

**THE DEDUCTIBILITY OF INDIRECT EMPOWERMENT
MEASURES RELATING TO BLACK ECONOMIC
EMPOWERMENT (BEE) IN TERMS OF THE INCOME TAX
ACT**

by

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SUMMARY

The requirements of broad-based black economic empowerment ('BEE') are set out in the BEE scorecard. When an entity incurs expenditure relating to indirect empowerment measures (i.e. the preferential procurement, enterprise development, skills development and socio-economic development categories on the BEE scorecard), it is unclear whether the expenditure will be deductible for income tax purposes (BEE Partner, 2008).

The objectives of the current study are to determine whether such expenditure is deductible and to formulate best practice guidelines for the deduction of the expenditure. The best practice guidelines consist of factors that should be considered when determining whether expenditure is deductible, as well as recommendations on how to justify that such expenditure should, in fact, be deductible.

The methodology used was to first consider the requirements of the BEE scorecard, the types of expenditure and the reasons for incurring expenditure towards indirect empowerment measures. The deduction of such expenditure was then considered in a general sense and specifically for each broad category of expenditure. Lastly, the best practice guidelines were formulated based on the conclusions reached.

Common expenditure towards indirect empowerment measures of BEE was grouped into broad categories. The different reasons why entities incur such expenditure were identified, as the reason for incurring expenditure can influence whether it is incurred in the production of income (Van Schalkwyk, 2010b:110). It is submitted that expenditure that is excessive or that is incurred for philanthropic purposes would not be incurred in the production of income.

Four issues were identified that could preclude a deduction in terms of the general deduction formula (section 11(a)) – notably, that expenditure has to be in the production of income and non-capital in nature to be deductible. In addition to section 11(a), special income tax deductions (sections 12H, 12I or 18A) and capital allowances (sections 11(e), 13sex or 15(a)) could also possibly apply, but only for certain types of expenditure and only in qualifying circumstances. The conclusions drawn as to the deductibility of expenditure are summarised as a guideline for taxpayers.

The above-mentioned conclusions, along with the literature examined, were used to formulate general best practice guidelines. One such guideline is that the onus is on taxpayers to show (through one of the ways suggested) that expenditure is in the production of income. Taxpayers should also note that excessive expenditure is not in the production of income and that certain expenditure required by sector charters is more likely to be capital in nature.

Furthermore, specific best practice guidelines were submitted for each broad category of expenditure and relate to, for example, the applicability of the identified special deductions and the quantification of non-monetary expenditure. The specific best practice guidelines should be considered when incurring expenditure in a specific category.

In summary, even though expenditure towards indirect empowerment measures has been found to be deductible in most cases, there are exceptions of which taxpayers should be aware. The proposed best practice guidelines include guidance that could be considered before incurring expenditure towards indirect BEE measures.

OPSOMMING

Die vereistes van breë-basis swart ekonomiese bemagtiging ('SEB') word in die SEB-telkaart uiteengesit. Wanneer 'n entiteit onkoste met betrekking tot indirekte bemagtigingsmaatreëls (die telkaartkategorieë vir voorkeurverkryging, besigheidsontwikkeling, vaardigheidsopleiding en sosio-ekonomiese ontwikkeling) aangaan, is dit nie duidelik of sodanige onkoste vir inkomstebelasting-doeleindes aftrekbaar sal wees nie (BEE Partner, 2008).

Die doelwitte van hierdie studie was om te bepaal of sulke onkoste belastingaftrekbaar is en om bestepraktijk-riglyne te formuleer vir die aftrekking van die onkoste. Die bestepraktijk-riglyne bestaan uit faktore wat oorweeg moet word in die bepaling of onkoste belastingaftrekbaar is, sowel as aanbevelings oor hoe aftrekbaarheid geregverdig kan word.

Die studiemetodologie het eerstens 'n ondersoek behels na die vereistes van die SEB-telkaart, die soorte onkoste sowel as die redes vir die aangaan van onkoste wat met indirekte bemagtigingsmaatreëls verband hou. Daarna is die belastingaftrekbaarheid van sodanige onkoste in die algemeen sowel as spesifiek vir elke breë kategorie van onkoste oorweeg. Laastens is die bestepraktijk-riglyne opgestel op grond van die gevolgtrekkings wat bereik is.

Algemene onkoste wat met indirekte SEB-maatreëls verband hou, is in breë kategorieë gegroepeer. Die verskillende redes waarom entiteite die uitgawes aangaan, is bepaal, aangesien dit kan beïnvloed of die uitgawe in die voortbrenging van inkomste is of nie (Van Schalkwyk, 2010b:110). Daar word aangevoer dat onkoste wat oormatige is of onkoste met betrekking tot filantropiese doeleindes nie as deel van die voortbrenging van inkomste beskou kan word nie.

Vier kwessies is geïdentifiseer wat 'n aftrekking ingevolge die algemene aftrekkingsformule (artikel 11(a)) kan verhoed – die belangrikste is dat die onkoste in die voortbrenging van inkomste aangegaan moet word en nie kapitaal moet wees om afgetrek te kan word. Benewens artikel 11(a), kan spesiale belastingaftrekkings (artikel 12H, 12I of 18A) en kapitaaltoelaes (artikel 11(e), 13sex of 15(a)) ook moontlik geld, maar slegs vir sekere soorte onkoste en in omstandighede wat daarvoor in aanmerking kom. Die gevolgtrekkings oor die belastingaftrekbaarheid van onkoste word uiteindelik as 'n riglyn vir belastingbetalers opgesom.

Bogenoemde gevolgtrekkings, tesame met die bestudeerde literatuur, is gebruik om algemene bestespraktyk-riglyne te formuleer. Een so 'n riglyn is dat die bewyslas op die belastingbetaler rus om (op een van die voorgestelde maniere) aan te toon dat onkoste in die voortbrenging van inkomste aangegaan word. Belastingbetalers moet ook daarop let dat oormatige onkoste nie as deel van die voortbrenging van inkomste beskou kan word nie en dat sekere onkoste ingevolge die vereistes van sektorhandveste meer waarskynlik kapitaal van aard sal wees.

Spesifieke bestespraktyk-riglyne is voorts vir elke breë kategorie van onkoste voorgestel, byvoorbeeld met betrekking tot die toepaslikheid van die geïdentifiseerde spesiale aftrekkings en die kwantifisering van nie-monetêre onkoste. Hierdie spesifieke bestespraktyk-riglyne behoort in ag geneem te word wanneer onkoste in 'n spesifieke kategorie aangegaan word.

Ter samevatting behoort belastingbetalers daarop bedag te wees dat hoewel onkoste met betrekking tot indirekte bemagtigingsmaatreëls in die meeste gevalle belastingaftrekbaar is, daar wel sekere uitsonderings is. Die voorgestelde bestespraktyk-riglyne bied derhalwe leiding oor die faktore wat oorweeg kan word voordat onkoste met betrekking tot indirekte bemagtigingsmaatreëls aangegaan word.

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Chapter 1: Introduction

1.1 Background

Broad-based black economic empowerment ('BEE') was formally implemented by the South African government in 2003. The rationale behind the policy was to offer benefits to persons who were disadvantaged by South Africa's past racial segregation (Kruger, 2011:207). More relevantly, it hopes to assist persons whom are still marginalised in the economy due to socio-economic legacies of this segregation (Beukes, 2011a:94).

Regardless of the varying opinions on the normative validity of such a policy, BEE is currently a legislative reality in South Africa (Jack & Harris, 2007:viii). South Africa has been lauded for its innovative approach of using a multifaceted scorecard to implement the policy of BEE. The scorecard is mandated under a Code of Good Practice that is authorised by the Broad-Based Black Economic Empowerment Act 53 of 2003 ('the BBEE Act') (Department of Trade and Industry, 2007:1). The scorecard partly addresses the objective that BEE needs to be broad-based in terms of section 1 of the aforesaid Act.

Entities are awarded a BEE rating from level 8 (favourable) to level 1 (unfavourable), based on compliance with categories as per the BEE scorecard. Points are awarded based on seven categories and a favourable rating can only be achieved by scoring points in several categories of the scorecard. The seven categories of the scorecard can be divided into either direct or indirect empowerment measures, as illustrated in Table 1.1 below.

Table 1.1: Categories of BEE expenditure

Direct empowerment measures	Indirect empowerment measures
Ownership	Preferential procurement
Management	Enterprise development
Employment equity	Skills development
–	Socio-economic development

Source: Empowerdex, 2009.

