of blended learning by established governmental educational institutions, but also for the provision of fully digital educational services provided by privately owned educational services providers.

Perhaps the provider in South African with the most public awareness is GetSmarter, owing to their acquisition by the USA based education group 2U for what is thought to be in the region of \$123 million, and while GetSmarter may be the poster child for a South African based fully digital educational services, there are a number of other providers offering similar services with the historically government run universities also gaining traction with selected universities offering online degrees with limited or no face to face teaching time².

Given the changing nature of the industry and the nature in which services are rendered, the natural question must then be asked if South African taxation laws have evolved and been updated to match the changes within the industry. Specifically, whether the Value-Added Tax Act of 1991 makes provision for the shift towards digital education providers.

5.4 The Split between academic content as a stand-alone product vs. its integral nature as an element of educational services.

The historical method of presentation of educational services, has been a fairly unchanged one for many years³. Teacher or lecturers prepare the academic content, and then present it to the class face-to face or in more recent times perhaps via some form of digital transmission or physical form to provide distance learning as is the case with UNISA in South Africa.

1 Boughey, C., 2002. From Equity to Efficiency: Access to higher education in South Africa. *Arts & Humanities in Higher Education* vol 2(1), pp. 65-71.

2 University of Johannesburg, 2017. UJ's new online degree programmes at forefront of innovation. [Online] Available at: <https://www.timeslive.co.za/news/south-africa/2017-10-10-ujs-new-online-degree-programmes-at-forefront-of-innovation/>

3 Thinyane, H., 2010. Are digital natives a world-wide phenomenon? An investigation into South African first year students' use and experience with technology. *Computers & Education*, pp. 406-414.

The rise of digital learning and the growth in accessibility and speed of internet access, has meant that online learning has increased. With this increase the possibility of positioning one's self as simply the tool for the method of delivery of academic content is now an option. This raises an interesting question;

If one simply facilitates the delivery of educational services, is one providing "educational services" in their own capacity? Part of the same question is that of, "is providing academic content, but not the delivery of that content?" enough to qualify as providing educational services as defined.

What is meant by this is that if party one creates academic content, and then presents it themselves, they are quite clearly providing educational services as defined. However, if two parties were to collaborate and party one was to provide the content and accreditation, while the other, party two, was to provide the delivery of the content, the question must be asked if the supply of content by party one to party two (in order to enable the delivery) is educational services as defined? Secondly, is the supply by party two to the end user a supply of educational services as defined?

As a thought introduction, the idea of the creation of a textbook can be raised. The writing, creation and publication of that book on its own, would certainly not fall within the ambit of being educational services. The author or publisher is not going to be registered under any form of educational act and will therefore not qualify as providing educational services. Thus, when that book is sold to end users, even though it will have educational value it would not be educational services as defined.

Compare this to if the same person, instead of putting that content into a book for the purposes of sale, prepared it for use by their class at a school or university. The content of the material may be identical to a textbook or any other form of media, but as it is provided as a part of a supply by a registered institution, the fees charged (in some part to compensate for the academic content created by the lecturer) would be educational services as defined and therefore would be exempt from output VAT.

It can therefore be seen that the manner in which content is delivered can affect the status of academic material, and that the academic material has no explicit VAT status in and of itself.

Therefore, in the context of a digital education services provider, the question must be asked, if they provide academic content in partnership with an institution who is registered with the appropriate educational acts, is the digital service provider supplying educational services as well?

5.5 Principle vs. Agent

5.5.1 Principle vs. Agent: Introduction to the issue

Given the scenario outlined above with the two parties, one providing the content and the other facilitating the delivery of that content, it is important to go back to the principles found in the VAT act to determine if educational services are being provided.

There would need to be investigation as to whether Party one is actually still the one ultimately providing the services and whether Party two is simply a portion of the value chain by providing the digital delivery. The second possibility is that perhaps Party one allowing the use of the content by Party two is a single transaction, and then Party two subsequently supplying it to the end user a separate transaction.

The issue of whether to account for the process as two separate transactions or as a single one rest with the answer to the question of whether Party two is acting as a principle or an agent in respect of the transaction.

In terms of the VAT Act, when an agent makes a supply of goods or services for and on behalf of its principal with a third party, the supply is deemed to be made by the principal and not by the agent. In this scenario if Party two was to provide the digital delivery of the academic content and they were acting as an agent, it would follow that:

Section 54 would allow party two to issue a tax invoice to the purchaser on behalf of party one for the taxable supply of Party one's educational services, as if it was a supply made by Party two. However, party two is not liable to account for output tax on the sale, as Party two is not the principal in respect of the supply.

Party two must maintain sufficient records and submit the required statement in writing to Party one within 21 days of the end of the calendar month in which the supply took place, so that Party one can correctly account for VAT.

Furthermore, Party two is required to issue a tax invoice to Party one in relation to agency services supplied to Party one.

This would mean that as the supply is deemed to be made by Party one, with Party two only providing a portion of the service, being the digital delivery, the essence of the portion of the service being deemed to be supplied by Party two on Party one's behalf is still educational services and as such should be exempt under the applicable portion of section 12.

The tax invoice issued by Party two to Party one in relation to the agency services being digital presentation of the content would be subject to normal VAT rules based on the registration status of Party two.

If however the relationship between Party one and two was not seen to be an agency relationship, but rather one in which Party two is acting as a principal in their own right, the outcome would look a bit different:

Section 54 would not allow Party two to issue a tax invoice to the purchaser on behalf of Party one for the taxable supply of Party one's educational services, as if it was a supply made by Party two because they would be seen as 2 separate transactions. Party two would be liable to account for output tax on the sale as they are not going to fall into the requirements of section 12, as they are not going to be registered with the relevant educational board. And as such would need to collect VAT on the supply of their services as per regular VAT requirements if they are a VAT vendor.

In this scenario, the supply from Party one to Party two is seen as a separate transaction. Therefore, Party one would issue an invoice to Party two for the transfer or use of the presented content. This would have the possibility of being classified as educational services as Party one would be registered with the required educational boards to enable the exemption of the supply under section 12. As such Party one would not be liable to collect output VAT, and since no VAT was incurred by Party two, they would not be in the position to claim anything in their VAT return as input VAT if applicable.

Deciding if an agency relationship exists or if each party is acting as a principle would depend on the facts and circumstances of the agreement between the parties.

Section 54 however also has a pragmatic element which should be noted for additional information as it relates to documentary evidence: it provides that, where an agent makes a supply on behalf of a principal, the agent may issue the client with a tax invoice as if it had

itself had made that supply and levied output tax (and in which case the principal may not also issue an invoice). This concession is created with practicality in mind. As where a third party deals with an agent, the third party will often be unaware of the principal on whose behalf the agent is acting and documents will typically be issued to that agent, and the client will be expecting to receive documents from the agent; not some unknown party with whom it had not been dealing with in setting up the particular transaction in question. As such Party two would be able to issue invoices in their own name, and still have the transaction exempted as educational services, provided a principal – agent relationship exists.

This position contained in section 54 is merely the statutory confirmation of the common law position as would have existed in terms of the law of agency.¹

5.5.2 Principle vs. Agent – Legal Framework

While the principle of the treatment of agency relationships are covered by section 54, the VAT act makes no provision or gives no specific guidance as to what constitutes an agency relationship. As such one needs to look to precedent and common law principles to determine what form of relationship exists between 2 parties.

"An act of representation," held by Corbett JAA in *Joel Melamed and Hurwitz v Cleveland Estates (Pty) Ltd*²; and in *Joel Melamed and Hurwitz v Vornier Investments (Pty) Ltd*³ "needs to be authorized by the principal. Such authorization is usually contained in a contract." The authorisation of the representative is usually a distinct unilateral act which bounds the agent to carry out a mandate of the principal⁴. This gives the historical context for what constitutes an agency relationship, but in truth simply gives a backbone to the discussion, with many more intricacies needing to be examined to come to a conclusion.

In commercial law, as illustrated by the case *Blower v Van Noorden*⁵ the agent is seen to be "simply and solely the representative of the principal, on whose behalf the agent transacts

1 Roos, T., 2017. VAT CONSEQUENCES WHERE AGENTS ARE INVOLVED, s.l.: T Roos.

2 *Joel Melamed and Hurwitz v Cleveland Estates (Pty) Ltd*

3 *Joel Melamed and Hurwitz v Vornier Investments (Pty) Ltd*

4 De Villiers, J. E. d., Macintosh, J. C. & Knight, D. B., 1956. *The law of agency in South Africa*. Cape Town: Juta & Co.

5 *Blower v Van Noorden* 1909 T.S. 890 at 899

with third parties”. Such transactions are the principal’s transactions. They are to the principal’s benefit or render the principal liable, as the case may be, without any benefit or liability attaching to the agent. The agent acts merely as a conduit to bring about a legal relationship between the principal and the third party and are generally compensated for such services.

5.5.3 Principle vs. Agent – Practical guidance

This guidance above provides a legal framework for identifying an agency relationship though it lacks the practical elements required to decide whether each party is acting as a principle or agent, and as such some considerations could be garnered from the IFRS requirements found in IFRS 15 as an additional level of guidance.

Under IFRS 15 the following indicate that an entity is acting as an agent:

- Another party has primary responsibility for fulfilling the contract or service obligations
 - This would be a matter dependent on the specifics in a contract, but key questions to ask are; Who delivers the majority of the “value” of the product, who requires the greater “man hours” to deliver the service or “which party could continue to offer the service without the presence of the other?”
- The entity has no inventory risk before or after the goods have been ordered, during shipping or on return.
 - Not relevant in the case of educational services as no physical products are being delivered.
- The entity does not have discretion to establish pricing for the other party’s goods or services (i.e., the benefit the entity can receive from those goods or services is limited)
 - In the case presented, if Party two is able to establish pricing for the services offered by Party one this may be an indicator that it is not acting as an agent, but rather as a principle.
- The entity’s consideration is in the form of a commission.
 - This would again depend on the details but consideration on a per student/course basis might be an indicator of an agency relationship, while a lump sum amount may be an indicator of Party two acting as a principle.

