

REFORMING THE CHARITABLE CONTRIBUTION DEDUCTION :
THE SOUTH AFRICAN PERSPECTIVE

Michael Katz, Esq.
Edward, Nathan & Friedland

1. **Introduction**

- 1.1. The income tax and related fiscal legislation in South Africa dealing with public benefit organisations (“PBO’s”) has recently undergone significant amendment with the introduction of section 30 into the Income Tax Act, No 58 of 1962, as amended.
- 1.2. These reforms have come as part of the general reform of the South African income tax system. Soon after the election of South Africa’s first democratic government in April 1994 the cabinet, under President Nelson Mandela, appointed a Commission of Enquiry To Investigate the Tax Structure of South Africa (“the Tax Commission”).
- 1.3. The Nine Interim Reports submitted to the Government by the Tax Commission have resulted in significant changes to the South African Income Tax structure and system. The Ninth Interim Report dealt exclusively with the fiscal issues affecting non-profit organisations.
- 1.4. It is therefore essential, in order to gain a proper appreciation of the changes that have been effected to the fiscal position of public benefit organisations, that certain principles that have informed the recommendations of the Tax

Commission are briefly explained. Those principles which are relevant in the present context include the following :

- 1.4.1. a material reduction in tax rates, both corporate and personal;
- 1.4.2. a significant broadening of the tax base, to be achieved mainly by the elimination of exemptions and concessions;
- 1.4.3. enhancements in tax administration;
- 1.4.4. reductions in the cost of tax administration and tax compliance.

1.5. Based on these principles it is to be noted that the Tax Commission recommended that a comprehensive evaluation of the tax legislation be undertaken with the objective of eliminating, as far as possible, every exemption and concession from the tax system. In order for an exemption to remain intact there would require satisfactory fulfilment of the following requirements :

- 1.5.1. the cause for which the exemption exists must represent an important policy of government;
- 1.5.2. the tax system must represent the best means of achieving that policy objective;
- 1.5.3. the granting of the exemption must not facilitate tax avoidance or evasion or be susceptible to abuse;
- 1.5.4. the cost of the exemption must be capable of being measured periodically so as to determine whether its continuation is cost effective based on the foregoing principles.

2. Motivation for Beneficial Tax Treatment of PBO's

2.1. In its Ninth Interim Report the Tax Commission argued strongly for the retention of the privileged tax status of NPO's and for the extension of the ambit and reach thereof.

What was the reason for these recommendations against the background of a strong desire by the Tax Commission to broaden the tax base?

2.2. A Sub-Committee of the Tax Commission, strongly representative of the NGO community and which had access to international advice, dealing with these issues had a very powerful influence on the ultimate recommendations. The factors which influenced the Sub-Committee appear hereunder.

2.3. Cognisance was also taken of the extremely difficult financial conditions that are currently being experienced by NPO's, many of which are compelled to seek alternative funding sources and means of generating donation and "earned" income. These circumstances can be attributed not only to prevailing economic conditions, but also to a certain measure of defection by overseas donors who, ironically, are less motivated to support a post-apartheid society than they were in respect of the beleaguered NPO sector prior to South Africa's transition to democracy. These circumstances have exacerbated fiscal anomalies and have sharply focused the restrictive nature of present fiscal legislation with particular reference to so-called "trading income", and other endeavours by NPO's to secure the survival of their operations.

2.4. It is apparent that a great many countries recognise the desirability of supporting NPO's by granting them some degree of preferential tax treatment and donor incentives, although the eligibility criteria, the benefits available, and the fiscal methodology differ in many instances. However, there is a broad consensus in the international community regarding the justification for such beneficial treatment. Factors which are most frequently cited include the following :

2.4.1. NPO's are seen to be a relatively cost-effective means of delivering social and developmental services in a manner which relieves the financial burden which otherwise falls upon the State;

2.4.2. as civil society initiatives, NPO's are seen to promote important values in society, including voluntarism, self-responsibility, and participative democracy; and

2.4.3. in societies such as South Africa where there exist gross disparities of income and wealth, NPO's represent an important mechanism for encouraging philanthropy and promoting greater equity and redistributive policies.