The direct measures of empowerment, which were part of BEE when it was originally envisioned are commonly known (Tucker, 2003). The three direct empowerment measures involve metrics for, respectively, the number of black shareholders, the number of black managers and the number of black employees. The emphasis in recent years has, however, been to ensure that BEE is truly broad-based. For said reason, the lesser-known indirect measures of empowerment on the BEE scorecard have been gaining more attention (Empowerdex, 2011:9).

The indirect empowerment categories of the scorecard mostly involve an entity incurring some expenditure that indirectly empowers a previously disadvantaged person. Preferential procurement points are earned by means of purchasing goods and services from other businesses with a good BEE score. Enterprise development involves making financial contributions towards the development of black-owned businesses. Points are awarded for skills development when employees are given training. Lastly, points can be awarded for socio-economic development by making contributions to social causes (Empowerdex, 2007c). This study is concerned with the latter four categories of the scorecard, meaning the so-called 'indirect methods' of empowerment (Table 1.1), and expenditure that falls under those categories.

Enterprises frequently incur expenditure relating to BEE, whether it is to gain points on their BEE scorecard, for marketing purposes (Sartorius & Botha, 2008:443), to achieve a positive corporate image (Ferreira & De Villiers, 2011:23) or for general philanthropic aims (Van Jaarsveld, 2005:263).

Clearly various reasons why entities would spend money on BEE exist (Empowerdex, 2006:3). Financial managers are often troubled by the tax deduction implications of spending on indirect empowerment measures, as such expenditure often does not directly influence the amount of profit made (Brincker, 2010:120). Various expenditures relating to BEE fall into said category, including, for example, those related to helping black businesses start up, certain training expenditures, termination pay for non-black employees, or general social

responsibility spending. The expenditures would respectively correlate to the enterprise development, skills development, employment equity and socio-economic development categories on the BEE scorecard, but would not necessarily have a direct impact on the profits made (BEE Partner, 2008).

1.2 Research problem

When an entity incurs expenditure relating to the indirect empowerment measures of BEE, it is unclear whether such expenditure will be deductible for income tax purposes in terms of the Income Tax Act 58 of 1962 ('the Act') (BEE Partner, 2008). PwC and KPMG have reached slightly incongruent conclusions regarding the matter. PwC (2004) holds the opinion that BEE expenditure will sometimes be deductible, but not in all cases. KPMG (2004) has stated that the expenditure related to BEE should be tax deductible in all cases. PwC (2009b) has also stated that socio-economic contributions (which is also one component of BEE) will be deductible, but only under 'appropriate circumstances'.

The above-mentioned views are based on the superficial view of considering all expenditures relating to BEE together. The case for the tax deductibility of expenditure relating to indirect empowerment measures has to be considered separately for different kinds of expenditure and in different situations. The reason for the separate consideration is because all the elements of the general deduction formula need to be considered (Van Schalkwyk, 2010b:110). It is, however, clear that there is a degree of uncertainty as to whether expenditure related to BEE is deductible in all cases.

Whilst the South African Revenue Service ('SARS') has given an indication to certain taxpayers that they will allow such deductions in some cases, certainty regarding the matter is currently lacking (PwC, 2009a; SARS, 2009). A thorough analysis of the legal foundation for such deductions is needed.

Further aspects relating to indirect empowerment measures that also require exploration are:

- What categories of expenditure for indirect empowerment measures can be deducted;
- Can entities deduct indirect empowerment-related expenditure in all situations; and
- Are there possible Capital Gains Tax ('CGT') implications that might require consideration as result of incurring expenditure relating to indirect empowerment measures.

Companies currently have little guidance as to how the above-mentioned aspects will impact their cases in terms of the deductibility of expenditure relating to indirect empowerment.

1.3 Research objective and rationale for study

The objective of the current research is to formulate best practice guidelines for the deduction of expenditure relating to the indirect empowerment measures of BEE. The best practice guidelines consist of factors that require consideration when determining whether such expenditure is deductible for tax purposes. Possible expenditures relating to indirect empowerment measures were grouped into similar categories and best practice guidelines were then formulated for the categories concerned.

The government has indicated that indirect empowerment measures (Table 1.1) will constitute a larger portion of the scorecard when future Codes of Good Practice are issued (Department of Finance, 2003). The Broad-Based Black Economic Empowerment Amendment Bill, tabled in Parliament in 2012, proposes certain changes to the current scorecard that would increase the weightings of the indirect empowerment categories (Department of Trade and Industry, 2011). As indirect empowerment measures become more important, the importance of certainty regarding the tax implications of such expenditure and of this study will increase (Ngcobo, 2011).

The current position is that many entities are deducting expenditure relating to their BEE scorecard (KPMG, 2004). There is, however, no certainty as to whether doing so is allowable. Consequently, such deductions could potentially expose a taxpayer to liability in the form of penalties and interest, if deductions are claimed that are not allowed.

This research could assist taxpayers when doing their tax planning and when planning how most effectively to achieve the points that they want on their BEE scorecard. It could also assist entities that wish to increase, or to maintain, their BEE rating to do so in the most cost- and tax-effective manner possible. The study could also encourage entities to increase their level of corporate social investment and other socially beneficial expenditure, by providing clarity regarding tax deductions that are currently uncertain (Thersby, 2006:5).

Differing views on the certainty of a deduction for BEE expenditure create a need for the undertaking of a more detailed theoretical study. The literature that is currently available does not address the income tax deductibility of specifically indirect empowerment measures. No literature currently exists that considers the specific context of an entity as a factor in determining the deductibility of BEE expenditure – for example, whether an entity requires a specific outlay to reach a certain BEE level. Sufficient literature relating to BEE compliance requirements and to tax deductions in general is available. These are the two areas that are investigated in the current study in order to formulate best practice guidelines. A limited amount of literature is also available for use by companies in determining whether their indirect empowerment expenditure is deductible, taking into account their specific expenditure, reasons and situation.

1.4 Research design and methodology

A literature review was performed to identify different views that currently exist on the deductibility of expenditure relating to indirect BEE empowerment measures. This literature review relied on the Scopus, EBSCOhost, Sabinet and Lexisnexis[®] databases to identify literature from tax, mercantile law and economic policy journals. The study also investigated publications by authorities in the field of tax

and BEE, such as law firms, auditing firms, banks and BEE verification agencies, as well as BEE publications by the South African Department of Trade and Industry. As the objective of the study was to determine best practice guidelines, popular media articles on the deductibility of expenditure relating to indirect BEE empowerment measures were also considered. The theoretical underpinnings supporting the identified opinions were investigated in an attempt to formulate best practice guidelines relating to the deductibility of indirect empowerment expenditure relating to BEE in terms of the Act.

As the starting point, the legislative and regulatory requirements of BEE were investigated, with the focus on the BEE scorecard and its authority. Said factors, along with the context in which entities incur expenditure relating to indirect empowerment measures, can influence the deductibility of such expenditure. The potential impact of BEE sector charters was only briefly considered, as it is unlikely that they would affect the general principles of the tax deductibility of expenditure (Department of Trade and Industry, 2006:6).

This study focuses on expenditure relating to the indirect empowerment measures (Table 1.1) on the BEE scorecard, namely preferential procurement, enterprise development, skills development and socio-economic responsibility. For each of the categories mentioned, expenditure is discussed in general rather than in reference to any one specific type of expense. The reason for doing so is that most expenditure incurred to earn BEE points under said categories is deemed to be of a similar nature (Empowerdex, 2007c). Examples of common expenditures are used where necessary.

Guides by Empowerdex (2007a) and Bowman Gilfillan (2005), as well as other literature, were used to identify the common expenditures under each section of the scorecard. The different broad categories of expenditure relating to indirect empowerment measures were then formulated. Expenditures were considered per the broad categories of expenditure when considering the deductibility for income tax purposes in Chapter 3. The same broad categories of expenditure were used when formulating the best practice guidelines. The following categories of

expenditure incurred as indirect empowerment measures relating to BEE were explored:

- general procurement expenditure;
- charitable contributions to persons other than employees (including donations to socio-economic initiatives or towards the development of black-owned enterprises);
- non-monetary assistance to persons other than employees (such as the amount of time spent by employees on enterprise development and socio-economic development);
- monetary expenditure by employers towards skills development of qualifying employees;
- non-monetary assistance by employers towards skills development of qualifying employees; and
- expenditure incurred for BEE verification services.