- The entity is not exposed to credit risk for the amount receivable in exchange for the goods or services.
 - This would be dependent on the terms of the contract once more, as it would need to be examined whether Party one or two would be liable or exposed to the risk of non-payment.

While not legally binding, these considerations would give rise to some indication whether parties are acting as principles or agents,

6 A case study: Analysis of a Digital Educational Services Provider

6.1 Outlining the case:

Given the issues and uncertainties outlined in the above discussions, it can be seen to be beneficial to analyse the current VAT application in context. Furthermore, given the issues experienced in traditional universities¹, and the shift towards digital learning², it would perhaps be most beneficial to analyse a case and to see the challenges in terms of application which they may face:

This case will assume the following about the party to be examined and will call the digital services provider to be examined, LearningInc, an entirely fictitious company with the following attributes.

- LearningInc is a 100% privately owned, South Africa Limited Liability Company.
- LearningInc, is at all times deemed to be a South African resident for tax purposes, as it was incorporated in South Africa.
- The main focus of LearningInc is to provide online educational services in the form of pre-recorded lectures, webinars, and online learning support in both video and text

¹ Mbiza, M., 2018. *The Issues with South Africa's Education System*. [Online] Available at: <https://educonnect.co.za/the-issues-with-south-africas-education-system/>

² University of Johannesburg, 2017. *UJ's new online degree programmes at forefront of innovation*. [Online] Available at: <https://www.timeslive.co.za/news/south-africa/2017-10-10-ujs-new-online-degree-programmes-at-forefront-of-innovation/>

form. They also provide support services to encourage learners through their courses and admin services related to the courses offered.

- LearningInc offers two forms of courses to students; courses which are created in-house which are usually of a length of 12 months or shorter, and those offered in partnership with institutions which are usually of a length of 12 months or longer.
- The short courses are not accredited with any external educational board, while the longer courses are recognised through the partner institute's registration. These institutes are all registered with the appropriate educational boards in their countries of operation.
- Partner institutions as well as the prospective students are mostly located within South Africa, but foreign partner institutes and students are present.

The above listed characteristics match quite closely the model of a South African Company, GetSmarter. GetSmarter was recently sold to 2U, an America education conglomerate with the aim of taking the South Africa Company global and beyond the current scope of their offerings¹. Some comparisons will be made to the policies followed by GetSmarter. However, this case study focuses on a fictional entity and not GetSmarter.

¹ Howard, C., 2017. *EdTech Giant 2U Acquires GetSmarter For \$103 Million*. [Online] Available at: <https://www.forbes.com/sites/carolinehoward/2017/05/02/edtech-giant-2u-acquires-getsarter-for-103-million/#6bfad3e22bf7>

6.2 The nature of the services offered – Type of Offering:

The nature of the services which can be offered by players in this space can differ from provider to provider, but on a macro level a provider has two options to determine the nature of its services.

1. Provide degrees or programs which are accredited in their own name.
2. Provide degrees or programmes on behalf of another institution. The degrees are then presented by the service provider but are ultimately ratified and conferred by the accrediting institution.

Option 1 provides greater autonomy and ultimately the ability for growth and profit for the company however this is coupled with the administrative requirements of registering with the department of higher education, and well as the other administrative procedures surrounding this registration process.

Option 2 allows a provider to enter the market quicker, and avoid having to create their own content. Instead they can simply deliver the created content. They can for the most part avoid the administrative requirements of registering with the department of higher education, and well as the other administrative procedures surrounding this registration process. This reduces the time and administrative costs associated with providing their services.

For the purposes of this case, LearningInc will offer a combination of both possibilities.

6.3 Registration in terms of Educational Acts

Option 2 presented above provides a much lower administration burden in terms of not having to register programs with the relevant educational boards. However, it does limit the provider to be tied to the courses provided by a partner institute, and they are also bound to the specific negotiated requirement of the partner institute. For the purposes of presenting programmes under Option 2, LearningInc would not register with the appropriate educational board.

For the purposes of the case study, the services provided under Option 1, will not be accredited, but rather offered as short training courses, as LearningInc have decided to not register with the relevant educational boards owing to the duty of compliance related to this.

6.4 Nature of the services offered – choice of partner institutions

For this case it will be assumed that LearningInc will offer courses through partnerships with both South African universities as well as foreign universities. It is assumed that both are registered with the relevant educational boards in their respective countries. It is also assumed that the foreign university has no other presence in South Africa, and as such is not a registered VAT vendor in South Africa.

6.5 The separation of Content and delivery.

For this case it is assumed that with a digital services provider partnering with an institution the services are structured in such a way so that:

The Partner Institute provides academic content, which LearningInc uses to provide digital educational services to students. The partner institutions still ratify and confer any certification upon completion. The services provided by LearningInc are deemed to be services whereby LearningInc is acting as an agent of the respective institution, and charges the institution an amount, either fixed or variable for providing the digital transmission of the academic content.

6.6 Issues of Global expansion of delivery.

For this case it will be assumed that LearningInc will offer courses to both South African students as well as foreign students. It is assumed that South African students are defined as South African tax residents or those that consume the services entirely within South Africa. Foreign students are defined as those that are not South African residents and consume the services entirely outside of South Africa. Situations which contain elements of each of these situations are not being investigated further in this research.

6.7 List of Applicable Cases:

Case 1: A supply of self-created content to a South African Based Student

Case 2: A supply of self-created content to a foreign Based Student

Case 3: A supply of a South African Partner Institutes content to a South African based Student

Case 4: A supply of a South African Partner Institutes content to a foreign based Student

Case 5: A supply of an international Partner Institutes content to a South African based Student.

Case 6: A supply of an international Partner Institutes content to a foreign based Student.

6.8 Applicable monetary assumptions:

- In all circumstance the students are invoiced an amount of R10 000 for receiving any educational services no matter the nature of those services.
- LearningInc has entered into agreement with all partner institutes whereby any proceeds will be shared on a 50%/50% basis between LearningInc and the partner institution.
- LearningInc incurs employment costs of in respect of administration of R2 500, no matter the nature of services offered as well as an additional employment cost of R2 500 if courses are presented without a partner institution.
- LearningInc incurs running expenses of R2 500 no matter the nature of services provided, which are all purchased from VAT vendors and all required documentation re available to enable a claiming of these expense on any VAT return if required.
- All amount are VAT exclusive where indicated and applicable.

6.9 Application of Cases:

Case 1: A supply of self-created content to a South African Based Student

Under this case , the supply of education services would be a standard rated supply which would attract vat at a rate of 15% being $R10\,000 \times 15\% = R1\,500$. This would need to

be withheld by LearningInc and paid over to SARS in accordance with the type of vendor they are registered as. The supply will not qualify for an exemption because LearningInc is not registered with the applicable educational bodies to meet the definition of supplying educational services. There are no cross-border considerations as both parties are South African residents. The costs involved in presenting and creating the courses would be possible to be claimed in respect of claimable administration expenses to the extent that VAT was incurred, $R2500 \times 15\% = R375$ input as the related services are standard rated taxable supplies. The costs incurred in respect of paying for staff, as not considered to be in the furtherance of an enterprise and therefore do not incur VAT, thus no VAT inputs may be claimed on this expense.

Output VAT	1 500
(Input VAT)	(375)
Net Vat Payable	1 125

Case 2: A supply of self-created content to a foreign Based Student

Under this case, the supply of education services would be a zero rated supply which would attract vat at a rate of 0% being $R10\ 000 \times 0\% = R0$. The supply will not qualify for an exemption because LearningInc is not registered with the applicable educational bodies to meet the definition of supplying educational services. However, it is a cross-border transaction with services being exported to a non-resident, resulting in the transaction being zero-rated. The costs involved in presenting and creating the courses would be possible to be claimed in respect of claimable expenses to the extent that VAT was incurred, $R2500 \times 15\% = R375$ input as the related services, while being zero-rated, are still taxable supplies. The costs incurred in respect of paying for staff, as not considered to be in the furtherance of an enterprise and therefore do not incur VAT, thus no VAT inputs may be claimed on this expense.

Output VAT	0
(Input VAT)	(375)
Net Vat Claimable	375

Case 3: A supply of a South African Partner Institutes content to a South African based Student

Under this case, the supply of educational services would be deemed to be provided by the South African partner institute, with LearningInc acting as an agent. Given this, the supply would be educational services as defined as the partner institute would be registered with the appropriate educational board. As such there will be no output VAT levied on the amount charged to students by LearningInc as the supply will be exempt.

With LearningInc acting as an agent they would be entitled to compensation as agreed upon in a contract. This element would be a supply made by LearningInc to the South African Partner Institution and as LearningInc is a VAT vendor and not registered with the appropriate educational board, the supply to the South African Partner Institution would be subject to VAT at a standard Rate of 15%, being $R5\ 000 \times 15\% = R750$. The costs involved in presenting and creating the courses would be possible to be claimed in respect of claimable expenses to the extent that VAT was incurred, $R2500 \times 15\% = R375$ input as the related services are taxable supplies and not exempt. The costs incurred in respect of paying for staff, as not considered to be in the furtherance of an enterprise and therefore do not incur VAT, thus no VAT inputs may be claimed on this expense.

Output VAT	750
(Input VAT)	(375)
Net Vat Payable	375

Case 4: A supply of a South African Partner Institutes content to a foreign based Student

Under this case, the supply of educational services would be deemed to be provided by the South African partner institute, with LearningInc acting as an agent. Given this, the supply would be educational services as defined as the partner institute would be registered with the appropriate educational board. As such there will be no output VAT levied on the amount charged to students by LearningInc as the supply will be exempt. Even though the

supply would be an export of services, the classification of the supply as exempt overrides the classification as a zero rated supply.

With LearningInc acting as an agent they would be entitled to compensation as agreed upon in a contract. This element would be a supply made by LearningInc to the South African Partner Institution and as Learning Inc. is a VAT vendor and not registered with the appropriate educational board, the supply to the South African Partner Institution would be subject to VAT at a standard Rate of 15%, being $R5\ 000 \times 15\% = R750$. The costs involved in presenting and creating the courses would be possible to be claimed in respect of claimable expenses to the extent that VAT was incurred, $R2500 \times 15\% = R375$ input as the related services are taxable supplies and not exempt. The costs incurred in respect of paying for staff, as not considered to be in the furtherance of an enterprise and therefore do not incur VAT, thus no VAT inputs may be claimed on this expense.

