GMS Flash Alert

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South Africa - Foreign Services Exemption Amended

South Africa's Taxation Laws Amendment Act, No. 17 of 2017, promulgated on 18 December 2017, contained the amendment, capping the private-sector foreign employment income tax exemption to ZAR 1 million foreign-earned remuneration per annum, as of 1 March 2020.[1]

This report explains how the capped exemption works, who will be affected, the process for claiming tax credits, and makes some observations.

WHY THIS MATTERS

The limitation could result in increased tax costs for employers and assignees alike. Where appropriate, adjustments to gross-up packages and withholding taxes need to be considered.

Currently, employers of South African tax resident assignees benefit from the exemption, in that:

- the exemption can be applied upfront in their payroll (cash-flow benefit);
- there is no need to interpret and apply a double taxation treaty (DTT) to determine potential double taxation;
- there is no need to collect proof of income tax paid and claim credits for income tax paid;
- they can send employees to comparatively low income tax jurisdictions (with concomitantly high import or consumer taxes), without having to consider the effect of a mismatched tax burden.

Background

South African tax residents are taxed on their worldwide income through the residence-based system. While DTTs exist to prevent double taxation under certain circumstances, a specific provision in the South African tax legislation provides a pre-emptive exemption, i.e., an exemption that statutorily limits South Africa's taxing rights based on a set of criteria.

Many South African tax residents work abroad for a period during their working lives. Section 10(1)(o)(ii) of the Income Tax Act, No. 58 of 1962 (ITA) exempts employment income received by a South African tax resident during any year of assessment for services rendered outside South Africa for or on behalf of any employer, if that individual was outside South Africa for:

- a period or periods exceeding 183 full days in aggregate during any 12-month period, and
- a continuous period exceeding 60 full days during that 12-month period.

The exemption is only available to employees of private-sector companies.

KPMG NOTE

There is currently no requirement that tax be payable in another country for this exemption to apply. As a result, it is possible that under certain circumstances no income tax will be paid anywhere by South African tax residents for periods worked outside of South Africa.

Furthermore, because the exemption is pre-emptive, individuals do not have to rely on DTTs or make use of the tax credit system to avoid double taxation.

New Cap

According to National Treasury, the exemption of foreign employment income from the South African tax net appears excessively generous, particularly in instances where the individual worked in a foreign country with a low or zero personal income tax rate. National Treasury is of the view that the current exemption creates opportunities for double non-taxation and unequal tax treatment for South African residents employed by a national, provincial, or local sphere of government or any public or municipal entity (who do not qualify for the exemption).[2]

The amendment limits the exemption to only allow for the first ZAR 1 million of foreign remuneration to be exempt from tax in South Africa. The other requirements will still apply: the individual must be outside of the Republic for more than 183 days, as well as for a continuous period of longer than 60 days during a 12-month period.

KPMG NOTE

The new exemption cap should not affect lower- to middle-class South African tax residents who are earning remuneration abroad. Relief from foreign taxes paid on the income earned for services rendered outside South Africa will be available under section 6*quat* of the ITA, to the extent that a DTT does not convey exclusive taxing rights.

Who Will Be Affected?

- The new cap will mainly affect South African tax residents working abroad; either as self-sponsored individuals who take a job opportunity in a foreign jurisdiction, or as employer-sponsored assignees that may or may not be tax protected/equalised.[3-4]

- In addition to ordinary South African tax residents, the new cap will also affect foreign tax residents who are placed on long-term assignment in South Africa (with some remaining foreign employment obligations), who then become South African tax residents while working in South Africa.

- In the case of employer-sponsored employees, the relevant employers (whether foreign or South African) will be affected, not only due to the impact of the amendment on tax equalisation and tax protection costs, but also in attracting talent in a competitive global environment where income tax rates play a role in accepting an assignment.

When Will the New Cap Come into Effect?

The National Treasury has made the amendment effective from 1 March 2020, to allow time for individuals (and employers) to either adjust their contracts or their circumstances, and to finalise or formalise their tax status.

KPMG NOTE

What Will the Impact Be?

- It is commonly accepted that the exemption threshold should limit the impact of the amendment for lower- to-middle-class self-sponsored South African tax residents who are working abroad in high income tax jurisdictions.

- However, from an initial high-level analysis, the ZAR 1 million exemption will provide little relief for employer-sponsored assignees that typically have high tax-equalised remuneration packages (including benefits and tax gross-ups), which will leave the employers (or individuals, where no equalisation applies) worse off.

What about Double Taxation Treaties?

- When the section 10(1)(o)(ii) exemption was first introduced, it was clear that even though the exemption would operate outside of the South African DTT network, the provision would be similar to the 183-day test found in most tax treaties.