For each of the categories of expenditure, the tax deductibility was then considered. The sections of the Act that could provide a deduction for the different broad categories of expenditure towards indirect empowerment measures were then investigated, with the main focus on section 11(a) of the Act, as, at the time of the study, there were no specific deductions allowing for any deduction of BEE expenditure (Bowman Gilfillan, 2005). An abundant amount of literature is available on this topic, and the study also utilised the relevant case law. The case of *Warner Lambert SA (Pty) Ltd v C:SARS* is of specific interest here, as various commentators have speculated that the case can be applied to the deduction of BEE expenditure (Clegg, 2009:17). In the case mentioned, an American company operating in South Africa has been allowed to deduct expenditure for social responsibility projects. This expenditure was incurred to avoid penalties under US legislation (Strydom, 2003:85).

The next step was to apply the principles of the Act and case law to the facts and circumstances surrounding expenditure on indirect empowerment measures. The application allowed for the investigation of current opinion that expenditure towards indirect empowerment is deductible and further allowed for the

exploration of the theme to include conclusions in respect of different categories of expenditure and different circumstances of the taxpayer. The conclusions were summarised in the form of best practice guidelines.

The effects of potential changes in income tax and BEE legislation were continuously monitored and considered throughout the study.

1.5 Scope

Other categories of taxation, such as Value-Added Tax ('VAT') and Donations Tax, have not been considered as part of the scope of the current study. Expenditure relating to direct categories (Table 1.1) of the BEE scorecard has also not been specifically investigated. The nature of the direct categories of the scorecard (for example, ownership) is such that they often do not result in any direct additional expenditure (Empowerdex, 2009).

When evaluating whether expenditure relating to indirect empowerment measures is deductible, the current study did not seek to provide an exhaustive dichotomy of all those expenditures that can be deducted and all those that cannot. The aim was rather to give a general overview of the factors that require consideration when determining whether an expense is deductible for tax purposes.

1.6 Organisation of the research

Chapter 2 covers compliance with BEE requirements and the categories of expenditure incurred. The provision of a background to BEE and the categories of expenditure under indirect empowerment measures facilitates an understanding of the structure chosen for the study. Companies' motives for complying with BEE and the nature of the expenditure that they incur were investigated and summarised, as such factors can have an impact on the tax deductibility of the expenditures concerned.

Chapter 3 covers tax deduction requirements and the application thereof to the deduction of expenditure relating to indirect BEE measures. The available tax deductions and their requirements required investigating. Said matters were then

applied to the categories of expenditure and to other factors, as identified in Chapter 2, with the aim of formulating best practice guidelines in Chapter 4.

Chapter 4 formulates best practice guidelines for the deduction of expenditure relating to indirect empowerment measures of BEE. Guidelines have been formulated to assist companies in judging what categories of expenditure can and cannot be deducted and under what circumstances the deductions can, or cannot, occur. The above includes factors that require considering when incurring such expenditure.

Chapter 5 consists of the conclusion of the study and the recommendations made as a result of the study. The study concludes with a summary of the conclusions reached and of the main findings of the best practice guidelines.

Chapter 2: Compliance with BEE requirements and the categories of expenditure incurred

2.1 Background to BEE and legislative framework

The purpose of this study was to determine the tax deductibility of expenditure relating to indirect BEE empowerment measures and to formulate related best practice guidelines. The current chapter first gives a general description of the BEE requirements facing companies, in order to gain a better understanding of the nature of such requirements. The purpose of the present chapter, then, is to investigate the nature of expenditure relating to indirect BEE empowerment measures, the reasons for incurring such expenditure and the context in which BEE requirements should be seen.

To gain an understanding of BEE requirements, the relevant legislation was considered, with specific regard to the regulations relating to the BEE scorecard. Consideration was also given to the BEE sector charters. Various sources were then used to find examples of expenditures relating to indirect BEE empowerment measures. The expenditures were then grouped into similar broad categories so as to allow for them to be considered together when doing a systematic analysis. BEE literature was used to understand companies' different motives for incurring BEE expenditure and the possible situations in which such expenditure would be incurred. The product of this chapter was, then, a selection of factors that can be weighed against the Act and related literature in Chapter 3 in order to determine whether an expense is deductible. The results obtained were then used in Chapter 4 when formulating best practice guidelines.

BEE is an economic policy that was implemented in South Africa in 2003. The purpose of the policy is to offer economic benefits and opportunities to qualifying persons who were disadvantaged by South Africa's past racial segregation (Beukes, 2011a:94). To understand the scope of qualifying persons intended by the BBEE Act, the definition of 'black' requires consideration. 'Black' is defined as 'African, Coloured and Indian' (South Africa, 2003).

Compliance with BEE is measured using different categories on the BEE scorecard. The result of the scorecard is a BEE rating from level 8 to level 1, with the former being the poorest score and the latter the best score possible (Standard Bank, 2008:11). The BEE scorecard contains seven categories in which points can be awarded, as was previously illustrated in Table 1.1.

The purpose of having different categories on the scorecard and of limiting the amount of points awarded in each category is largely to ensure that BEE is applied in a broad-based manner, meaning that a large number of people are beneficiaries of the policy. Ongoing BEE compliance is required, with the indication of such on an annual basis, and not to be given account of only once, in order to ensure that entities remain BEE-compliant (Bowman Gilfillan, 2005:6).

A different scorecard may be used in certain cases, such as where sector charters apply. Different requirements also apply to entities of different sizes, as will be seen below.

BEE in South Africa is governed primarily by the BBEE Act. The preamble of this Act states that the purpose of the Act is to 'establish a legislative framework for the promotion of BEE', which is mainly achieved by enabling the Minister of Trade and Industry to issue Codes of Good Practice and to publish sector charters (Harris, 2010:22). Although the current study focuses on the requirements of the BBEE Act and on related codes, other acts, such as the Preferential Procurement Policy Framework Act 5 of 2000 (South Africa, 2000), also form part of the government's broader BEE policy. Such acts, where applicable and as listed and described by De Klerk (2008:22), have also been considered in the present study.

The BBEE Act strives to achieve its goals not by obligation, but by the means of encouraging the following of various guidelines (Ponte, Roberts & Van Stittert, 2007:942-944). The BBEE Act provides a mechanism whereby such guidelines can be issued by the Minister of Trade and Industry. Allowing for such issuance provides for subsequent revisions and adjustments to be made easily and quickly

than might otherwise have been possible. Compliance with the BBBEE Act is, therefore, in most cases not obligatory.

The BBBEE Act states the objectives of BEE, but does not give any guidelines on how compliance to BEE is to be measured. Thus, when the BBBEE Act was promulgated in 2003, no tangible requirements were made with which companies had to comply. The BBBEE Act did, however, make provision for the issue of Codes of Good Practice by the Minister of Trade and Industry. The subsequent issue of Code of Good Practice number 000 detailed the generic scorecard to be used. The other Codes of Good Practice that were issued describe how scores in each category of the scorecard are to be measured and the differences in rules for entities of different sizes (Department of Trade and Industry, 2007:5). The codes carry the same legislative weight as the BBBEE Act itself (Department of Trade and Industry, 2007:5).

South Africa's innovative approach to transformation involves the use of a multidimensional generic scorecard to measure an entity's commitment to the objectives prescribed by the BBBEE Act (Bowman Gilfillan, 2005:6-8). The generic scorecard contains seven categories, as described in Table 1.1. Four of the categories are often referred to as indirect empowerment measures, as they do not necessarily place qualifying persons in positions of economic benefit (Empowerdex, 2011:1). The four categories are preferential procurement, enterprise development, skills development and socio-economic development (Empowerdex, 2009).

A major development in the BEE legislative environment was the introduction of the Broad-Based Black Economic Empowerment Amendment Bill in 2012. The major amendments proposed by the bill are stricter measures to punish fronting and an increase in the weightings of the indirect empowerment categories (Department of Trade and Industry, 2011). Neither of the changes impacts the findings of the current study materially. The importance of certainty regarding the tax implications of expenditure towards indirect empowerment measures was,

however, to increase, due to the proposed higher weightings for the indirect categories of the scorecard (Ensor, 2011).

The detail of how scores are calculated in each category of the scorecard was not considered relevant to the current study. The focus was rather on the general workings and principles of the BEE requirements, in order to understand the income tax implications concerned. Although compliance is not (in most cases) legally required, the idea of an official BEE rating for every entity is that it becomes a competitive advantage to have a high BEE rating (Department of Trade and Industry, 2005). Further reasons why entities would want to be BEE-compliant are discussed in section 2.5.

In summary, compliance with BEE is not obligatory, except for certain entities, as described in section 1.2. Compliance is measured through a standardised BEE scorecard. Sector charters exist that vary the standard rules of the scorecard for entities in specific sectors. The BEE scorecard and the impact of sector charters are considered next, followed by indirect empowerment measures and their related expenditures.