Output VAT	750
(Input VAT)	(375)
Net Vat Payable	375

Case 5: A supply of an international Partner Institutes content to a South African based Student.

Under this case, the supply of educational services would be deemed to be provided by The International partner institute, with LearningInc acting as an agent. Given this, the supply would be made by the International partner and as such would not attract VAT as the supply was made by non-resident who would not be registered for VAT. As such there will be no output VAT levied on the amount charged to students by LearningInc as it would be deemed to be made by a non-resident, who is a non-vendor. The definition of electronic services excludes educational services supplied by a foreign supplier who is registered with an educational authority in a foreign country.

With LearningInc acting as an agent they would be entitled to compensation as agreed upon in a contract. This element would be a supply made by LearningInc to the South Foreign partner Institution and as LearningInc is a VAT vendor and not registered with the appropriate educational board, the supply to the Foreign Partner Institution would be subject

to VAT at a standard Rate of 15%, However The supply is made to a Foreign based institution, and the work performed by LearningInc as such would be exported services which are zero rated thus no output VAT is levied on the supply by learning Inc. $R5000 \times 0\% = R0$.

The costs involved in presenting and creating the courses would be possible to be claimed in respect of claimable expenses to the extent that VAT was incurred, $R2500 \times 15\% = R375$ input as the related services are taxable supplier(A zero rated supply is taxable at 0%, thus still a taxable supply). The costs incurred in respect of paying for staff, as not considered to be in the furtherance of an enterprise and therefore do not incur VAT, thus no VAT inputs may be claimed on this expense.

Output VAT	0
(Input VAT)	(375)
Net Vat Claimable	375

Case 6: A supply of an international Partner Institutes content to a foreign based Student.

Under this case, the supply of educational services would be deemed to be provided by The International partner institute, with LearningInc acting as an agent. Given this, the supply would be made by the International partner to an international student as such would not fall into the ambit of South African VAT. As such there will be no output VAT levied on the amount charged to students by LearningInc as it would be deemed to be made by a non-resident, to another non-resident.

With LearningInc acting as an agent they would be entitled to compensation as agreed upon in a contract. This element would be a supply made by LearningInc to the Foreign partner Institution and as LearningInc is a VAT vendor and not registered with the appropriate educational board, the supply to the Foreign Partner Institution would be subject to VAT at a standard Rate of 15%, however The supply is made to a Foreign based

institution, and the work performed by LearningInc as such would be exported services which are zero rated thus no output VAT is levied on the supply by learning Inc. $R5000 \times 0\% = R0$.

The costs involved in presenting and creating the courses would be possible to be claimed in respect of claimable expenses to the extent that VAT was incurred, $R2500 \times 15\% = R375$ input as the related services are taxable supplier (A zero rated supply is taxable at 0%, thus still a taxable supply). The costs incurred in respect of paying for staff, as not considered to be in the furtherance of an enterprise and therefore do not incur VAT, thus no VAT inputs may be claimed on this expense.

Output VAT	0
(Input VAT)	(375)
Net Vat Claimable	375

7. Conclusions

In conclusion it can be seen that this research aimed to undertake the following and concluded that:

- Explaining the role of VAT in the context of both public and private education from a historical, current and forward looking perspective provides guidance and understanding to enable the examination of the role of VAT and educational service from an informed perspective.
- The role of VAT as a funding method for public educational institutes contains difficulties from both an administrative and legislative perspective. Issues of efficiency are at odds with issue of equity as well as funding objectives of the country.
- VAT has an effect on private education institutions which may not be in line with the funding objectives of the country.
- There exists a number of uncertain elements with regards to the provision of services by a digital educational services provider, with the most prevalent being the nature of the content provided as well as whether a party is acting as an agent or as a principal.

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**Foreign Remuneration Earners and section 10(1)(o)(ii): Amendments,
Associated Applications and Applied Analysis**



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Research dissertation/ research paper presented for the approval of Senate in fulfilment of part of the requirements for the in approved courses and a minor dissertation/ research paper. The other part of the requirement for this qualification was the completion of a programme of courses. I hereby declare that I have read and understood the regulations governing the submission of dissertations/ research papers, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation/ research paper conforms to those regulations.

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1. Abstract

After the proposed repeal of s10(1)(o)(ii) on 19 July 2017 by the National Treasury through the release of the Draft Taxation Laws Amendment Bill 2018¹, there has been a subsequent turn around on this front with the repeal being subject to revision² with an amendment, to only be repealed to the extent that remuneration exceeds R1 million per annum as per the Taxation Laws Amendment Act of 2018³. This change will be effective for years of assessments starting from 1 March 2020. There exists a need to explain how this proposed change will affect taxpayers in terms of application as well as the changes to their current taxation position. It is also seen that the change will lead to issues of inequality amongst taxpayers as well as lead to negative consequences from the responses employed to avoid the consequences of the proposed changes.

2. Introduction to s10(1)(o)(ii) in the current context.

2.1 Background

Before 2001, s10(1)(o) of the Income Tax Act only granted an exemption to officers and crew members employed aboard any South African ship, provided they were outside South Africa for more than 183 days during the year of assessment⁴.

Starting from 1 March 2001, South Africa moved to a residence-based tax system for individuals from for the previous source-based system. As a consequence, the scope of s10(1)(o) was extended to include South African tax residents who performed services outside South Africa for longer than 183 days during a 12-month period. This exemption also would

¹ National Treasury. (16 July 2018). *Draft Taxation Laws Amendment Bill 2018*. National Treasury. Retrieved 10 14, 2018, from <http://www.treasury.gov.za/public%20comments/TLAB%20and%20TALAB%202018%20Draft/2018%20Draft%20Taxation%20Laws%20Amendment%20Bill%20-%202016%20July%202018.pdf>

² National Treasury. (16 July 2018). *Explanatory Memorandum on the Taxation Laws Amendment Bill 2018 (Draft)*. National Treasury. Retrieved 10 14, 2018, from <http://www.treasury.gov.za/public%20comments/TLAB%20and%20TALAB%202018%20Draft/2018%20Draft%20Explanatory%20Memorandum%20on%20the%202018%20draft%20TLAB.pdf>

³ National Treasury. (18 December 2017). *Taxation Laws Amendment Act*. National Treasury. Retrieved 10 14, 2018, from <http://www.sars.gov.za/AllDocs/LegalDoclib/AmendActs/LAPD-Laws%20Amendment%20Act%202017%20of%202017%20GG%2041341%202018%20December%202017.pdf>

⁴ Kamdar, M. (2015). SOUTH AFRICANS WORKING ABROAD –. *Tax Professional*(26), 14-17.

only apply if, during the same 12-month period, a person rendered services outside South Africa for a continuous period of at least 60 full days. The exemption in this form was a full exemption and applied to all foreign remuneration earned if the requirements were met. It must also be noted that this exemption was not applicable to those employed by the public sector or those who are holders of public office¹.

A proposed repeal of s10(1)(o)(ii) was announced on 19 July 2017 by the National Treasury through the release of the Draft Taxation Laws Amendment Bill 2017². In this bill, the proposal was to repeal the entirety of s10(1)(o)(ii), being the subsection relating to the full exemption from normal tax for South African tax residents who performed services outside South Africa for longer than 183 days during a 12-month period. The public response to this proposal appeared to be mostly negative with many resorting to public outcries over the proposed repeal³⁴.

By the time the Taxation Laws Amendment Act of 2017 had been completed, the full repeal contained in the draft version had become rather a part-repeal with a monetary condition. Per the Taxation Laws Amendment Act of 2017, as effective for years of assessments starting from 1 March 2020, only remuneration to the extent that remuneration exceeds R1 million, shall not fall into the ambit of s10(1)(o)(ii). In effect this means that it will be possible for a person to exempt the first R1 million of foreign remuneration earned per tax year, but any foreign remuneration which exceeds R1 million will not be entitled to the s10(1)(o)(ii) exemption, even if they meet the requirements therein.

¹ Ensor, L. (2017, July 20). *Plan to scrap tax exemption on income earned outside SA*. Retrieved from Business Day: <https://www.businesslive.co.za/bd/national/2017-07-20-plan-to-scrap-tax-exemption-on-income-earned-outside-sa/>

² National Treasury. (15 december 2017). *Explanatory Memorandum on the Taxation Laws Ammendment Bill 2017*. National Treasury. Retrieved 10 14, 2018, from <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2017-01%20-%20Explanatory%20Memorandum%20on%20the%202017%20Taxation%20Laws%20Amendment%20Bill%2015%20December%202017.pdf>

³ Steenkamp, C. (2018, July 1). *What's new for taxpayers seeking foreign work exemptions and other claims*. Retrieved from Businesslive: <https://www.businesslive.co.za/bt/money/2018-07-01-new-measures-for-taxpayers-who-want-to-claim-tax-exemption-for-income-earned-outside-of-sa/>

⁴ Cordeur, M. I. (2017, September 20). *Why Treasury wants to keep the 183 day rule for expat taxpayers*. Retrieved from Fin24: <https://www.fin24.com/Economy/why-treasury-wants-to-keep-the-183-day-rule-for-expat-taxpayers-20170920>

It should be noted that there are no proposed changes to the requirements in terms of days spent in or out of the Republic¹, or the number of consecutive days spent out of the republic. The monetary limit also only applies in the context of s10(1)(o)(ii) part (aa) and is not applicable for any other sections through the Income Tax act.

The effect of this change affects taxpayers not only in terms of their local taxation liability within South Africa but it also needs to be examined in the context of international taxation and any applicable DTA's which South Africa is a party of. Examination needs to investigate whether the changes are in line with the model tax convention of the OECD², as well as whether the changes are equitable across taxpayers as this is one of the goals of any tax policy.

