

Determining Income Tax

The Reduction Formula

Points for Discussion

- Introduction
- Gross Income
- Exemptions
- Deductions
- General Deduction Formula (Application)

Income Tax vs VAT

Income Tax

- Tax levied on Taxable Income of Person
- Tax only payable if Taxable Income exists
- Calculated annually
- Levied on basis of:
 - The more you earn, the more you pay
Sliding scale (e.g. Natural Person & Special Trust)
 - Fixed percentage (e.g. Companies)

Income Tax vs VAT

VAT (Value-Added Tax)

- Tax on consumption
- VAT is a tax on the value a VAT Vendor adds to goods sold and services rendered
- VAT Vendor collects VAT on behalf of SARS
- Separate registration from Income Tax
- Currently levied at 14%

Reduction Formula

General path followed when determining amount on which tax is to be calculated

Gross Income

Less: Exempt Income

Income

Less: Allowable Deductions

Add: Taxable Capital Gains

Taxable Income

Gross Income

- Year of Assessment
- Total Amount
- In Cash or Otherwise
- Received By or Accrued To
- From anywhere if SA Resident
- From a South African source if not SA Resident
- Other than receipts or accruals of a Capital Nature

Year of Assessment

Year of Assessment

- Period over which tax is calculated

Natural Person

- 1 March to last day of February next calendar year

Companies and Close Corporations

- A 12 month period aligned with financial reports

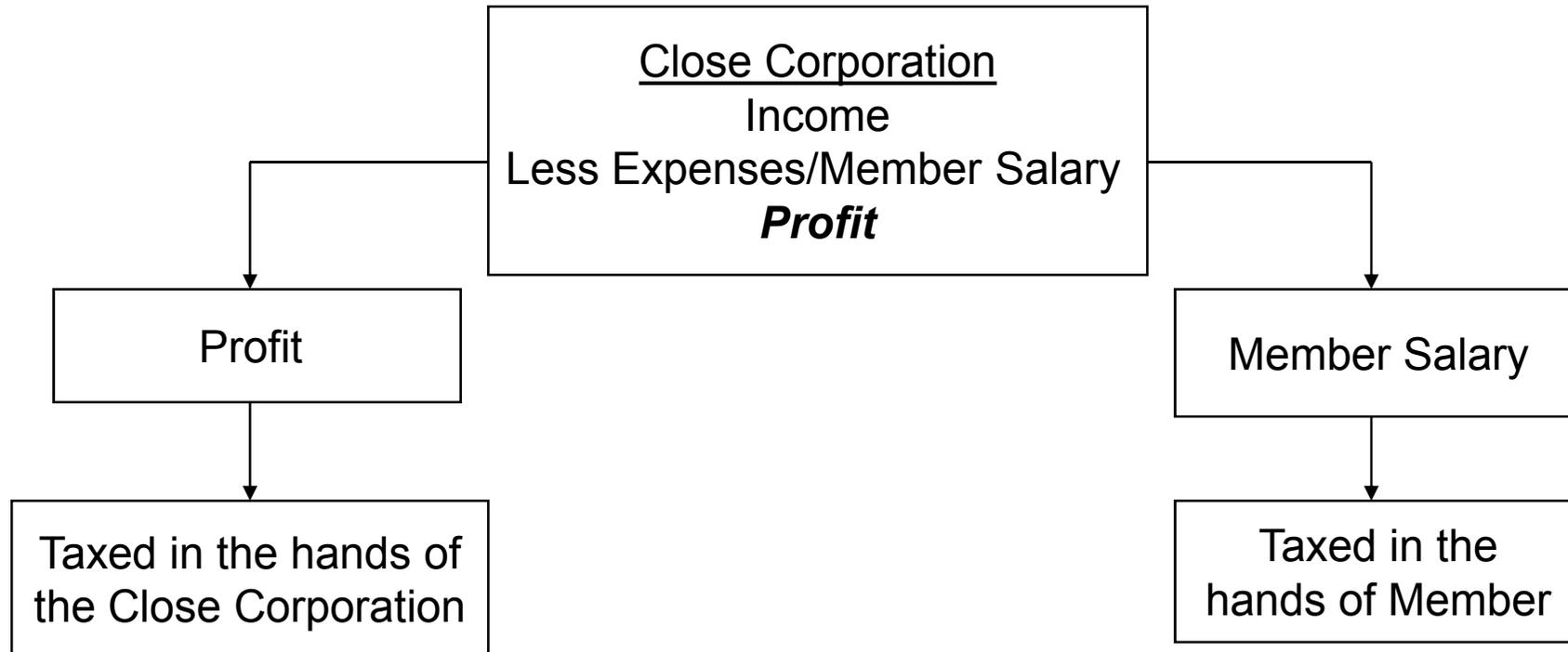
Person

- For purposes of the Income Tax Act **“person”** includes the following:
 - Natural person
 - Companies (including Close Corporations)
 - Company in liquidation
 - Trusts*
 - Deceased estates*
 - Estate of an insolvent person*

* Added after court rulings that they were not subject to tax as they were not persons

Person

Close Corporation vs Natural person



Total Amount

Refers to

- Money
 - Cash receipts
- Value
 - Determined cash value
- Any other currency to be converted into South African currency

In Cash or Otherwise

Two basic principles apply

- In cash
 - Monetary amount received or accrued
- Otherwise
 - Receipts or accruals can be in any form other than money
 - Amount determined at market value or value specified in Act

In Cash or Otherwise

Example

- Ms Y is working for a fixed salary at Sally X Curtains as a Line Manager
- During the tax year, she devised a system that not only saved the company money, but also improved production, without too much interruption
- The company's management decided to reward her by sending her on an all expenses paid vacation

➤ Question: What will be included in Ms Y's Gross Income?

In Cash or Otherwise

Cruise ticket for Ms Y	R 4 000
Cruise ticket for husband	R 4 000
Holiday accommodation	R 12 000
Spending money	<u>R 10 000</u>
Total value of vacation	R 30 000
Annual salary	<u>R120 000</u>
Gross Income	<u>R150 000</u>

Received by or Accrued to

Income is included in Gross Income at the earliest of:

– **Date of receipt**