2.2 The BEE scorecard

The BEE scorecard provided by the South African Department of Trade and Industry provides different weightings to each category. In addition to the generic scorecard, there is an alternative scorecard that qualifying small enterprises ('QSEs') can follow. QSEs are companies that have an annual turnover of less than R35m (EconoBEE, 2009).

Table 2.1: The BEE scorecards

Element	Points available per generic scorecard	Points available per QSE scorecard
Direct empowerment measures		
Ownership	20	25
Management	10	25
Employment equity	15	25
Subtotal for direct measures	45	75
Indirect empowerment measures		
Preferential procurement	20	25
Enterprise development	15	25
Skills development	15	25
Socio-economic development	5	25
Subtotal for indirect measures	55	100
Total	100	100 (max.)

Source: Empowerdex, 2009.

As can be seen from Table 2.1 above, an entity would have to score points in most categories of the generic scorecard in order to achieve a high score. A QSE can achieve a high score more easily, as the QSE scorecard makes more points available and allows for a company to choose the 4 categories in which it scores the most points (EconoBEE, 2009). Table 2.2 below lists the BEE rating level that is achieved by having a certain score.

Table 2.2: BEE rating levels

Score	Level
Over 100 points	1
85–100 points	2
75–85 points	3
65–75 points	4
55–65 points	5
45–55 points	6
40–45 points	7
30–40 points	8
Under 30 points	Non-compliant

Source: EconoBEE, 2009.

A company using the generic scorecard can score up to 55 points from indirect empowerment measures. A QSE can score the maximum amount of points from indirect empowerment measures alone (Table 2.1). A large number of the points in indirect empowerment measure categories can effectively be obtained by incurring expenditure towards the categories concerned (Empowerdex, 2007b). A further concession is made to entities that have an annual turnover of less than R5m, with such entities automatically receiving a BEE rating of at least level 4 (EconoBEE, 2009). The Codes of Good Practice that are issued by the South African Department of Trade and Industry provide some guidance as to what expenditure qualifies for points in terms of each category of the scorecard (South Africa, 2007:54–96).

An entity's BEE rating is determined on an annual basis using the scores achieved in the direct and indirect empowerment measure categories on the BEE scorecard. The rating process is performed by an accredited BEE verification agency (South Africa, 2008:14). The factors that determine the points awarded in every category of the BEE scorecard, as listed above, are considered in section 2.4 below in order to determine the broad categories of expenditure relating to

indirect empowerment measures. Perusal of the BEE guidelines and literature showed that expenditure can be incurred in every category of the BEE scorecard (Jack & Harris, 2007).

The nature of the most common expenditure under the indirect empowerment categories (Table 1.1) of enterprise development, skills development, preferential procurement and general corporate social responsibility are fairly apparent (Empowerdex, 2007c). Without delving into the details of measurement, the fundamentals of each indirect empowerment measure are also explained in section 2.4 below. Such an explanation is necessary in order to convey an understanding of what expenditure can be said to relate to these categories.

2.3 Impact of sector charters

BEE sector charters were already in place when the BBBEE Act was promulgated. The charters were, however, just a vague expression of commitment to transformation by the relevant industries, without obligations or incentives for them to comply with the conditions set (Department of Trade and Industry, 2007:1). It was commonly recognised at the time that the sector charters had various problems and that a unified approach by the government would be needed to ensure that transformation did, indeed, take place (Fauconnier & Mathur-Helm, 2008:1–2). The issue was addressed by the BBBEE Act and the subsequent Codes of Good Practice, which included sector charters.

The sector charters can be seen as being additional requirements or variations to the requirements of the generic scorecard that are applicable to entities in a specific sector. This affects the way in which the BEE score for an entity is calculated. Sector charters are, thus, only important to entities operating in the sectors concerned. Sector charters are published in the *Government Gazette* under section 12 of the BBBEE Act. As the situation prevailed at the time of the current study, confusion could have arisen, due to the fact that the BEE sector charters had been gazetted under different sections of the BBBEE Act. Furthermore, some sector charters have been issued as amendments to the Mineral and Petroleum Resources Development Act 28 of 2002, rather than being

issued as Codes of Good Practice under the BBBEE Act (Empowerdex, 2007a). These sector charters therefore currently contain legislative authority. By 2010, 15 sector charters had been issued in total (Harris, 2010:23).

The rationale behind the sector charters is that some industries have more need of transformation in certain areas than in others. For example, the mining industry has a great deficit in black ownership. For said reason, the mining sector charter has an objective to achieve 26 per cent black ownership of mining assets by 2014. In 2009, the figure concerned was only 8.9 per cent (Brougham-Cook, 2010). The mining sector charter was, as has previously been mentioned, not issued under the BBBEE Act, but regardless formed part of the government's legislative attempts to encourage the furtherance of BEE. The mining sector charter in question also contains more stringent non-compliance provisions – in some cases, an entity's mining licence might not be renewed as a sanction against non-compliance. An entity would, thus, have more of an obligation to adhere to the requirements involved than to the requirements of the generic scorecard or to the requirements of other sector charters falling under the BBBEE Act.

In summary, most sector charters only change the weightings of the generic scorecard, or add requirements for entities operating in the sectors concerned. There are, however, two sector charters that form part of the Mineral and Petroleum Resources Development Act and that impose compulsory requirements on entities in the sectors involved. Said sector charters are considered when investigating the reasons for entities to incur expenditure in complying with BEE requirements.

2.4 Indirect empowerment measures and examples of expenditure

It can be seen that, based on the requirements of the BEE scorecard, entities incur certain expenditure in order to score points towards achieving a BEE rating (Brincker, 2010:120). Doing so is especially true in the case of indirect empowerment measures, due to the nature of the scorecard's requirements. An examination of BEE literature renders several examples of expenditure that

could be incurred in each category of the scorecard. This section gives non-exhaustive examples of common expenditure in each category of the scorecard, with the purpose of summarising what the most common broad categories of expenditure are. The summary is presented in section 2.6, together with the other conclusions of this chapter. The tax deductibility of the broad categories of expenditure mentioned is then investigated in Chapter 3, with the same categories of expenditure being used to formulate best practice guidelines in Chapter 4.

2.4.1 Preferential procurement

Preferential procurement points are awarded when goods and services are procured from businesses that have a BEE rating. The score calculation allows for a greater percentage of the procurement expenditure for buying from businesses with higher BEE rating levels. In other words, more points are effectively awarded for buying from a business with a higher BEE rating level. The calculation is based on the percentage of procurement from BEE-accredited businesses, in relation to the total procurement by the entity concerned (Standard Bank, 2008:16).

The nature of the preferential procurement category of the BEE scorecard is such that most general expenditures would be included here. Preferential procurement includes both operational and capital expenditure (Empowerdex, 2007b:9). Examples include bank fees, insurance, rent, legal fees, raw material and most services. The category also specifically includes empowerment-related expenditure (Jack & Harris, 2007:314). Expenditures that specifically do not form part of said calculation are salaries, social investments, donations, VAT and other taxes, intergroup charges and certain imports (Standard Bank, 2008:16–17).

A wide variety of expenditure could, therefore, be said to relate to preferential procurement. It would, however, never be cost-efficient for an entity to incur expenditure with the primary aim of scoring points on their BEE scorecard under preferential procurement. The lack of efficiency in such regard would be due to the fact that the points concerned are calculated using a percentage of total procurement by the entity, as has been described above. The impact of the above

on the tax deductibility of general procurement expenditure is considered in Chapter 3.

2.4.2 Enterprise development

Enterprise development points are awarded based on the percentage of profit that is contributed to the growth of businesses that are owned by qualifying persons. An example of such contribution would be donating a vehicle to a qualifying person in order for him or her to start or to expand a delivery company. Different 'benefit factor' ratios are also applied, based on the type of contribution made (Ibid, 2008:16).

Expenditure incurred towards enterprise development can be either monetary or non-monetary (Ibid, 2008:18). Points can be awarded for any non-monetary contributions that can be quantified, such as loans, guarantees, credit facilities, the provision of training or the donation of an asset. The Codes of Good Practice includes examples such as direct costs or overheads incurred to assist a beneficiary entity, preferential credit terms or prices, payments to third parties to perform enterprise development on its behalf or the maintenance of an enterprise development unit to support beneficiary entities (Bowman Gilfillan, 2005:46). Enterprise development points can be awarded for the giving of indirect benefits, such as training or mentoring (Department of Trade and Industry, 2005:40–41). Recipients of contributions do not have to be employees of the contributing entity (Standard Bank, 2008:18).