- The general assumption is that the individual may be able to rely on a DTT for relief should the limited exemption not provide it.

- However, in the South African DTT network, the country of source is only given taxing rights when the requirements equivalent to the current exemption are met. At no point does a DTT give the country of source exclusive taxing rights. Therefore, unless a DTT applies to break the individual's tax residency status from South Africa through the tie-breaker clause (with the concomitant exit charge becoming payable in South Africa), there will not be any relief available through the use of the DTT mechanism for those affected by the new cap.

Claiming Tax Credits

- To the extent that individual income tax has been paid in the country where the services have been rendered, a section 6*quat* tax credit may be available in South Africa. However, the section 6*quat* rebate will be limited to the amount of tax the individual would have paid, had the income been earned in South Africa.

- South Africa has progressive marginal income tax rates varying from 18 percent to 45 percent for amounts in excess of ZAR 1.5 million in taxable income. No tax credit will be available for paid taxes that do not qualify as income tax (e.g., social security).

- While an individual claiming relief through the use of foreign tax credits can ordinarily only do so when submitting a tax return, it is possible for an employer to apply for a "tax directive" from the South African Revenue Service (SARS) allowing the employer to apply the tax credit in advance through its payroll, thereby mitigating the cash-flow impact on the assignee/employer.

- However, the additional administration and compliance requirements for SARS and the assignee/employer will be substantial. Other than the low rate of recovery through the rebate (in the case of no- and low-tax jurisdictions), the administrative constraints will also play a role in adding additional cost to the project.

KPMG NOTE

Particular Areas of Concern

- Provisional tax liabilities may be difficult to estimate, especially because no foreign country's tax year is aligned with that of South Africa.

- Determining what would satisfy SARS as sufficient proof of foreign taxes paid upon assessment (since certain self-assessment taxes do not require assessment from the revenue authorities in the particular country, e.g., the U.K.).

Next Steps

- The capped exemption is significantly "softer" than the initial proposal (total deletion of the exemption as of 1 March 2019). However, questions have been raised as to whether the effect of the new cap will ultimately be beneficial for the National Treasury.

- Submissions to that effect have been made to the National Treasury, arguing that the change would result in a significant impact on the bottom line of companies engaged in current and future foreign inbound investment into South Africa, and South African companies alike. However, very few companies have provided any detailed analysis to substantiate assertions as to expected increases in their administration, employment, or tax costs.

At present, further industry discussions are being held to collate data on:

- the increased cost to employers and the expected results (externalisation of both South African employers and individual tax residents, possible retrenchments, the continued competitiveness of South African business in the continent, the attractiveness of South Africa as the "Gateway to Africa," etc.);
- the efficacy of the current tax credit system (average turn-around time, number of objections required, etc.).

Timelines: The legislative cycle runs from the November of the prior year for any legislative amendments to be promulgated each year. Therefore, in order to effectively support a possible change to the capped exemption, the information substantiating such a change would have to be made available to the National Treasury by November 2018 at the latest.

Should affected parties wish to analyse the potential effect of the capped exemption on their business, they should consult with their qualified tax professionals.

Furthermore, the KPMG International member firm in South Africa would welcome any parties that would be able to share their statistics with National Treasury with a view to supporting a review of the capped exemption.

FOOTNOTES:

1 Taxation Laws Amendment Act, No. 27 of 2017. The TLAA can be found on the National Treasury (www.treasury.gov.za) and SARS (www.sars.gov.za) websites.

2 Budget Review 2017, Annexure C, p. 138; Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017, (15 December 2017), p. 6.

3 Under tax protection, the employer generally reimburses an assignee for the excess taxes incurred while on international assignment. The assignee usually bears responsibility for paying all actual taxes in the home and host countries. The annual tax protection calculation compares the "stay-at-home" or "hypothetical" tax to the actual worldwide taxes paid by the assignee. The employer reimburses any excess to the assignee. Tax protection policies generally put the burden of filing and paying home and host country taxes on the assignee. Any benefit from the payment of less tax than the stay-at-home position is retained by the assignee.

4 The objective of tax equalisation is to make sure that assignees do not have a higher or lower income tax liability than if they had remained in their home country. Therefore, they will receive a net amount of remuneration as if they had remained in their home country (i.e., their packages are recalculated with reference to the tax that they would have paid, had they remained in their home countries – so that all assignment-related benefits are paid tax-free, over and above this net package entitlement). The employer usually bears the responsibility of paying the assignee's actual taxes in the home and host countries.

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ZAR 1 = EUR 0.09678
ZAR 1 = USD 0.0843
ZAR 1 = INR 5.36
ZAR 1 = GBP 0.0594

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