2.2 Problem Statement

Given the fact that the changes to s10(1)(o)(ii) are only effective 1 March 2020 coupled with the uncertain nature of the implementation of the changes , there exists uncertainty in terms of future application of the section. Furthermore the changes to s10(1)(o)(ii) do not only have effects from the Income tax act but the related effects within the context of the OECD model tax convention as well as DTA's to which South Africa is party, are also of importance to understand, and there is currently limited application guidance. Lastly the monetary threshold for application of R 1 million poses multiple consequences and further investigation is needed in this regard both for tax planning and for tax regulators when promulgating future amendments.

¹ Cordeur, M. I. (2017, September 20). *Why Treasury wants to keep the 183 day rule for expat taxpayers*. Retrieved from Fin24: <https://www.fin24.com/Economy/why-treasury-wants-to-keep-the-183-day-rule-for-expat-taxpayers-20170920>

² OECD. (2018). *About the OECD*. Retrieved from The OECD: <http://www.oecd.org/about/>

2.3 Research Objectives

This study aims to undertake to provide guidance on the following objectives:

- To create knowledge on the history as well as current applicability of s10(1)(o)(ii) within South Africa.
- To examine the changes to s10(1)(o)(ii) within the context of the OECD model tax convention as well as DTA's to which South Africa is party.
- To examine the changes to s10(1)(o)(ii) in comparison to comparable OECD countries
- To examine whether the changes to s10(1)(o)(ii) are of an equitable nature by containing a monetary threshold on applicability.
- To examine possible tax mitigation schemes which might be possible, to circumvent the changes to s10(1)(o)(ii)

2.4 Importance and benefits of this study

The importance of this study is based mainly on the creation of knowledge around the applicability, application and effects of promulgated changes to s10(1)(o)(ii). It also aims to provide possible predicted methods of avoidance surrounding this issue, as well as to highlight concerns in regards to equality of the amendment which will allow both for efficient tax planning as well as for tax regulators to identify any possible areas of unintended tax leakage from the fiscus. Lastly there is a benefit in terms of limited comparison to other tax jurisdictions to allow for comparisons and possible areas of future consideration for tax regulators.

2.5 Definitions of key terms and abbreviations

Term/Abbreviation	Explanation
Article 15	An article of the OECD Model Tax convention which deals with the topic “Income From Employment” ¹ .
Double Tax Agreement	Agreements between two countries tax administrations so as to enable the administrations to eliminate double taxation ² .
Normal Tax	Taxation levied in terms of the Income Tax Act No 58 of 1962 on taxable income as defined
Remuneration	Remuneration means any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered.
SARS	The South African Revenue Services, the tax authority in South Africa.

¹ OECD. (2010). Commentaries of the articles of the model tax convention. In OECD, *Model Tax Convention(Condensed Versions)*. Retrieved 10 14, 2018, from <http://www.oecd.org/berlin/publikationen/43324465.pdf>

² SARS. (2018, February 12). *DOUBLE TAXATION AGREEMENTS (DTAS) & PROTOCOLS*. Retrieved from SARS: <http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/default.aspx>

2.6 Research design and methodology

This research paper is designed as an analysis and critical interpretation of the literature and legislation surrounding the changes made to s10(1)(o)(ii). The outcomes of this investigation will be used to answer questions posed, and to create knowledge around the application of legislation as well as to provide insight through the comparison and critical analysis of this knowledge in the context of both South African tax systems as well as International taxation practices.

2.7 Limitations of this study

This study is only designed to look at selected portions of legislation in depth and certain sections will not be examined with the same level of investigation or explanation. This study is related to certain sections which are still to become effective, thus changes in the legislation before the effective date remains a possibility. This study also only looks at the changes to s10(1)(o)(ii) with reference to a limited number of selected international comparisons and sources.

2.8 Possibilities of future study

This study could be extended to look at all relevant portions of legislation in greater depth and to examine all relevant sections with the same level of investigation or explanation. This study can be reexamined post 1 March 2020 to ascertain how the amendments are enacted and enforced by SARS which would allow for greater reflection on the effectiveness of the changes. Lastly this study can also be extended to look at the changes to s10(1)(o)(ii) with reference to a greater number of international comparisons and sources.

3. Currently enacted legislative position

3.1 An introduction to the application of s10(1)(o)(ii) pre-1 March 2020

The starting point for any analysis of an exemption for normal tax purposes is that of “What is it exempting?” The initial point of analysis thus lies with the definition of Gross Income, found in s1 of the Income Tax Act No 58 of 1962. It states the following;

Gross Income 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 or in favour of such resident; or

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

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

The effect of the above is that for a South African tax resident working in a foreign country, due to subsection (i) of the definition above, any foreign remuneration which they earn will be included in their gross income as defined. An individual who is not a tax resident of South Africa and works in a foreign country, would not have any remuneration falling into the ambit of their South African gross income unless it is of a South African source.

The above definition is a direct result of South Africa moving from a Source-based system of normal taxation to a residence based system of normal taxation on 1 March 2001¹.

Following after the general definition of gross income are a number of specific inclusions in the definition of gross income. These will not be covered in further detail in this research.

Once something has been included in gross income, then the question needs to be asked if there exists any legislation which might exempt that income from normal taxation. These exemptions are found in section 10. s10(1)(o)(ii) is a section which seeks to exempt any form of remuneration which meets the following requirements;

¹ Di John, J. (2006). The political economy of taxation and tax reform in developing countries. *UNU-WIDER*.

s10(1)(o)(ii) Remuneration received by or accrued to any employee during any year of assessment by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument or allowance, including any amount referred to in paragraph (i) of the definition of gross income in section 1 or an amount referred to in section 8, 8B or 8C in respect of services rendered outside the Republic by that employee for or on behalf of any employer, if that employee was outside the Republic—

(aa) for a period or periods exceeding 183 full days in aggregate during any period of 12 months; and

(bb) for a continuous period exceeding 60 full days during that period of 12 months,

and those services were rendered during that period or periods: Provided that—

(A) for purposes of this subparagraph, a person who is in transit through the Republic between two places outside the Republic and who does not formally enter the Republic through a port of entry as contemplated in section 9 (1) of the Immigration Act, 2002 (Act No. 13 of 2002), or at any other place as may be permitted by the Director General of the Department of Home Affairs or the Minister of Home Affairs in terms of that Act, shall be deemed to be outside the Republic;

(B) the provisions of this subparagraph shall not apply in respect of any remuneration derived in respect of the holding of any office or from services rendered for or on behalf of any employer, as contemplated in section 9 (1) (e); and

(C) for the purposes of this subparagraph, where remuneration is received by or accrues to any employee during any year of assessment in respect of services rendered by that employee in more than one year of assessment, the remuneration is deemed to have accrued evenly over the period that those services were rendered;

The overall effect of the above is that if a South African tax resident works in a foreign country and earns remuneration, that remuneration will be exempted from normal tax provided that:

- They are in a foreign country for more than 183 during any 12-month period. This means that any 12 month period can be analysed, it does not need to be a calendar year. For example it may be a period running from March to March or December to December. It is only required that if the exemption is to be applied to remuneration, that remuneration must have been earned in the 12 month period being analysed. This method is sometimes known as a 12-month rolling period.
- They are in a foreign country for a continuous period of more than 60 days during that 12-month period. This requirement is in place to separate those that earn remuneration while residing in a foreign country and those who simply travel outside of South Africa regularly for work. The requirement does not require being in the same foreign jurisdiction for the entire 60 days, simply being outside of South Africa, thus the period may be split across multiple countries. A point of contention as to whether periods spent outside of South Africa for purposes other than employment count towards this requirement will be discussed in further detail in a later section¹.
- Any foreign remuneration must have been earned while they were in a foreign country and not while in South Africa, meaning that payment for services rendered in South Africa will not be applicable for exemption even if they are paid by a foreign company.
- This exemption does not apply to any employees in the public sector or those who are in public office, for example those who work for government or a state-owned entity of South Africa.

If all of the above requirements are met then any foreign remuneration earned by a South African Tax resident will be exempted under s10(1)(o)(ii) and will not be subject to taxation in South Africa. South African Income tax law has no effect in and of itself on the taxation which may be levied by the foreign jurisdiction on this income however.

¹ SARS. (2018, 10 14). *Interpretation Note: No. 16 (Issue 2)*. Retrieved from SARS: <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-16%20-%20Exemption%20Foreign%20Employment%20Income.pdf>

3.2 The role of the OECD Model Tax Convention (Article 15)

As mentioned before, the fact that any foreign income earned by a South African tax resident may be exempt under s10(1)(o)(ii) does not mean that the income earned is 100% tax free. The foreign country in which it is earned may (and most likely will) also levy taxation on that income. If the foreign jurisdiction had a similar gross income definition to that of South Africa, the foreign country would have the remuneration earned being a portion of that country's Gross Income owing to the fact that it was earned in that foreign country and the associated source of the income being within that foreign country. This raises the key concept of international taxation and the fact that when remuneration is earned there is both a country of source and a country of residence of the earner which may be different and may lead to each having some form of a claim to tax that income. If there was no system to outline which country had the right to tax the income, it would result in much uncertainty. Thus to deal with these instances, countries need to have some method of agreement of taxing rights, or the remuneration earner may be taxed twice, once in each country, resulting in double taxation.

The Organization for Economic Co-operation and Development (OECD)¹ is an intergovernmental economic organisation with 36 member countries, founded in 1961 to stimulate economic progress and world trade. South Africa is not a full member of the OECD but is an Associate in 6 OECD Bodies and Projects, and a Participant in 15. It has also adhered to 19 OECD instruments.

The OECD have created a model tax convention² to act as a guide for countries when dealing with cross border taxation issues, and have given specific guidance in article 15 titled "Income from Employment". The purpose of this article is to outline the desired process between two tax jurisdictions when income is earned from employment. It should be noted that as South Africa is not a full member of the OECD, it is not bound by this tax convention,

¹ OECD. (2018). *About the OECD*. Retrieved from The OECD: <http://www.oecd.org/about/>

² OECD. (2010). Commentaries of the articles of the model tax convention. In OECD, *Model Tax Convention(Condensed Versions)*. Retrieved 10 14, 2018, from <http://www.oecd.org/berlin/publikationen/43324465.pdf>

however South Africa generally uses this convention as a base for their international tax dealings and as a best practice guideline¹.