As can be seen from the above examples, expenditure incurred under said section of the scorecard would generally be of no direct benefit to the entity making the contribution. The expenditures could generally be divided into two subclasses. Firstly, there are those that have a clearly defined monetary cost for the entity making the contribution, for example the donation of money, or the paying of expenses on behalf of the beneficiary. Secondly, there are contributions that do not have a direct monetary cost, or that do not cause incremental expenditure for the contributing entity. Such contributions would include donating

assets, granting guarantees, discounting prices or using staff to provide mentorship.

2.4.3 Skills development

Skills development points are awarded for the percentage of payroll spent on the training and development of qualifying employees. Only spending on certain types of learning programmes and learnerships is allowed, as outlined in Code 400. The aforesaid types include programmes at schools and universities, certain recognised workplace training, some informal work-based programmes, SETA-approved training, and some others (Ibid, 2008:15).

Skills development points are awarded for expenditure on specified learning programmes and on accredited learnerships for qualifying employees. Legitimate expenditure includes the cost of trainers, materials, training facilities, catering, course fees, travel, accommodation and others. Points can also be awarded for such occupationally-directed programmes as workshops and seminars, or informal work-based training (South Africa, 2007:54–58). This means ‘on-the-job’ training would qualify, if it could be quantified by using a reasonable method, such as a percentage of payroll. Granting bursaries to qualifying employees would also qualify for points under this category. Points will be awarded for bursaries, regardless of whether bursary beneficiaries are required to work back the time spent studying (Standard Bank, 2008:15). From the above examples, it can be seen that most expenditure relating to training and development qualifies for inclusion on the scorecard, even when the expenditure is only indirectly related.

Two broad categories of expenditure can be discerned in the above. Firstly, there are the majority of expenditures relating to training for employees that involve actual incremental expenditure for the employer. Secondly, there are those contributions that are not actual incremental expenditures for the entity, but which would still be included as an amount in the scorecard calculation. Such contributions would, for example, be amounts that are calculated as a percentage of payroll for time spent by employees presenting training.

2.4.4 Socio-economic development

Socio-economic development points are awarded for making donations to charity or for involvement in industry-specific charity initiatives. The percentage of qualifying beneficiaries determines the percentage of the donation that can be claimed for the scorecard. The points awarded are calculated based on the percentage of net profit after tax contributed (Ibid, 2008:18).

Donations to charities and contributions to industry-specific charity initiatives earn points in the socio-economic development category of the BEE scorecard (Ibid, 2008:18–19). Any contributions that are quantifiable would qualify for such points. Quantifiable contributions include loans, preferential interest rates or prices, security of guarantees, donations of funds or assets, direct costs and overheads incurred in assisting beneficiaries and mentoring of beneficiaries (Bowman Gilfillan, 2005:47). Socio-economic development points can also be awarded for the granting of bursaries, even if the bursaries concerned are not linked to future employment possibilities (SARS, 2009).

Two broad categories of contributions are recognised: charitable grants and contributions in the form of human resource capacity (Bowman Gilfillan, 2005:24). As is the case for the enterprise development category, non-monetary contributions that can be quantified qualify for points. Such quantification would include, for example, quantifying the value of staff time that is spent on charitable initiatives (Department of Trade and Industry, 2006:41).

2.4.5 Verification expenditure

A general expense related to all indirect empowerment measures is the fee paid to a BEE verification agency to verify points awarded on the BEE scorecard. The fee involved would normally be paid annually. Only an accredited BEE verification agency may perform this task (South Africa, 2008:7). Consulting with a BEE verification agency could be regarded as an additional initial or ongoing expenditure (EconoBEE, 2010).

2.4.6 Sector charters

As was previously stated, the current study neither examines the full population of sector charters, nor does it attempt to provide an exhaustive list of expenditure. The literature study that was performed included an examination of the requirements of some sector charters to determine whether the nature of expenditures required materially differs from those under the generic BEE scorecard. It was found that expenditures that would be incurred due to having to comply with a sector charter are similar to categories of the generic scorecard, for purposes of the present study. For example, industry levies paid by entities in the tourism sector are similar to socio-economic development contributions.

Some exceptions exist where the nature of expenditure incurred due to a sector charter could be different to expenditure under the generic scorecard. One such example is the additional BEE requirements under the mining sector charter, such as the general development of mining communities and the improvement of housing and living conditions for mineworkers (Department of Trade and Industry, 2010:2–4). Expenditure incurred in said categories would be likely to be capital in nature (KPMG, 2004).

A common feature of most sector charters is a change to the weightings per category of the generic scorecard. As such a change would have no effect on the tax deductibility of expenditure incurred in the categories concerned, it is not given further consideration in the current study.

2.5 Reasons for complying with BEE requirements

Most entities have some incentive to become BEE-compliant and would want to do so in a cost-effective manner (De Klerk, 2008:43). Before the tax deductibility of expenditure incurred to comply with indirect empowerment measures of BEE can be investigated, the reasons for complying with BEE have to be understood. Such an understanding is necessary because the reason for incurring expenditure has an impact on its tax deductibility (Van Schalkwyk, 2010b:110). As discussed earlier, South African legislation places no explicit legal obligation on entities to be

BEE-compliant. The current section discusses the most common reasons for an entity wanting to expend time and funds on ensuring that they are BEE-compliant. All the literature considered thus far has been used to identify these reasons. A summary of the conclusions reached in this section is presented in section 2.6 below.

2.5.1 Requirement of BEE for public enterprises

Section 10 of the BBEE Act requires every organ of state and public entity to take into account and to apply 'as far as is reasonably possible' any Code of Good Practice issued under the BBEE Act (Department of Trade and Industry, 2003). The above effectively means that all government entities and state-controlled companies are required to comply with the generic scorecard as far as they can reasonably be expected to do. The requirement does, of course, raise the question as to what level of compliance is expected by such entities to constitute a 'reasonable effort'. Should they, for example, have a BEE rating (according to the generic scorecard) of level 8 or level 1? The only guidance that is provided on the matter by the Preferential Procurement Policy Framework Act (South Africa, 2000) is that, when evaluating a contract, 20 per cent of the points are given for socio-economic factors, including BEE (Jack & Harris, 2007:297). It is sufficient for the purpose of the current study to note that such entities are required to have some degree of BEE compliance. Such compliance could be achieved through either direct or indirect BEE measures, with the latter usually involving the incurrence of some expenditure (Empowerdex, 2007b:9). The BEE compliance of public enterprises has a knock-on effect for the private sector, as can be seen in the following section.

2.5.2 Preferential procurement requirements and benefits

The preferential procurement category of the generic scorecard is one of the measures of BEE that aims to ensure that empowerment and transformation is broad-based and pervasive, by ensuring that all businesses have some incentive to be BEE-compliant. Entities should want to achieve a higher BEE rating not just because they want to encourage transformation, but also because doing so serves their own financial interest (Arya, Bassi & Phiyega, 2008:236).

Government bodies and public companies often require a certain level of BEE compliance when awarding tenders for work (Bowman Gilfillan, 2005:9). In the past, only the ownership category of BEE was considered when tenders were awarded. However, since 2012 an entity's BEE rating per their verified BEE scorecard has been used when awarding tenders (Steyn, 2011). An entity wishing to tender for such contracts could increase its BEE rating and thereby win more government contracts (Arya & Bassi, 2011:687). The full BEE scorecard, at the time at which the current study was done, was not yet considered in all scenarios. For example, it was decided in *Oceana Group Ltd v Minister of Water & Environmental Affairs* that only black ownership had to be considered when awarding commercial fishing rights.

The preferential procurement category of the BEE scorecard is an incentive for most entities to take measures to become BEE-compliant. Such is the case for any entity tendering for government work, as well as it is for any supplier to a business that is trying to increase its BEE rating (De Klerk, 2008:43). Preferential procurement, therefore, has a trickle-down effect on the different parties in the procurement chain (Boshoff, 2012:217). A business supplying goods to, for example, a construction company that does government contract work would, therefore, have to be BEE-certified. Such certification would, in turn, provide an incentive for customers to buy from the business concerned, as they could thereby increase their own BEE rating. A survey by IQUAD and KPMG (2010:24) showed that 46 per cent of respondents had set a minimum BEE level for their suppliers, mostly at level 4 or at level 5. Even businesses that currently have no pressure from clients to have a BEE rating could improve their future opportunities by having a BEE rating (Geldenhuys, 2006). According to Standard Bank (2008:17), a higher BEE rating provides more benefits through preferential procurement. Businesses that have a BEE rating of lower than level 1, therefore, always have an incentive to improve their rating. There is, however, no incentive for engaging in any activities beyond that.

In addition to the requirements of the generic BEE scorecard, BEE sector charters require consideration for entities operating in the affected industries (Brougham-Cook, 2010:14). The sector charters impose additional transformation requirements, usually by adding categories to the BEE scorecard or by changing its weights (IQUAD & KPMG, 2010:6).