- Amount actually received
- For the benefit of that person

– **Date of accrual**

- Became entitled to
- Not necessarily received

Received by or Accrued to

Example: Doctor's Payments

Patient	Visit Date	Payment Method	Payment Date	Gross Income
Patient 1	16/02/11	Cash	16/02/11	2011
Patient 2	16/02/11	Cheque	15/03/11	2011
Patient 3	16/02/11	Medical Scheme	31/03/11	2011

Resident

Natural Person

Ordinarily Resident in SA

OR

Physical Presence Test

Other than Natural Person (e.g. a Company)

- Established, Incorporated or Formed in SA
- Effective Management in SA

Resident

Ordinarily Resident

“Ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings...” Cohen v CIR (13 SATC 362)

Physical Presence Test

Present in SA for:

- 91 days in total in SA each year in the current year and each of the previous five years
- 915 days in total over the previous five years

Resident

Place of Effective Management

“The place of effective management is the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets.” SARS Interpretation Note 6

Resident

Example

- Mr. H is a wild life expert working for the Karoo National Park as a lion specialist.
- During the course of the tax year, Mr H was contracted by the Namibian Government to go to their country for three weeks and help them with their lion project.
- For this job Mr H was paid by the Namibian Government and did not receive any payment for this specific job from the Karoo National Park.

➤ Question: Will the Namibian payment be taxed in South Africa?

Resident

Taxed in South Africa on worldwide income if

1. Ordinarily Resident of SA

- Is SA his permanent home?
- Where will he return to if job is done?
- Is it his intention to return to his permanent home?

2. Physical Presence Test

- Determined by looking at number of days present in SA

Capital

- Capital receipts and accruals are excluded from gross income, so what is capital and what is revenue?
- The classic analogy is that capital is the tree and that revenue is the fruit of the tree. Thus rental from a flat is of a revenue nature but proceeds from the sale of the flat are generally of a capital nature.
- Why “generally of a capital nature”? The flat may have been purchased by an estate agent for resale. If so, the proceeds on sale will also be of a revenue nature.

Capital

- The most important test laid down by the courts is the test of intention. What was the taxpayer's intention when acquiring and holding the asset? If for the purpose of resale in a scheme of profit making, the proceeds are of a revenue nature.
- Some factors to test intention:
 - Nature of the taxpayer's business
 - Frequency of similar transactions
 - Length of time asset was held
 - Circumstances of the realisation

Capital

Example

- Office building rented out for 20 years is sold after receiving an unsolicited offer
- Money invested in interest bearing account

Question:

- Which amounts will be included in Gross Income?