Article 15

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and

c) the remuneration is not borne by a permanent establishment which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

¹ Pfister, M. (2009). *TAXATION FOR INVESTMENT AND DEVELOPMENT*:. NEPAD-OECD Africa. Retrieved 09 25, 2018, from <http://search.oecd.org/development/investmentfordevelopment/43966821.pdf>

The effect of paragraph one above is that if a South African tax resident works in South Africa, any remuneration earned will only be taxable in South Africa. If they work in any other country, the model tax convention states that remuneration earned while in that other country may be taxed in that other country.

The article does not impose any methods on how a country may tax its own citizens, it only outlines the scenarios in which a country may tax the citizens of another country, and not specifying the nature of how that taxation must be effected either. Effectively it makes provision for when another country may tax a South African tax resident's remuneration, but it does not impose any rules or restrictions on the taxation which South Africa may impose on its own citizen's worldwide income. That decision is at the hands of local revenue authorities.

Paragraph two adds further to this by saying that a South African resident who earns remuneration in another country may only be taxed in South Africa (and not in the other country) if:

- *The recipient is present in the other country for a period less than or equal to 183 days in any twelve-month period during the fiscal year concerned, and*
- *The remuneration is paid by, or on behalf of, an employer who is not a tax resident of the other country, and*
- *The remuneration is not borne by a permanent establishment which the employer has in the other country.*

Requirement one is used as a simply proxy to determine where the majority of a 12-month period is spent, with 183 days being approximately half of the length of a year. If less than half the year is spent in a foreign country then that country will possibly not have the right to tax that remuneration. If more than 183 days are spent in that country then they will have the right to tax that income.

In conjunction with requirement one, requirements two and three deal with the issue of who incurs or bears the remuneration paid to the South African Tax resident. If the remuneration is paid by a tax resident of the foreign country or through a permanent establishment in that foreign country then the foreign country will have the right to tax the remuneration.

3.3 The role of DTA's in respect of foreign employment

Double tax agreements are bilateral (between two countries) agreements which outline which country is entitled to levy taxation on income which may fall into the taxation ambit of either nation¹. South Africa currently has bilateral DTA's with 87 countries² (SARS, 2018).

The model tax convention published by the OECD serves as a guideline for the creation of DTA's between countries, with the DTA's themselves being the legally binding legislation. In these DTA's the two contracting states outline the scenarios and circumstances under which each is entitled to levy taxation on members of the other contracting state.

Once published in the Government Gazette following its approval by Parliament, a double tax agreement (DTA) has the effect of law (s 108(2)). Where there is a conflict between The Income Tax Act and the double tax agreement, the double tax agreement enjoys preference over the Act³.

Below is article 14 (Which outlines the treatment for "Income from Employment") from the DTA between South Africa and the United Kingdom and Northern Ireland.

**Convention between the government of the republic of South Africa and the
government of the United Kingdom of Great Britain and Northern Ireland for the
avoidance of double taxation and the prevention of fiscal evasion with respect to taxes
on income and on capital gains**

Article 14

Income from Employment

¹ Egger, P., Merlo, V., Ruf, M., & Wamser, G. (2015). Consequences of the New UK Tax Exemption System: Evidence from Micro-level Data. *The economic journal : the journal of the British Economic Association.*, Vol.125(589), 1764-1789.

² SARS. (2018, February 12). *DOUBLE TAXATION AGREEMENTS (DTAS) & PROTOCOLS*. Retrieved from SARS: <http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/default.aspx>

³ Stiglingh, P. M., Koekemoer, P., van Heerden, P., Wilcocks, P., de Swardt, R., & van der Zwan, P. (2018). *Silke: South African Income Tax*. LexisNexis.

- 1. Subject to the provisions of Articles 15, 17 and 18 of this Convention, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived there from may be taxed in that other State.*

- 2. Notwithstanding the provisions of paragraph 1 of this Article, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:*
 - (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned, and*
 - (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and*
 - (c) the remuneration is not borne by a permanent establishment which the employer has in the other State.*

- 3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic may be taxed in the Contracting State of which the enterprise operating the ship or aircraft is a resident.*

The effect of paragraph one above is that if a South African tax resident works in South Africa, any remuneration earned will only be taxable in South Africa. If they work in the United Kingdom or Northern Ireland (UK), the DTA states that remuneration earned while in the UK may be taxed in the UK.

The DTA does not impose any methods on how South Africa or the UK own residents, it only outlines the scenarios in which each may tax the residents of the other, and not specifying the nature of how that taxation must be effected either.

Paragraph two adds further to this by saying that a South African resident who earns remuneration the UK may only be taxed in South Africa (and not in the UK) if:

- *The recipient is present in the UK for a period less than or equal to 183 days in any twelve-month period during the fiscal year concerned, and*
- *The remuneration is paid by, or on behalf of, an employer who is not a tax resident of the UK, and*
- *The remuneration is not borne by a permanent establishment which the employer has in the UK.*

Requirement one states that if less than half the year is spent in the UK then they will possibly not have the right to tax that remuneration. If more than 183 days are spent in the UK then they will have the right to tax that income.

In conjunction with requirement one, requirements two and three deal with the issue of who incurs or bears the remuneration paid to the South African Tax resident. If the remuneration is paid by a tax resident of the UK or through a permanent establishment in the UK then they will have the right to tax the remuneration.

It can be seen that the double tax agreement matches in content almost exactly to the OECD model, and this is true for most of South African DTA's¹. The key take away from the above is that given the circumstances in which s10(1)(o)(ii) would apply to a South Africa tax resident, applicable DTA's would provide no actions or effects as the proposed change to s10(1)(o)(ii) and SARS's desire to take residents on foreign source income in within their rights as a tax authority in terms of South Africa's applicable DTA's

3.4 The application of Section 6Quat

Section 6Quat is a section envisioned to account for the situation when foreign source income is included in the table income of a South African resident, and foreign taxes are paid on this amount. If the amount is included in South African taxable income, it would possibly be subject to South African Normal Tax. The effect of s6Quat is to provide relief in South

¹ SARS. (2018, February 12). *DOUBLE TAXATION AGREEMENTS (DTAS) & PROTOCOLS*. Retrieved from SARS: <http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2013-01%20-%20Status%20Overview%20of%20All%20DTAs%20and%20Protocols.pdf>

Africa for this double taxation. The summarised and selected contents of this section are outlined below.

6quat. Rebate or deduction in respect of foreign taxes on income.—(1) Subject to subsection (2), where the taxable income of any resident during a year of assessment includes—

- (a) any income received by or accrued to such resident from any source outside the Republic;

there must be deducted from the normal tax payable in respect of that taxable income a rebate determined in accordance with this section.

(1A) For the purposes of subsection (1), the rebate shall be an amount equal to the sum of any taxes on income proved to be payable to any sphere of government of any country other than the Republic, without any right of recovery by any person (other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment) by—

- (a) such resident in respect of—
 - (i) any income contemplated in subsection (1) (a);

which is so included in that resident's taxable income:

(1B) Notwithstanding the provisions of subsection (1A)—

- (a) the rebate or rebates of any tax proved to be payable as contemplated in subsection (1A), shall not in aggregate exceed an amount which bears to the total normal tax payable the same ratio as the total taxable income attributable to the income, proportional amount, taxable capital gain or amount, as the case may be, which is included as contemplated in subsection (1), bears to the total taxable income: Provided that—

- (i) in determining the amount of the taxable income that is attributable to that income, proportional amount, taxable capital gain or amount, any allowable deductions contemplated in sections 11 (k), 18 and 18A must be deemed to have been incurred proportionately in respect of income derived from sources within and outside the Republic;

- (ii) where the sum of any such taxes proved to be payable (excluding any taxes contemplated in paragraphs (iA) and (iB) of this proviso) exceeds the rebate as so determined (hereinafter referred to as the excess amount), that excess amount may—

- (aa) be carried forward to the immediately succeeding year of assessment and shall be deemed to be a tax on income paid to the government of any other country in that year; and

- (bb) be set off against the amount of any normal tax payable by that resident during that year of assessment in respect of any amount derived from any other country which is included in the taxable income of that resident during that year, as contemplated in subsection (1), after any tax payable to the government of any other country in respect of any amount so included during such year of

assessment which may be deducted in terms of subsections (1) and (1A), has been deducted from the amount of such normal tax payable in respect of such amount so included; and

- (iii) the excess amount shall not be allowed to be carried forward for more than seven years reckoned from the year of assessment when such excess amount was for the first time carried forward;*

(1D) Notwithstanding the provisions of subsection (1C), the deduction of any tax proved to be payable as contemplated in that subsection shall not in aggregate exceed the total taxable income (before taking into account any such deduction) attributable to income which is subject to taxes as contemplated in that subsection, provided that in determining the amount of the taxable income that is attributable to that income, any allowable deductions contemplated in sections 11 (k), 18 and 18A must be deemed to have been incurred proportionately in the ratio that that income bears to total income.

(2) The rebate under subsection (1) and the deduction under subsection (1C) shall not be granted in addition to any relief to which the resident is entitled under any agreement between the governments of the Republic and the said other country for the prevention of or relief from double taxation, but may be granted in substitution for the relief to which the resident would be so entitled.

(4) For the purposes of this section the amount of any foreign tax proved to be payable as contemplated in subsection (1A) or (1C) in respect of any amount which is included in the taxable income of any resident during any year of assessment, shall be translated to the currency of the Republic on the last day of that year of assessment by applying the average exchange rate for that year of assessment.

An explanation of s6Quat is as follows:

Subsection one outlines that this section is applicable when a South African resident has income from a foreign source included in their taxable income. The key word here is *income* which as per the definition means gross income less any exemptions. In this context it would thus only include the portion of foreign remuneration as it exceeds R1 Million, as the first million would be exempted if the requirements are met, and would not form part of *income* as defined because it would be exempted. A rebate is then calculated to be deducted from normal tax payable in respect of that taxable income, determined in accordance with section 1A.