2.5.3 Marketing and public image

Marketing could be a motive for an entity to achieve an acceptable BEE rating (Jack & Harris, 2007:301). An entity might believe that a BEE rating will enhance customers' perceptions of it, thus leading to increased business. A BEE rating could pre-emptively help a business avoid losing customers to competitors who are BEE-certified (Sartorius & Botha, 2008:443). A study by Empowerdex (2006:4) has shown that profit margins generally increase after an entity becomes BEE-compliant. The adoption of such BEE measures as skills development and involvement in socio-economic development could also increase the morale and productivity of the employees involved (Shera & Page, 1995:2).

Ferreira and De Villiers (2011:23) have shown that there is a positive correlation between a higher BEE rating and share price. Entities could desire to comply with BEE requirements due to the demand for increased corporate accountability relating to social issues (Ackers, 2009:2).

2.5.4 Commitment to transformation or general philanthropic reasons

An entity might want to achieve a BEE rating purely because it believes in the worthiness of the cause of transformation. Entities that support the acceleration of qualifying people into the South African economy could choose to do so through adoption of the measures prescribed by the BEE scorecard (Beukes, 2011a:94).

Activities on the BEE scorecard, such as socio-economic development and enterprise development, are areas to which many entities contribute resources, regardless of BEE requirements (Matten & Moon, 2008:404). Differentiating which of such activities were undertaken for social reasons would be difficult to determine, as would which were performed with the goal of scoring points on the

BEE scorecard. In most cases, although not always, both elements would be present, according to Ernst & Young (as cited by Jooste, 2010). Entities might also tailor their social responsibility activities in such a way that they qualify to earn points on the BEE scorecard (Onojaefe & Bytheway, 2010:8–9).

2.5.5 Legal requirements for some entities

As was previously mentioned, the mining sector charter imposes a legal obligation to comply with its provisions, as it is issued as an amendment to the Mineral and Petroleum Resources Development Act (South Africa, 2002). This is an exception in which case entities have to comply with the BEE provisions of the sector charter, as non-compliance could result in a loss of mining rights (Mohamed & Roberts, 2008:27).

2.5.6 Other considerations regarding reasons for BEE compliance

It is important to consider that BEE compliance is measured in terms of discrete levels, with level 8 being the worst and level 1 the best. Different motives for achieving BEE compliance would determine the level of BEE compliance that an entity wishes to achieve. One entity might want to achieve the highest level, so that it can market itself as having the highest level of BEE compliance in its industry. Another entity might be satisfied with a lower rating, if such a rating is the minimum requirement for a certain government contract for which they are tendering. For example, suppliers tendering to Spoornet, a division of state-owned Transnet, are only required to have a level-5 BEE rating (Lutchka, 2007).

The list of motives given above is not exhaustive. Furthermore, it could be the case that an entity strives for a certain BEE rating due to a combination of reasons, rather than as the result of a single motivation (Clegg, 2009:18–19). An entity could take actions and incur costs towards scoring points on its BEE scorecard for one purpose, up to a certain point, and thereafter for another purpose (Ibid, 2009:18–19). For example, a business might incur costs to become a level-5 BEE certified entity, because doing so is required for the contract for which it is tendering. The business might then want to increase its rating to level 1 for marketing purposes. As the entity would have to score points in different parts

of the BEE scorecard during a 12-month period, it would be difficult to determine which expenditures or activities contributed to achieving the level-5 rating and which expenditures or activities further increased the rating to level 1 (South Africa, 2008:17–18).

A further illustration of the above problem would be the case where an entity already has a level-1 BEE rating (the highest level). In such a case, any further expenditure towards activities that could score points on the BEE scorecard could not be incurred for the reason of increasing the BEE score. As the entity would already be at the maximum BEE level, some expenditure would have to be for some other purpose, for example for reasons of making general philanthropic contributions. Doing so would especially be the case for smaller enterprises, as they require fewer points in total on the BEE scorecard to reach a level-1 rating (Empowerdex, 2007b).

2.6 Conclusion

The current chapter has given a general description of BEE requirements. The understanding of such requirements is key to the determination of whether expenditure incurred to meet the requirements of indirect empowerment measures is tax-deductible. In summary, BEE compliance consists primarily of scoring points for various activities or expenditures, per the categories of the generic BEE scorecard. The result is a BEE rating of a level from 8 to 1. The common expenditure incurred to score points in the indirect empowerment sections of the BEE scorecard can be grouped into six broad categories of expenditure, as were identified in section 2.4 above.

Based on the considerations under section 2.4, the broad categories of common expenditure that are incurred by entities in order to achieve points in the indirect categories of the BEE scorecard can be summarised in the following table.

Table 2.3: Broad categories of common expenditure incurred due to BEE requirements

	Broad categories of expenditure	Indirect empowerment measure
1	General procurement expenditure	Preferential procurement
2	Charitable contributions to persons other than employees	Enterprise development & socio-economic development
3	Non-monetary assistance to persons other than employees	Enterprise development & socio-economic development
4	Monetary expenditure by employers towards skills development of qualifying employees	Skills development
5	Non-monetary assistance by employers towards skills development of qualifying employees	Skills development
6	BEE verification expenditure	Not applicable

The broad categories of expenditure, as listed in Table 2.3 above, have been compiled based on examples of common expenditure identified through the available literature. As was described in subsection 2.4.6, expenditures relating to sector charters do not require a separate category, but relate to several of these categories. The broad categories of expenditure in Table 2.3 are used to organise the consideration of tax deductibility in Chapter 3. Before doing so, the reasons for incurring the expenditures also required investigation.

Based on the considerations under 2.5 above, Table 2.4 consists of a list of common reasons that have been identified as to why entities would wish to comply with BEE requirements.

Table 2.4: Common reasons for complying with BEE requirements

	Common reasons for complying with BEE requirements
1	Requirement of BEE for public enterprises
2	Preferential procurement-related requirements and benefits
3	Marketing and public image
4	Commitment to transformation or general philanthropic reasons
5	Legal requirements under the Mineral and Petroleum Resources Development Act

An entity could want to comply with BEE requirements for one of the above-mentioned reasons, or, more likely, for a combination of them. An entity could also need or want to reach different BEE levels for different reasons, based on its situation. In conclusion, many cases could exist where it might be difficult to ascertain the exact reason why an entity takes actions to achieve BEE compliance. When considering the tax deductions of expenditure incurred to become BEE-compliant, it is necessary to remember that the motive for doing so is definitely not the same in all cases.

The investigation into the deductibility of expenditure in Chapter 3 and into the best practice guidelines in Chapter 4 will be organised around the above-mentioned identified broad categories of expenditure. Although BEE compliance is not a legal requirement, various reasons have been identified for why entities would wish to be compliant with BEE. The reasons, along with considerations regarding the maximum BEE level required by an entity and the broad categories of common expenditure, are considered when judging the tax deductibility of expenditure related to indirect empowerment measures in Chapter 3.

Chapter 3: Tax deduction requirements and the application thereof to the deduction of expenditure relating to indirect BEE measures

3.1 Introduction

In Chapter 2, the broad categories of common types of expenditure incurred towards indirect BEE measures were identified. The defined objective of the current study was to investigate the deductibility of such expenditure and to formulate best practice guidelines regarding the deductibility. The current chapter applies the principles of the deductibility of expenditure in accordance with the Act to the identified broad categories of expenditure concerned. The other considerations that were identified in subsection 2.5.6 are also considered in order to draw conclusions regarding the impact of such factors on the deductibility of expenditure.

An understanding of the deductibility of expenditure in terms of the Act first has to be obtained. This is done by examining the literature on special deductions and general deductions. The theoretical understanding conveyed in this way is then applied to expenditure relating to indirect BEE measures. The views of various commentators on the general situation of the deductibility of expenditure related to indirect BEE measures are then also examined here. This also identifies certain general issues requiring consideration. The tax deductibility of the broad categories of expenditure (Table 2.3) is then considered. Such consideration is done in terms of each individual category of expenditure, as the nature of expenditure can determine its deductibility (Van Schalkwyk, 2010b:110).