Capital

- **Sale of building**
 - Excluded from Gross Income
 - Capital gain
 - Building used to generate income and not purchased for resale
- **Interest received**
 - Included in Gross Income
 - Generated from capital

Reduction Formula

Gross Income

Less: **Exempt Income**

Income

Less: Allowable Deductions

Taxable Income

Add: Taxable Capital Gains

Exempt Income

- Income, exempt from normal tax
- Could be because of:
 - **Special character**
 - Alimony and maintenance
 - **Special nature of the income**
 - Local dividends
 - **Prevent the income from being taxed twice**
 - Foreign dividends paid out of income taxed in SA

Exempt Income

Example:

- Ms J was married for four years before getting a divorce
- She now works for a fixed salary
- As part of the divorce settlement she is entitled to monthly alimony

➤ Question: What amounts are taxable?

Exempt Income

- **Salary**
 - Included in Gross Income
- **Alimony Payments**
 - Exempted from Gross Income

Reduction Formula

Gross Income

Less: Exempt Income

Income

Less: **Allowable Deductions**

Taxable Income

Add: Taxable Capital Gains

Allowable Deductions

- To determine Taxable Income, you have to deduct all allowable amounts in terms of:
 - **Section 11(a)** which specifies what may be deducted
 - **Section 23(g)** which stipulates what may not be deducted
 - **Sections 11 to 19** cover specific deductions, other prohibitions in section 23

Allowable Deductions

Section 11(a)

- the expenditure and losses
- must be actually incurred
- during the year of assessment
- in the production of income
- not of a capital nature

Section 23 (g)

- Prohibits the deduction of an expense not expended for the purpose of trade

Actually Incurred

- Incurred is not equivalent to paid
- Incurred = Legal obligation to pay
- Obligation should be unconditional
- If obligation has not been met then the expense cannot be claimed

Actually Incurred

Example:

- Goods purchased on credit on 16 February 2011 for R 2 000
- Delivery did not take place immediately
- Payment only due upon delivery

Question:

- When should the expense be claimed?

Actually Incurred

Purchase Date	Delivery Date	Payment Date	Tax Year Claimed?
16/02/2011	18/02/2011	16/02/2011	2011
16/02/2011	28/02/2011	15/03/2011	2011
16/02/2011	15/03/2011	31/03/2011	2012

In Production of Income

- Most important requirement for general deduction to be allowed
- Closely connected to business operation

In Production of Income

Example

- Mr R is a commission agent selling life insurance policies
- He claims the following expenses
 - Telephone
 - Vehicle expenses
 - Clothing account

Question:

- What can be allowed as deductible expenses?

In Production of Income

Only expenses linked to actual generation of income will be allowed

Expense	Linked (Yes/No)	Allowable (Yes/No)
Telephone	YES	YES*
Vehicle	YES	YES*
Clothes	NO	NO

* To the extent not for private use

Not of Capital Nature

- Main tests to determine whether expense was capital or revenue
 - Adds to taxpayer's income-earning structure
 - Once-off expense from which future benefits flow
 - Creates enduring benefit or advantage for the taxpayer

Not of Capital Nature

Example

- Mr W installs two new fridges in his shop
- Claims the installation of the fridges as a deduction

Question: How will this transaction be treated in his business' tax return?

Not of Capital Nature

- The fridges and the installation thereof constitutes a capital expense
- Will not be allowed as a full deduction
- Depreciation on capital assets allowed over a period of time

Reduction Formula

Gross Income	XXXXXX
<u>Less:</u> Capital Income	
<u>Less:</u> Exempt Income	
Income	YYYYYY
<u>Less:</u> Allowable Deductions	
<u>Add:</u> Taxable Capital Gains	
Taxable Income	ZZZZZZ

CALCULATE TAX LIABILITY

Normal Tax Rates

ENTITY	TAX RATE
Companies and Close Corporations	28% Flat Rate
Small Business Corporations	Split Rate
Trusts	
Normal Trust	40% Flat Rate
Special Trust	According to Tax Tables
Natural Person	According to Tax Tables