This rebate is equal to the sum of any taxes on income proved to be payable to any sphere of government of any foreign country which are not recoverable. It must be noted that these must be taxes on income and not sales or consumption related taxes. It is also important to note

that the legislation says that the sum of taxes must be in respect of the income as mentioned in section one and does therefore not simply include all foreign taxes paid, only a specific portion.

A further limit on the quantum of this rebate is that it shall not in aggregate exceed an amount calculated as the ratio of total taxable income attributable to the foreign income as included in subsection one to total taxable income as it bears to the total normal tax payable. This means that if foreign source income included is equal to 50% of the total taxable income, the rebate under 6quat would have a limitation equal to 50% of normal South African tax payable. It is important to note that deductions as they relate to retirement funding and donations to PBO's are proportionally split as well in the same ratio of foreign source income to total taxable income.

Should the limit be applicable, the excess amount not allowed as a rebate under 6quat shall be deemed to be a tax incurred in the following year, and used again in the calculation of 6quat as per the above procedure. This carry forward can place for a maximum of seven years.

Subsection two states that the 6quat rebate shall not be granted in addition to any specific relief under any agreement between the governments of the Republic and the said other country for the prevention of or relief from double taxation, i.e. as contained in the DTA, should one exist, but may be granted as a substitute for the relief to which the resident would be so entitled in terms of a DTA. It is not clear if this process is one which may be self-selected and applied or if a more formal application to apply this subsection is needed¹.

Lastly subsection four states that all foreign taxes are translated to Rands at the average exchange rate for the relevant South Africa year of assessment, being 1 March until 28 February for a natural person should not other factors influencing the year exist.

¹ KPMG. (2018, January 26). *South Africa – Foreign Services Exemption Amended*. Retrieved from KPMG: <https://home.kpmg.com/za/en/home/insights/2018/01/flash-alert-2018-020.html>

4. The future enacted position of s10(1)(o)(ii)

4.1 Application of s10(1)(o)(ii) post-1 March 2020

The origin of this legislative change began with the 2017 budget speech delivered by Pravin Gordham¹. He mentioned the desire to make changes to the exemption in order to ensure that it would only apply if the foreign remuneration is subject to tax in the relevant foreign country. The general prevailing feeling here was that the purpose of the exemption was to prevent taxing an amount twice, but in actual fact it now meant that in many cases amounts were simply not being taxed at all, or at least at very low rates in the foreign jurisdictions. This made foreign employment very desirable for South Africans².

On 19 July 2017, the National Treasury released the Draft Taxation Laws Amendment Bill, 2017 for comment from the public. The expected changes were contained therein, with it being perhaps the most controversial element of this draft bill. The proposal was that section 10(1)(o)(ii) be repealed in its entirety. Met with general public outcry, the feeling was that this move would unfairly impact workers who earned moderate levels of remuneration overseas such as teachers and nurses³.

¹ Ensor, L. (2017, September 2017). *Working abroad? Treasury rethinks exemption on foreign earnings*. Retrieved from Sunday Times: <https://www.timeslive.co.za/sunday-times/business/2017-09-15-working-abroad-treasury-rethinks-exemption-on-foreign-earnings/>

² PwC National Tax Technical. (24 July 2017). *Foreign employment income: proposed repeal of exemption in section 10(1)(o)(ii)*. PwC. Retrieved 11 11, 2018

³ Robinson, G. (2017, September 2017). *South Africa's expat tax diluted after pressure pays off*. Retrieved from International Investment: <https://www.internationalinvestment.net/internationalinvestment/news/3505047/south-africa%E2%80%99-expat-tax-diluted-pressure-pays>

After some time and public deliberation¹, the Taxation Laws Amendment Act of 2017 was released and contained the following amendments:

by the substitution in subsection (1)(o)(ii) for the words preceding item (aa) of the following words:

“to the extent to which that remuneration does not exceed one million Rand in respect of a year of assessment and is received by or [accrued] accrues to any employee during any year of assessment by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument or allowance, including any amount referred to in paragraph (i) of the definition of gross income in section 1 or an amount referred to in section 8, 8B or 8C, in respect of services rendered outside the Republic by that employee for or on behalf of any employer, if that employee was outside the Republic—”;

The effect is now that subsection (1)(o)(ii) will no longer be applicable to foreign source income to the extent that it exceeds R1 Million. As such if the other requirements of (1)(o)(ii) are met the first R1 million will be exempt from normal tax, but the excess cannot be, even if the other requirements of the section are met. This means that this portion of income will be included in taxable income, and can result in normal taxation being levied. As the foreign source income will be included in taxable income, s6Quat will now be applicable to foreign remuneration earners as a means of combating double taxation.

4.2 The impact of changes in light of the OECD Model Tax Convention

Firstly it must be noted that as South Africa is not a member of the OECD, there is no requirement that it must comply with any model tax conventions it publishes, however this analysis is simply one of good practice. The key issue at play here is that the model tax convention outlines the guidelines for when another country may tax a South African tax resident's remuneration, but not when South Africa may impose a tax on its own citizens. Therefore any changes to section 10(1)(o)(ii) do not impact the position of South Africa and its application of article 15

¹ Ensor, L. (2017, July 20). *Plan to scrap tax exemption on income earned outside SA*. Retrieved from Business Day: <https://www.businesslive.co.za/bd/national/2017-07-20-plan-to-scrap-tax-exemption-on-income-earned-outside-sa/>

4.3 The impact on existing DTA's in respect of foreign employment

There will be no impact on the existing DTA's which South Africa has entered into owing from the change in (1)(o)(ii). The DTA's outline the times when a foreign jurisdiction may tax a South African resident, as well when South Africa may tax a foreign resident for work performed in South Africa. They do not however have any prescription for how South Africa may tax a South African tax resident, regardless of the source of the income. As such no DTA's will be required to be amended because of this change.

5. Potential areas of concern or consequences

5.1 Implications of being outside of the republic for purposes other than work.

One of the key issues which arise when looking at the implication of s10(1)(o)(ii) is that of whether days spent outside of the republic for purposes other than work are counted toward the 60 or 183 day limits.

A prime example of this is Graeme Smith, a South African Cricketer who famously after the cricket world cup in 2011, did not join the rest of his teammates in returning to South Africa but rather went to Ireland¹. At least part of his reasoning for this was that he was looking to fulfill his requirements of being outside of South Africa for 183 in total during the year and for a continuous period of at least 60 days. The argument here being that s10(1)(o)(ii) makes reference to the fact that any services which are to be exempted need to be rendered during the periods outside the country, but no specific mention is made that services have to be rendered during those periods for them to count as being outside of the republic. This would mean that Graeme Smith's provision was in line with legislation as permissible tax avoidance.

¹ Dachs, P., & Du Plessis, B. (2011, May 1). Retrieved from ENS BUbusiness Update May 2011: <https://www.ensafrica.com/Uploads/News/ENS%20Business%20Update%20--%20May%20pg4.pdf>

SARS however in Interpretation note 16, issued 2 February 2017¹ note that a distinction must be made between a situation where a person is in employment and is actually outside the Republic but is not physically rendering services, and a situation where a person is physically present outside the Republic but is not in employment. They argue that Section 10(1)(o)(ii) clearly links the days test to the person's employment and as such days spent outside the Republic when a person is not in employment do not qualify as days outside the Republic under section 10(1)(o)(ii), and are thus not taken into account in the determination of the 183 days for purposes of the exemption.

Weekends, public holidays, annual leave days, sick leave days and rest periods (as required under the specific terms of a contract of employment) that are spent outside the Republic are taken into account for purposes of calculating the period or periods outside the Republic.

SARS raises the example whereby an employee may be employed on a contract basis and enter into separate employment contracts for each broken period of employment. The time in-between the contracts where the employee is unemployed and where no services are rendered do not qualify under section 10(1)(o)(ii) as days outside the Republic.

This appears to be an area where there may be contention and an incongruity between the guidance issued by SARS and the letter of the legislation, and a possibility exists that a court may find in opposition to the guidance issued by SARS if tested.

In relation to the quantum of 183 days, Kyle Mandy, a Director at PwC said that one of the concerns Treasury had when PwC engaged with them was that the number of days spent outside the country were being manipulated by some individuals in order to take advantage of

¹ SARS. (2018, 10 14). *Interprietion Note: No. 16 (Issue 2)*. Retrieved from SARS: <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-16%20-%20Exemption%20Foreign%20Employment%20Income.pdf>

the exemption. This was publically evidenced by the Graeme Smith Incident a few years ago, but it is believed that the practice is very prevalent¹.

"All that is required is that the person is outside the country for the required number of days in which case any foreign services remuneration will qualify for the exemption. "Staying out of the country for 183 days is relatively easy to manipulate where an individual is out of the country for an extended period of time," he said. As a proposed solution to this, Mandy suggested increasing the limit to 325 day per 12 month period.

Chris Axelson, director of personal income taxes and saving at National Treasury, responded by stating that increasing the days to 325 would impact expats that earned lower incomes². In defense of keeping the 183 day requirement Axelson stated "Under the 325 day proposal, if there were teachers, nurses, security guards or others on lower incomes who worked on contracts overseas for less than 325 days, they would be significantly impacted as the R1m threshold would not apply to them.

5.2 Marginal vs Average Rate- Which to use

When looking at the requirements of s6Quat the following emerges:

Using the relevant elements of 6Quat; The rebate shall be an amount *equal to the sum of any taxes on income* proved to be payable to any sphere of government of any country other than the Republic by such resident *in respect of any income received by or accrued to* such resident from any source outside the Republic.

¹ Cordeur, M. I. (2017, September 20). *Why Treasury wants to keep the 183 day rule for expat taxpayers*. Retrieved from Fin24: <https://www.fin24.com/Economy/why-treasury-wants-to-keep-the-183-day-rule-for-expat-taxpayers-20170920>

² Steenkamp, C. (2018, July 1). *What's new for taxpayers seeking foreign work exemptions and other claims*. Retrieved from Businesslive: <https://www.businesslive.co.za/bt/money/2018-07-01-new-measures-for-taxpayers-who-want-to-claim-tax-exemption-for-income-earned-outside-of-sa/>

The issue then arises when looking at the portion of Foreign remuneration which is included in income, i.e. the portion above R1 million, how does one determine the taxes associated with that income incurred in a foreign state?