2.5. Ultimately the Tax Commission favoured a relatively generous use of the tax system to support PBO's for two principal reasons :-

2.5.1. PBO's, of which there are approximately 55 000 registered organisations in South Africa, play a pivotal role in underpinning democracy in South Africa. This is vitally important in the context

of a society in transition that is being subjected to stress from a multiplicity of sources. In the absence of strong support from the tax system donor funding has proved to be inadequate for this very important purpose;

2.5.2. secondly, there is a strong recognition that many of contemporary South African society's welfare needs are beyond Government's budget.

3. Problems with the Previous Legislative Framework

3.1. Having determined the need to support NPO's in the tax system the next vexing question was to formulate the precise form that the fiscal assistance was to take within the framework of the tax reform principles that the Tax Commission had set for itself.

3.2. The previous fiscal legislation relating to PBO's was archaic in its formulation. The previous legislation exempted from income tax receipts and accruals of religious, charitable and educational institutions of a public character, whether or not supported wholly or partly by grants from public revenue. Unfortunately there was an absence of statutory definitions and a paucity of case law. The interpretation and implementation of these provisions imposed a substantial interpretative burden on the Commissioner.

3.3. Arising from these issues there were two questions :

3.3.1. which NPO's should enjoy the fiscal assistance; and

3.3.2. what fiscal benefits should be made available.

3.4. As regards the first issue the Tax Commission found that a key problem which becomes evident in most countries surveyed is the matter of defining eligibility criteria and identifying activities and organisations which qualify for beneficial tax treatment. Each country has sought to grapple with these problems and achieve a tax regime which is certain, equitable and administratively practical. As regards this latter aspect the Tax Commission pointed out that “any system should recognise the severely limited resources available to the South African Revenue Service. The system should not place undue demands upon Revenue personnel to monitor and exercise oversight thereby preventing “tax leakage” and “abuse”. Accordingly, the provisions should, insofar as possible, be self-regulating and should be devised in a manner that limits the need for extensive audit.”

3.5. Insofar as concerns the nature of the fiscal benefits the Tax Commission pointed out that “as in most countries which have devised fiscal regimes favourable to NPO’s, South African law recognises two distinct benefits which are available, namely :

3.5.1. an exemption available to the NPO itself, in respect of its liability for income tax, and other fiscal levies; and

3.5.2. a right available to donors to deduct from their taxable income, limited amounts representing philanthropic contributions for the benefit of eligible institutions.”

3.6. A number of difficult issues, inherent in this type of legislation, were also considered, including :

- 3.6.1. trading activities;
- 3.6.2. public policy;
- 3.6.3. public accountability;
- 3.6.4. conflicts of interest;
- 3.6.5. unfair competition; and
- 3.6.6. prudent investment.

4. Trading Activities

The analysis of the Tax Commission with regard to trading activities is set out in paragraph 5.6 of the Ninth Interim Report which is attached marked Annexure “D”.

5. Public Policy

The analysis of the Tax Commission with regard to public policy is set out in paragraph 5.7 of the Ninth Interim Report which is attached marked Annexure “D”.

6. Public Accountability

The analysis of the Tax Commission with regard to public accountability is set out in paragraph 5.8 of the Ninth Interim Report which is attached marked Annexure “D”.

7. Conflict of Interest

The analysis of the Tax Commission with regard to conflict of interest is set out in paragraph 5.9 of the Ninth Interim Report which is attached marked Annexure “D”.

8. Unfair Competition

The analysis of the Tax Commission with regard to unfair competition is set out in paragraph 5.10 of the Ninth Interim Report which is attached marked Annexure “D”.

9. Prudent Investment

The analysis of the Tax Commission with regard to prudent investment is set out in paragraph 5.11 of the Ninth Interim Report which is attached marked Annexure “D”.

10. Recommendations of the Tax Commission

Taking cognisance of all of the foregoing factors a number of recommendations were made by the Tax Commission in respect of fiscal assistance to PBO’s. These are set out in Annexure A hereto.