In order to contextualise the issue of the deduction of expenditure relating to indirect BEE measures, a few opinions of authoritative sources are provided below. Some writers have considered the deductibility of BEE costs as a whole as the issue at stake (Tarrant, 2007:18), whereas others have also looked at specific BEE expenditure per selected categories of the BEE scorecard (Ntombela, 2006). KPMG (2004) suggests that BEE expenditure is deductible if a failure to comply

might result in a significant loss of trade benefits. Such reasoning casts the potential net of deductions quite wide, but a potential problem is the fact that BEE expenditures are not legally required (Tarrant, 2007:18). PwC (2004) holds the narrower view, namely that failure to incur BEE expenditure would likely have to result in 'almost certain' losses for it to be deductible. Mazars (as cited in Scholtz, 2009:14) has stated that expenditure relating to enterprise development and socio-economic development is deductible. Such expenditure would be deductible in all cases where they are to enhance the trading position of the entity concerned, whether it be by attaining or enhancing its BEE status. According to Jack (2009), a binding class ruling by SARS allows for expenditure in certain categories of the BEE scorecard to be deducted under section 11(a) of the Act.

The conclusions reached in the current chapter regarding the deductibility of expenditure are then used to formulate the best practice guidelines in Chapter 4. The best practice guidelines consist of factors that require consideration when determining whether expenditure is deductible for tax purposes. The factors considered when evaluating the deduction of expenditure in the present chapter will, therefore, also be considered in Chapter 4 when formulating the best practice guidelines.

3.2 Framework for income tax deductions and approach followed

Normal tax for taxpayers is based on 'taxable income', per the Act. (Van Schalkwyk, 2010a:2). As part of the calculation of taxable income, certain amounts are deducted from income, as defined in the Act. The main sections of the Act dealing with deductions are sections 11 to 19 and section 23 (Ibid, 2010b:108). Deductions are mostly allowed in terms of the so-called 'general deduction formula', consisting of sections 11(a) and 23(g) of the Act (Jones, 2009:2). In addition to the deductions that can be made under the general deduction formula, the Act allows for certain special deductions, mostly under sections 11(bA) to (x) (Wilcocks, 2010a:134). Certain capital allowances are also available for payments of a capital nature under various provisions ranging from sections 11 to 23 (Ibid, 2010b:186–187). Special deductions are considered in cases where a deduction in terms of the general deduction formula is not allowed

or is uncertain (Williams, 2009:528). The other consideration when determining deductions is section 23, as this section prohibits the deduction of certain expenditure and losses (Wilcocks, 2010a:134).

The general deduction formula, special deductions and capital allowances require consideration when determining the amount deductible for income tax purposes (PwC, 2010:48). This approach is applied for deductions in respect of indirect BEE measures. As was previously explained, the analysis of tax deductibility needs to be performed separately per the identified broad categories of expenditure. The methodology that has been followed involved first considering the tax deductibility of expenditure relating to indirect BEE measures in terms of the general deduction formula (refer sections 3.3 to 3.4), including identifying potential problem areas. Secondly, the requirements were applied to each broad category of expenditure (section 3.5).

In section 3.5, every broad category of expenditure has been analysed individually and measured against the requirements for tax deductibility. The available literature on tax deductions for expenditure relating to indirect BEE measures is considered. This analysis includes a detailed consideration of the applicability of, firstly, the general deduction formula, secondly, special deductions and, thirdly, capital allowances (including a consideration of whether CGT could be applicable). A conclusion is then drawn for every broad category of expenditure concerned.

3.3 General income tax deduction formula

The first consideration when determining whether expenditure is tax deductible is to consider the general deduction formula. The general deduction formula is contained in section 11(a) of the Act, read together with section 23(g). There is also abundant case law available that aids with interpretation and that requires consideration in understanding the requirements.

According to Van Schalkwyk (2010b:108), the so-called 'positive test of the general deduction formula' is contained in section 11(a) of the Act, as follows:

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

- a) *expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature...*

The positive test sets out what may be deducted. Section 11(a) cannot be considered in isolation – the so-called ‘negative test’ stipulates what may not be deducted (Ibid, 2010b:108). Section 23 of the Act lists the cases where a deduction cannot be made. Specifically, the negative test is contained in the introduction to section 23 and section 23(g), as follows:

No deductions shall in any case be made in respect of the following matters, namely –

- g) *any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purpose of trade ...*

To ascertain whether an amount is deductible in accordance with the Act, the requirements of section 11(a), read together with section 23(g), have to be considered (PwC, 2010:49). In summary, the two sections allow a deduction for:

- expenditure and losses;
- actually incurred;
- during a year of assessment;
- in the production of income;
- provided that they are not of a capital nature; and
- to the extent that they are for the purpose of trade.

The meanings of each of the above-mentioned components of the general deduction formula are now considered, together with the relevant landmark cases concerned. These theoretical principles are then applied to the categories of expenditure relating to indirect BEE measures, as summarised in Table 2.3.

3.3.1 Expenditure and losses

According to Williams (2009:422), 'expenditure' usually means a voluntary payment of money, whereas a 'loss' usually refers to an involuntary deprivation. Expenditure may be in the form of cash or in kind, so that payments made by means of assets transferred are therefore also included (PwC, 2010:49). Expenditure could be an outlay of cash, shares or assets on which a value can be placed (Van Schalkwyk, 2010b:111). It is recognised that certain BEE activities may not cause an incremental expenditure and that some non-monetary expenditures can score points on the BEE scorecard. The further analysis of 'expenditure and losses' that has to be specifically applied to such BEE activities is performed in subsections 3.5.3 and 3.5.5 below. The amount of time that is spent by employees on certain activities can score points on the BEE scorecard under certain circumstances (Jack & Harris, 2007:336–346). Therefore, it is submitted that, although the amount of 'time spent' does not qualify as expenditure, the portion of payroll expenses relating to such time spent does qualify as expenditure.

3.3.2 Actually incurred

Expenditure is 'actually incurred' when there is a definite and unconditional liability to pay an amount by the end of the year of assessment (PwC, 2010:49). As section 11(a) does not use the words 'necessarily incurred'; even expenditure that is due to inefficient or extravagant conduct can be deducted (Van Schalkwyk, 2010b:111). The principle concerned was established in *Port Elizabeth Electric Tramway Co v CIR*. As was seen in section 2.5 above, expenditure towards indirect BEE measures might not be incurred exclusively for business reasons. Therefore, it follows that such expenditure is still 'actually incurred', regardless of the reason for incurring it.

A further issue that has been pointed out by Williams (2009:422) is that the amount of a tax deduction is not the amount for accounting purposes or an estimated amount, but the amount that is 'actually incurred' by the taxpayer concerned. Said distinction between accounting and tax was also raised in *Pyott Ltd v CIR*. It is, therefore, recognised that determining the amount of a tax

deduction could be complicated by the fact that the accounting classification of expenditure is likely to differ from the classification as per Table 2.3 in the previous chapter. Also, the accounting expense is not necessarily the same as the amount used in the BEE scorecard calculation. As concluded above by Williams (Ibid:422), the amount of the tax deduction would be the expenditure actually incurred, and neither the accounting expense nor the amount used in the BEE scorecard calculations.

3.3.3 During a year of assessment

Expenditure has to be deducted in the year of assessment in which it is incurred by the taxpayer, subject to the provisions of section 23H (Van Schalkwyk, 2010b:113). This would not be a concern in most cases, as BEE verification has to be done on an annual basis, per financial year (Bowman Gilfillan, 2005:6). The expenditure incurred to become BEE-compliant would, therefore, in all likelihood fall within that financial year and year of assessment. Section 23H is only applicable to deductible expenditure (Ibid, 2010b). As deductibility is the focus of the current study, further consideration will not be given to the section 23H.

3.3.4 In the production of income

Expenditure and losses must have been incurred for the purpose of earning income in order to qualify as a deduction. Furthermore, expenditure must be so closely connected with the income-earning operations of the concern that they are regarded as forming part of the cost of performing them (PwC, 2010:50).

Expenditure is closely connected to an income-earning operation, to the extent that it would be reasonable to regard the expenditure as a part of the cost of performing the operation concerned. The purpose of the expenditure and what it actually achieves is taken into account (Ibid, 2010:50). In *Port Elizabeth Electric Tramway Co v CIR*, two tests were established to determine whether expenditure is in the production of income – a subjective purpose test and an objective nexus test (Williams, 2009:446). The subjective test is used to determine whether the act that entails the expenditure is performed in the production of income. The

objective test is used to determine whether the expenditure was linked closely enough to the act to be considered a part of performing it. In *Joffe & Co (Pty) Ltd v CIR*, said principle was phrased in the following way: the act that causes the expenditure needs to be a 'necessary concomitant' of the taxpayer's trading operations.

From the literature study that was performed, it could be seen that the question of whether expenditure is in the production of income is a central issue when determining the deductibility of expenditure relating to indirect BEE measures. This test is key when determining deductibility, as some types of expenditure do not always have a clearly apparent influence on profits (Brincker, 2010:120). The general principles identified above are now used to investigate whether expenditure incurred towards indirect BEE measures is incurred in the production of income.