Given an example based on assumption of the equivalent of R2 million earned during the tax year in the United Kingdom with an average exchange rate of 1\$/R15 for the year, there exists two possible options.

Average Method:

In this method the total taxation paid on all income is taken, and attributed based on the % of income which is to be included in South African income as defined vs. the total foreign income in the applicable country. This method would result in lower values for 6quat being obtained in a progressive tax system, higher values in a regressive system and equal results being obtained in a flat tax system when compared to the marginal method¹.

$$\begin{aligned} \text{Value of 6Quat} &= \frac{\text{Total Foreign Taxable Income} - \text{R1 Million}}{\text{Total Foreign Taxable Income}} \times \text{Total Foreign Income Tax} \\ \text{Value of 6Quat} &= \frac{\text{R2 000 000} - \text{R1 000 000}}{\text{R2 000 000}} \times 686475 = \text{R343 238} \end{aligned}$$

Marginal Method:

This method uses the marginal tax being levied on the amount as it exceeds R1million as the correct approach, being the difference between the tax on the total foreign income less the tax on the first R1 Million worth of Foreign Income. This method would result in higher values for 6quat being obtained in a progressive tax system, lower values in a regressive system and equal results being obtained in a flat tax system when compared to the average method.

$$\text{Value of 6Quat} = \text{Total Foreign Income taxes on R2 Million} - \text{Total Foreign Income taxes on R1 Million}$$

$$\text{Value of 6Quat} = \text{R686 475} - \text{R279 240} = \text{R407 235}$$

¹ Smartasset.com. (2018, December 23). *Smartasset.com Income-taxes*. Retrieved from Smartasset.com: <https://smartasset.com/taxes/income-taxes>

It can therefore be seen that the marginal rate would yield a large answer for s6Quat and would be the preferable method to use until further guidance by SARS on the appropriate method is issued.

5.3 Administrative considerations

Other potential negative consequences for Richard are related to administration and the effect which it can have on the efficiency and certainty of tax collection in South Africa

As a large overarching theme anyone who earns income other than remuneration, i.e. rental income from a South Africa property is required to register as a provisional tax payer in South Africa, subject to certain exceptions. As such at least twice a year they will be required to submit documentation and possible payments to SARS. Under the old s10(1)(o)(ii) remuneration earned in a foreign country would be fully exempt and as such would not affect provisional tax payments. Under the new dispensation s10(1)(o)(ii) will only partially exempt foreign source remuneration, and as such, there would need to be a possible pre-payment of taxation in South Africa.

Linked to this additional burden are the following considerations;

Foreign exchange calculations will now need to be done at each provisional tax payment. South African exchange rate fluctuations over the past decade have been glaring. For the rand/US dollar it was 106%, rand/euro 61%, rand/British pound 33% and rand/Emirati dirham 106%¹, meaning that there is an additional level of uncertainty about the potential tax position at each reporting date.

The calculation of s6Quat will need to be calculated for each provisional tax payment requiring proof of foreign taxes paid will need to be furnished to SARS with each payment if required, and obtaining these may be burdensome owing to the mismatch between South Africa's year of Assessment ending on 28 February each year, and the USA's ending on 31 December each year. Additionally there is no clear documentary requirements as to what will be sufficient as proof of having paid these taxes in the foreign country, as some countries have

¹ Visser, A. (2018, December 5). *Industry pleas for dialogue on capped foreign income exemption*. Retrieved from Moneyweb: <https://www.moneyweb.co.za/moneyweb-opinion/columnists/industry-pleas-for-dialogue-on-capped-foreign-income-exemption/>

self-imposed taxes, or do not provide documentary evidence at the same dates as required by South Africa tax authorities¹.

Many people who work overseas are not aware of the provisions of international tax law in South Africa, and would thus now be required to engage with a South African tax practitioner, possibly while not being present in South Africa at all, which will be an administrative burden and have financial consequences as well.

Another considerable flaw in the limitation on tax-free foreign income is the fact that it is expressed in rand terms, while foreign remunerations earners income is expressed in a local currency. This creates a mismatch which requires constant use of exchange rates to gauge the tax position making the tax position of the remuneration earner subject to uncertainty.

6. An analysis of the equitability of the proposed changes to s10(1)(o)(ii)

While the proposed changes to s10(1)(o)(ii) being that of wanting to tax South African tax resident currently not paying or paying very little tax, is one which make sense, it does come with some consequences owing to its current form of implementation. Some of the larger concerns raised by stakeholders include the following with several submitted proposals for the 2019 legislative cycle².

Perhaps the largest concern in relation to which industry bodies including The South African Institute for Tax Professionals (SAIT), Tax Consulting South Africa, the Expatriate Petition Group (EPG) and the South African Rewards Association (Sara) are asking relates to the R1 million cap which they argue is arbitrary and also exclude benefits such as housing, schooling or hardship allowances or, which are “a necessity” in some countries.

¹ Visser, A. (2018, December 5). *Industry pleas for dialogue on capped foreign income exemption*. Retrieved from Moneyweb: <https://www.moneyweb.co.za/moneyweb-opinion/columnists/industry-pleas-for-dialogue-on-capped-foreign-income-exemption/>

² Visser, A. (2018, December 5). *Industry pleas for dialogue on capped foreign income exemption*. Retrieved from Moneyweb: <https://www.moneyweb.co.za/moneyweb-opinion/columnists/industry-pleas-for-dialogue-on-capped-foreign-income-exemption/>

The EPG's approximately 20 000 members were polled and it was found that around 30% of those surveyed worked in the United Arab Emirates; half are obligated to pay income tax with the average marginal rate being 15%. It also found that on average 26% foreign income consisted of benefits and allowances such as medical aid, housing, school fees, and security or hardship subsidies. More than 70% of respondents confirmed that they would be subject to the proposed changes as their foreign remuneration would exceed the R1 million threshold when converted to Rands¹.

SAIT proposed that employer-provided accommodation be excluded from remuneration which would be in line with many other countries such as the USA which has both a salary and a separate housing exemption on its foreign remuneration exemption.

The key element of these concerns is that of equality. The 4 maxims raised by Adam Smith in *Wealth of Nations* of a what is generally regarded as the optimal tax system are one which is equitable, certain, convenient and efficient². When looking at the term equitable, it is generally defined as something which is fair or impartial³. The concern with the equitability of the proposed change is that it imposes an arbitrary monetary amount without taking into context what each jurisdiction is providing in exchange for their taxation collection.

As an example, the thinking behind the proposed changes was that those living in low or no tax jurisdictions should be subject to tax in South Africa, while those in relatively higher tax jurisdictions, should not be subject to the tax on foreign remuneration in South Africa as they have already paid tax elsewhere. The concern here is that in generally the higher the tax rate imposed by a jurisdiction, the greater the governmental services rendered to those within that jurisdiction. As such by paying the higher tax the taxpayer is receiving a greater benefit. Those in lower tax jurisdictions often received fewer governmental services and benefits. The problem here is that by paying higher tax rates, remuneration earners receive benefits in the

¹ Visser, A. (2018, December 5). *Industry pleas for dialogue on capped foreign income exemption*. Retrieved from Moneyweb: <https://www.moneyweb.co.za/moneyweb-opinion/columnists/industry-pleas-for-dialogue-on-capped-foreign-income-exemption/>

² Shay, S. E., Fleming, J. C., & J., R. (2015). *Designing a 21st Century Corporate Tax - An. Tax Rev*, 669(17th).

³ English Oxford Living Dictionaries. (2018, December 22). *English Oxford Living Dictionaries - Equitable*. Retrieved from English Oxford Living Dictionaries: <https://en.oxforddictionaries.com/definition/equitable>

form of services and also a larger tax rebate in South Africa, while those in lower rate jurisdictions receive fewer governmental services but also are penalized with having to now pay tax in South Africa as well. The benefits which they often receive as part of their remuneration package such as schooling for families or housing will now attract tax in South Africa, whereas in a country where those services are supplied as part of the taxation funded governmental services will be entitled to a large South African tax rebate, despite the taxpayer being in the same overall position in terms of services received. Additionally countries with lower income tax rates, often have higher consumption based taxes such as VAT or sales tax in place, which would further prejudice the taxpayer in the lower relative income tax levying state.

There is no absolute method to alleviate this issue as every tax jurisdiction is unique, however a separate cap or exemption for certain services such as housing schooling, retirement funding as well as hardship or danger allowances may be way forward to bring a larger level of equity to the promulgated changes.

7. Possible responses to mitigate the effect of the changes to s10(1)(o)(ii)

If a taxpayer is earning remuneration in a foreign country which charges a comparative tax rate to South Africa, and they have no other South African source income, the effect of this change can be seen to be minimal due to the relief offered under s6Quat, however persons in the situation whereby they currently pay no tax on earnings, such as South African pilots who take up employment abroad often have no foreign tax liability on their foreign earnings. Even though they qualify as South African tax residents who are taxable on a worldwide basis, they also qualify for the exemption in SA. So effectively, they receive that income tax free¹. Additionally those that work in areas such as Dubai where they tax rates are comparatively lower, may soon consider switching their tax residency.

While the concept of residency is not discussed in detail in this paper, the change of ordinary residence could be changed to the required foreign country, and given that the taxpayer already spends more than 183 days outside of South Africa it appears likely that they

¹ Lamula, T. (2018, January 25). *SA expats: glory days over by 2020*. Retrieved from 1/1 Private Collection Sanlam: <https://1of1privatecollection.co.za/fiduciaryandtax/sa-expats-glory-days-over-by-2020/>

could ensure that they do not meet the requirements of the physical presence test for residency imposed by South Africa as well¹.

If a taxpayer was to switch tax residency status to a foreign country it would have no effect on their citizenship or rights to hold a passport, but upon switching away from a South African tax residency there is an “Exit charge” imposed by SARS whereby they deem the SA tax resident to have disposed of his assets at market value on the day immediately before the day on which he ceases to be tax resident. There are, however, a number of exclusions to the exit charge, for example, immovable property which is located in South Africa is excluded from this charge².