11. Legislation

11.1. The Government generally accepted the recommendations and recently introduced legislation to give effect to the recommendations.

11.2. The relevant legislation is contained in a new section 30 inserted in the Income Tax Act 1962. A copy thereof is attached marked Annexure B.

- 11.3. The list of Public Benefit Organisations which have been gazetted in terms of section 30 is attached marked Annexure C.
- 11.4. In general terms the new provisions specify the type of activities that will qualify for exemption from income tax, donations tax, stamp duty and transfer tax, as well as those activities that will give rise to deductions being available to donations made to such bodies. It is important to observe that the category of activities giving rise to donor deductibility is narrower than the activities that will give rise to exempt status. Only a small portion of the organisations on the tax exempt list also qualify for donor deductibility.
- 11.5. In order to qualify for exemption from income tax there are a number of hurdles that must be passed. The first hurdle is that the entity seeking exemption must be regarded as a “public benefit organisation” (PBO). This term is defined in section 30(1) of the Act as any organisation of a public character which is formed either as a trust, a company formed under section 21 of the Companies Act, that is a company incorporated not for gain, or an association of persons. The sole object of the entity formed must be to conduct one or more public benefit activities, which activities will be expanded upon below, in a non-profit manner. It is also necessary that the activities conducted by the PBO are conducted in the Republic unless the Minister having regard to the circumstances in a particular case decides otherwise.

- 11.6. The Commissioner : SARS is only allowed to approve a PBO which complies with the conditions prescribed by the Minister by way of regulation to ensure that the activities and resources of the PBO are utilised in furthering its objects.
- 11.7. The officers of the entity in question must complete the application form referred to above and supply the Commissioner with a copy of the entity's constitution. It is essential that the organisation must have at least three persons who are not related that are prepared to accept fiduciary responsibility of the PBO's activities.
- 11.8. The Constitution, Articles and Memorandum of Association or trust deed must prohibit the PBO from distributing any of its funds to any person, other than to another public benefit activity as part and parcel of the PBO's own activities and is required to utilise its funds solely for the object for which it has been established. A PBO is only entitled to invest its funds in certain investments and particularly recognised financial institutions or in securities listed on the Johannesburg Securities Exchange SA. In the event that the PBO wishes to invest in other investments it can only do so where such investments are prudent investments and the Commissioner has consulted with the executive officer of the Financial Services Board and the Director of Non-Profit Organisations.
- 11.9. Where a PBO acquires an investment by way of donation bequest or inheritance it can retain such investment for a period of time.

- 11.10. It must be observed that in the event that the PBO is dissolved or wound up it is required to transfer its assets to a similar PBO which has been approved in terms of section 30 of the Act.
- 11.11. The next hurdle that must be overcome by the PBO is that it does not carry on any business undertaking or trading activity. There are certain exceptions to this rule which will be dealt with below.

The first exception is that the gross amounts derived from the trading activity may not exceed the greater of R25 000,00 or 15% of the gross receipts derived by the PBO.

If the trading activity yields an income in excess of these amounts the PBO will generally be unable to qualify for exemption from income tax. In the event that the PBO derives, for example, licence fees from the use of its name, sale of goods to members of the public or consulting fees for services rendered to third parties and these amounts are in excess of those stipulated above the organisation in question will be unable to obtain tax exempt status.

If the PBO can show that the business undertaking or trading activity is directly related to its sole object and carried out on a basis such that the PBO merely seeks to recover its costs and will not result in unfair competition in relation to taxable entities it may still qualify for exemption from income tax.

Where the PBO can show that the trading activity is directly related to the sole object of the PBO, is of an occasional nature and undertaken substantially with assistance made available by volunteers such as a church conducting a cake sale or a school operating a fete such activity will not jeopardise the entity's tax exempt status.

The last resort available to a PBO is where the business undertaking or trading activity is approved by the Minister who would have to have regard to the scope and benevolent nature of the activity conducted as well as the interrelationship of the trading activity with the sole purpose of the PBO, the profitability of such trading activity and the level of economic distortion that may be caused by the tax exempt status of the PBO from carrying out the trading activity. If the Minister is satisfied in regard to these factors a specific concession may be granted to the PBO in question.