Any person looking at this approach would need to weigh up the benefits of not paying additional income tax on foreign remuneration in South Africa versus the possible capital gains tax payable on upon exit of South African Tax residency.

¹ Tarrant, G. (2017, August 1). *Taxing expats on foreign income. What you need to know*. Retrieved from The South African: <https://www.thesouthafrican.com/taxing-expats-on-foreign-income-what-you-need-to-know/>

² Smith, C. (2017, August 7). *Think twice before becoming non-SA tax resident to avoid double tax - expert*. Retrieved from Fin24: <https://www.fin24.com/Economy/think-twice-before-becoming-non-sa-tax-resident-to-avoid-double-tax-expert-20170807-2>

8 An illustrative application of the effect of the legislative change to s10(1)(o)(ii)

8.1 The facts:

As a means of examination and application guidance in respect of the proposed changes a sample case of Richard shall be used:

- Richard is a 34 year old South African Tax resident
- Richard has been working in New York, USA for the previous 5 years as an audit manager at a “Big 4” audit firm
- Richard spends the majority of his time in the USA and only visits friends and family in South Africa over December and January.
- Richard earns remuneration of \$100 000 per annum.
- He owns and rents an apartment in South Africa which receives net rentals of R 240 000 per year.
- An average exchange rate for the year of R15/1\$ is assumed.
- Richard would pay Income Tax in the USA as follows based on him living in New York¹:

Tax Type	Marginal Tax Rate	Effective Tax Rate	2018 Taxes
Federal	24.00%	15.41%	\$15,410
FICA	7.65%	7.65%	\$7,650
State	6.57%	5.54%	\$5,538
Local	3.88%	3.44%	\$3,441
Total Income Taxes	42.1%	32.04%	\$32,039

¹ Smartasset.com. (2018, December 23). *Smartasset.com Income-taxes*. Retrieved from Smartasset.com: <https://smartasset.com/taxes/income-taxes>

8.2 Currently enacted position.

Based on the position of s10(1)(o)(ii) being effective Richard would have the following tax position in South Africa.

- As Richard spends the majority of his time in the USA and only visits friends and family in South Africa over December and January he would be in the USA for a period exceeding 183 days per 12 Month Period, and would also be outside of the republic for a continuous period of 60 days, thus the exemption of s10(1)(o)(ii) will fully exempt the remuneration he earns while in the USA.
- The remuneration earned in the USA will be taxed in the USA as per the applicable DTA's as well as article 14 of the OECD model tax convention(as guidance only) provide that based on the days outside of South Africa, the United States will have rights to tax the remuneration. The taxation paid of \$24 107 is outlined above.
- His Income earned in South Africa in the form of net rentals from the apartment will be taxed in South Africa as he is a South African tax resident, and thus his worldwide income is included in his gross income, with no applicable exemptions present.
- The USA operates on a residency based system for USA tax residents, but as Richard is a South African tax resident, and the rental income is from a Source within the republic, the net rental will not be taxable in the USA.
- His south African Normal tax calculation will thus appear as follows:

Taxable Income of Richard for the year ended 28 February 2018	
Gross Income	1 740 000
Remuneration from the USA	1 500 000
Net rentals from Apartment	240 000
Exempt income	(1 500 000)
s10(1)(o)(ii)	(1 500 000)
Taxable Income	240 000
Tax as per the tables	47 209
Less primary Rebate	(13 635)
South African Normal Tax payable	33 574

Total Income Taxation for Richard for the year of Assessment ended 28 February 2018	
USA Taxation Paid (\$32 039 x R15)	480 585
RSA taxation Paid	33 574
Total	514 159

8.3 Future enacted position.

Based on the position of s10(1)(o)(ii) as it would be effective from 1 march 2020 but using current taxation figures Richards position would be as follows

- As he spends the majority of his time in the USA and only visits friends and family in South Africa over December and January he would be in the USA for a period exceeding 183 days, and would also be outside of the republic for a continuous period of 60 days, thus the exemption of s10(1)(o)(ii) will exempt the remuneration he earns while in the USA to the extent of R1 million. The remaining remuneration will form part of Richards South African taxable income.
- As there is foreign source income included in his South African Taxable income s6Quat will come into effect. The total foreign taxes of \$32 039 will be

translated at the average exchange rate as per the last day of the tax year which is assumed to be R15/\$1 giving a 6quat rebate of R480 505.

- The rebate however though, can only be comprised of taxes imposed on remuneration which was income in South Africa. Thus as only R500 000 of the total R1 500 000 earned in the USA was included in South Africa, it follows that the total to be used for the rebate can be approximated as $R480\ 505 \times 500\ 000 / 1\ 500\ 000 = R\ 160\ 168$ if the average taxation was used.
- If the marginal tax rate was to be used the difference in tax payable between the first third 2 thirds of his income and the final third would translate as the marginal increase in tax based on the amount included in South African income as defined. Tax on the first third approximates to R282 915 while tax on the total amounts to R480 505.¹ This results in the difference of R 197 590 to be used for the 6Quat rebate.
- This rebate however cannot exceed the limit of R139 734 ($206\ 806 \times 500\ 000 / 740\ 000$) being the ratio of foreign source income included in South African taxable income in comparison to non-foreign source income as it bears to tax payable.
- The excess of R20 434 based on average or R57 856 based on marginal can be carried forward to future years as per s6Quat (1B)(ii). In the next year of assessment the excess amount will be deemed to be a tax on income paid to the government of a foreign country and it may be set off against the amount of normal tax payable by Richard in the next year of assessment on any amounts from any foreign income which is included in the Richards taxable income during the next of assessment.
- If the excess amount is to be deducted by Richard it is only after the deduction of the current rebate attributable to the foreign taxable in the next of assessment is calculated and deducted, with the excess amount not being able to be carried forward for more than seven years calculated from the year of assessment when it was for the first time carried forward.

¹ Smartasset.com. (2018, December 23). *Smartasset.com Income-taxes*. Retrieved from Smartasset.com: <https://smartasset.com/taxes/income-taxes>

- His Income earned in South Africa in the form of net rentals from the apartment will be taxed in South Africa as he is a South African tax resident, and thus his worldwide income is included in his gross income, with no applicable exemptions present.
- The USA operates on a residency based system for USA tax residents, but as Richard is a South African tax resident, and the rental income is from a Source within the republic, the net rental will not be taxable in the USA.
- His south African Normal tax calculation will thus appear as follows:

Taxable Income of Richard for the year ended 28 February 2018	
Gross Income	1 740 000
Remuneration from the USA	1 500 000
Net rentals from Apartment	240 000
Exempt income	(1 000 000)
s10(1)(o)(ii)	(1 000 000)
Taxable Income	740 000
Tax as per the tables	220 441
Less primary Rebate	(13 635)
S6Quat Rebate	(139 734)
South African Normal Tax payable	67 072

Total Income Taxation for Richard for the year of Assessment ended 28 February 2018	
USA Taxation Paid (\$32 039 x R15)	480 505
RSA taxation Paid	67 072
Total	547 577

8.4 Effect of proposed changes for Richard

The most obvious effect is that Richard is liable for more taxation overall, owing to the increase in South African income tax of R 33 418. This increase is due to the fact that the limit imposed on a 6Quat rebate by subsection (1A) is based on the differential between the effective tax rate of South African Source Income, in this case calculated as $240\,000/740\,000 \times 206806 = 67\,072 / 240\,000 = 27,9\%$. The calculated effective tax rate on the USA source income using the average rate is $500\,000/740\,000 \times 206806 = 139\,734/ 500\,000 = 27,9\%$. When Compared to the effected tax rate of the USA being 32,04¹%, this accounts for the fact that s6Quat will not provide a full rebate to bring the tax paid in line to the treatment when s10(1)(o)(ii) provides a full exemption. In fact even if a rate of 100% tax was paid in the foreign country, there would still be a larger tax burden in South Africa due to the changes in Legislation, meaning that the proposed changes to legislation will have a negative impact on those who pay tax in high rate jurisdictions, not only those in no or low rate jurisdictions.

It can therefore be seen that the desired effect of wanting to achieve avoid SA tax residents working overseas and paying no or little tax, will also have an additional tax burden on those that pay tax in higher taxed countries, even if that was not the desired effect.

The ability to carry the excess forward does have a monetary benefit, however that benefit is depended on there being future foreign source income, and if the existing country of earning the foreign source income and their tax rates do not change there will be no opportunity to apply this excess. Additionally if the excess can be applied, it would be at a later date, meaning the face value of the rebate would be worth less due to both the time elapsed and possible foreign exchange fluctuations. There would also be a negative effect on cash flow, as more tax is payable in year 1, with the benefit associated with the excess only claimable in a future tax period.

¹ Smartasset.com. (2018, December 23). *Smartasset.com Income-taxes*. Retrieved from Smartasset.com: <https://smartasset.com/taxes/income-taxes>

9. Conclusion

It can be seen that after the proposed repeal of s10(1)(o)(ii)¹ and the subsequent turn around to an amendment to only be repealed to the extent that remuneration exceeds R1 million per annum² come with issues of increased tax burdens for those at which the legislation was not aimed, a large administrative burden and the possibilities of weakening the overall South African tax base through residency shifting. The proposal, while only effective 1 March 2020 will need a larger amount of application guidance to address the concerns over documentary requirements as well as the numerical approach to determent the applicability of section 6Quat.

¹ National Treasury. (16 July 2018). *Draft Taxation Laws Ammendment Bill 2018*. National Tresury. Retrieved 10 14, 2018, from <http://www.treasury.gov.za/public%20comments/TLAB%20and%20TALAB%202018%20Draft/2018%20Draft%20Taxation%20Laws%20Amendment%20Bill%20-%2016%20July%202018.pdf>

² National Treasury. (18 December 2017). *Taxation Laws Ammendment Act*. National Treasury. Retrieved 10 14, 2018, from <http://www.sars.gov.za/AllDocs/LegalDoclib/AmendActs/LAPD-Laws%20Amendment%20Act%2017%20of%202017%20GG%2041341%2018%20December%202017.pdf>

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