Charities, schools and other exempt bodies that seek to reduce their reliance on donor funds via income derived from trading activities will have to review their operations. This is so because the trading activities, even if the funds so derived are used to fund the entity's philanthropy may forfeit its tax exempt status if trading income exceeds the limits specified above.

It is essential that the donations received by the PBO are irrevocable. If the donations are revocable this will jeopardise the tax exempt status of the PBO.

It is also necessary that the PBO must submit copies of amendments to the PBO's constitution, will or other instrument under which it was established to the Commissioner as and when such amendments are made.

The PBO is also required to satisfy the Commissioner that the entity is not knowingly used as part of a scheme aimed at the postponement or avoidance of tax.

A PBO seeking exemption from tax is only entitled to pay remuneration to its employees and office bearers which is not excessive having regard to what is generally considered reasonable in the particular sector and in relation to the services rendered.

The Act also requires that the PBO complies with such reporting requirements as may be specified by the Commissioner.

The law specifies that the Commissioner can stipulate that the PBO must, within a period of time, register under the Non-Profit Organisations Act, Act No 71 of 1997 and comply with any other requirements imposed in terms of that Act. The Commissioner has not yet specified a time frame in this regard and it is accordingly recommended that those entities seeking exemption register with the Non-Profit Organisations Act so as to ensure compliance with the Income Tax Act.

Historically it was possible for charities to obtain rental properties by way of donation or bequest and to retain such properties without their tax exempt status being jeopardised. The new rules specify that where a

PBO has acquired a trading activity by way of a bequest before 1 January 2001 it can continue to own such activity for a period of 5 years. Thereafter it would be necessary to dispose of the trading activity to a tax paying entity. In future, trading activities or rental properties bequeathed to a PBO would have to be owned by a separate tax paying entity and not by the PBO itself.

If the Commissioner is dissatisfied as to the manner in which the PBO has conducted itself and is of the opinion that the organisation has violated the provisions of the Act the Commissioner is obliged to withdraw the tax exempt status with effect from the commencement of the year of assessment in which the dissatisfaction arises.

The law furthermore requires that in the event that the Commissioner has withdrawn his approval of the particular organisation it shall within three months or such longer period as the Commissioner may allow after the date of withdrawal of exemption, transfer or take reasonable steps to transfer any remaining assets to any other organisation approved under the new rules.

If the remaining assets are not transferred to another PBO, the accumulated net revenue which has not been distributed in terms of the rules specified above, will be deemed to be an amount of taxable income fully liable to tax in the year in which the Commissioner withdraws the exemption.

The Act specifically requires that the PBO retains proper books of account and preserves such books and records for a period of four years after the date of the last entry in any such record.

Any person acting in a fiduciary capacity responsible for the management or control of a PBO who intentionally fails to comply with any provisions of the new rules shall be guilty of an offence and on conviction will be liable to a fine or to imprisonment for a period not exceeding two years.

It must also be remembered that the fact that a section 21 company is formed does not automatically mean that such company is exempt from income tax and other taxes. It is essential that such entity applies for exemption in terms of section 30 of the Act and complies with the statutory provisions contained therein. Many persons are under the wrong impression that by forming a section 21 company, such company is automatically exempt from the payment of income tax.

In the event that a charity conducts trading in excess of the maxima specified above it may be necessary to transfer such trading activities into a tax paying entity failing which the whole organisation would become liable to taxation on all amounts received by it. As pointed out above donations of trading activities received after 1 January 2001 must, upon receipt thereof, be transferred to a separate taxpaying entity.

Those bodies that are recognised as public benefit organisations will also enjoy exemption from stamp duty, estate duty, donations tax, secondary tax on companies and capital gains tax.

12. Conclusion

A number of burning issues arise from the new legislation. The most important is whether the published list of PBO's is sufficiently comprehensive and generic. Even more important will the new legislation sufficiently encourage philanthropy to meet the vital needs which the Tax Commission identified? The administrative stress which the new legislation will impose on the Revenue personnel also remains a matter of concern.