According to Ernst & Young (2011), if a company incurs corporate social responsibility expenditure with the aim of meeting BEE scorecard requirements, SARS is likely to allow it as a deduction. The same is likely to hold for other expenditure towards indirect BEE measures, even though such expenditure would likely not have been in the production of income, had it not been for BEE (Jack & Harris, 2007:468). It is submitted that the objective test can be addressed without difficulty – expenditure towards indirect BEE measures is incurred in order to become BEE-compliant and is therefore closely connected to the act performed. The subjective test is, however, not as simple, as it entails determining whether the act of becoming BEE-compliant is performed in the production of income. According to KPMG (2004), the 'actual purpose' of expenditure towards BEE compliance has to be considered to decide whether the expenditure is incurred in the production of income. If there is a trade benefit, such expenditure should be deductible (Ibid, 2004).

PwC (2004) took the view that the expenditure relating to BEE would be deductible only if it could be clearly shown that BEE compliance was needed to earn, or to protect, income. More recent literature has shown that SARS is willing

to allow such expenditure as a deduction. For example, a binding class ruling has been issued for the deduction of bursaries (SARS, 2009) and a binding private ruling has been issued for the deduction of enterprise development expenditure (SARS, 2012). The common reasons for complying with BEE requirements, as summarised in Table 2.4, have mostly been shown to be either a direct or an indirect means of increasing profits, as was discussed in section 2.5 above. Some exceptions to the former have been noted when applying the general principles of the production of income to the common reasons for complying with BEE, as are summarised in Table 3.1 below. In general, though, it is submitted that BEE compliance will be to the benefit of an entity's trade, and therefore in the production of income.

Expenditure can be seen as being in the production of income, even if the motive for the expenditure is partially a non-business reason, as, for instance, for philanthropic reasons (Clegg, 2009:17). Many of the sources referenced in the current section have mentioned that *Warner Lambert v C:SARS* strengthens the case for the deduction of expenditure related to BEE (Ntombela, 2006). In said case, the taxpayer would have faced fines under the USA's Comprehensive Anti-Apartheid Act, had it not taken steps towards transformation and performing social work (Williams, 2009:463). Even though taxpayers do not face fines under the BBBEE Act, there are negative financial consequences to not complying with BEE (Sartorius & Botha, 2008:443). The conclusion there is that, in general, expenditure towards indirect BEE measures is incurred towards the production of income.

The subjective test should, however, also be considered to determine whether the purpose of an act was to produce income. This test will always depend on the subjective motive of the taxpayer in the specific case, although some guidance can be achieved by considering common reasons for becoming BEE-compliant, as identified in Table 2.4:

- **Requirement for public entities.** Becoming BEE-compliant because of a legal obligation (with potential penalties) would qualify as being in the production of income.

- **Preferential procurement requirements and benefits.** As was described in section 2.5, there are various potential financial benefits to becoming BEE-compliant – to which extent, doing so would be in the production of income. However, when an entity already has a level-1 BEE rating and incurs further expenditure, or incurs expenditure to increase its BEE rating more than it needs to do, these excessive expenditures would be for a different reason, which would, most likely, be social good.
- **Marketing and public image.** An IQUAD and KPMG (2010:4) study has shown that BEE compliance increases profits – therefore, it would be in the production of income to become BEE-compliant for marketing purposes. Corporate social responsibility spending for marketing purposes is considered tax-deductible (De Villiers, 1996).
- **Commitment to transformation or general philanthropic reasons.** Expenditure incurred for these reasons would not be in the production of income. The principle that expenditure for social or philanthropic reasons is not deductible was affirmed in *CIR v Pick 'n Pay Wholesalers (Pty) Ltd* (Ernst & Young, 2011).
- **Legal requirements for some entities.** Entities that incur expenditure to become BEE-compliant in order to avoid the loss of a mining licence would do so in the production of income, for instance.

Based on the above considerations, the reasons for incurring BEE expenditure impact on any consideration as to whether the expenditure would be in the production of income. The results of the findings are summarised in Table 3.1 below.

Table 3.1: Reasons for becoming BEE-compliant – whether they can be viewed as being in the production of income

	Common reasons for complying with BEE requirements (as per Table 2.4)	Whether the reason qualifies as being in the production of income
1	BEE required for public enterprises	Yes
2	Preferential procurement-related requirements and benefits	Yes, but only to the extent that it is not excessive
3	Marketing and public image	Yes
4	A commitment to transformation or general philanthropic reasons	No
5	Legal requirements under the Mineral and Petroleum Resources Development Act	Yes

As can be seen from Table 3.1 above, expenditure towards becoming BEE-compliant is likely to be incurred in the production of income in most cases. The assumption is, therefore, made for the rest of this chapter (except for where it is otherwise stated) that the reason for wanting to become BEE-compliant is one that qualifies as being in the production of income. Although the summary in Table 3.1 above offers some guidance as to when expenditure is regarded as being in the production of income, additional salient issues are discussed in section 3.5.

3.3.5 Not of a capital nature

Expenditure that is incurred for an enduring benefit is said to be of a capital nature and is not deductible (despite, however, there being possible implications for capital allowances or for CGT). The distinction between capital and non-capital expenditure is a matter of fact and has to be determined for each individual transaction (Van Schalkwyk, 2010b:115). In *New State Areas Ltd v CIR*, the court distinguishes between expenditure that is a 'cost of performing the income-earning operations' (non-capital expenditure) and a 'cost of establishing or improving or adding to the income-earning plant or machinery' (capital expenditure). Capital expenditure is any expenditure to acquire an asset of a permanent nature or some enduring benefit (PwC, 2010:50).

In *Warner Lambert v C:SARS*, the court held that expenditures forming part of a social responsibility programme were not capital in nature, as they were made to protect the taxpayer's income (Williams, 2009:463). KPMG (2004) has commented that, as BEE payments are 'periodic payments', like the expenditure in the above-mentioned case, said expenditures are not capital in nature. As was previously discussed, as BEE compliance is an annual requirement, any expenditure incurred would be recurring, indicating a non-capital nature (Bowman Gilfillan, 2005:6). Section 23H could be applicable in cases where deductible non-capital expenditure is incurred that will score points on the BEE scorecard in the current year, as well as in future years. Such was the case for the applicant in a 2012 binding private ruling by SARS (Louw, 2012:2).

Expenditures occur under certain sector charters that might be capital in nature, such as expenditure towards integrated development plans for mining communities under the mining sector charter (KPMG, 2004). However, such expenditure could possibly be deducted under section 11(a), based on the decision in *Warner Lambert v C: SARS* (Ibid, 2004). The mining sector charter also requires expenditure towards mine community development, housing and living conditions, and sustainable development (Department of Trade and Industry, 2010:4–5). If above-mentioned expenditures (that have a greater chance of being capital in nature) are, in fact, capital in nature, certain capital allowances could be available, and the standard CGT provisions would apply (section 3.4).

In conclusion, expenditure towards indirect BEE measures would normally be seen as a part of the cost of operating the taxpayer's income-producing structure, and therefore not capital in nature. Certain expenditures under sector charters do, however, have a somewhat heightened chance of being capital in nature.

3.3.6 Carrying on a trade

Any expenditure that is incurred for a reason that is not commercially related is not deductible under section 11(a) (Williams, 2009:418). The term ‘trade’ is given a very wide definition in section 1 of the Act, ensuring that most activities would fall within its ambit (Van Schalkwyk, 2010b:108). Expenditure towards indirect BEE measures is a necessary part of business for most entities, as was seen in section 2.5, and is therefore undertaken for the purpose of their trade. One exception to the above is expenditure incurred for general philanthropic reasons – such expenditures are incurred for non-commercial reasons (refer subsection 2.5.4). If expenditure is partially for purposes other than the taxpayer’s trade, it can be apportioned and partially deducted (PwC, 2010:51). Expenditure towards indirect BEE measures is submitted as being incurred in the carrying on of a trade.

3.3.7 Summary

In summary, there are many cases where expenditure related to indirect BEE measures potentially qualifies for deduction under section 11(a) of the Act. The following potential issues have been identified in the preceding sections:

- Only outlays of money or assets qualify as expenditure or losses.
- The test for ‘in the production of income’ is subjective and will not be passed in all cases. General guidance, which was summarised in Table 3.1, has identified some reasons for becoming BEE-compliant that would qualify as being in the production of income. Said reasons will have to be considered in all cases to determine deductibility.
- Expenditure incurred to become BEE-compliant is not capital in nature. Expenditures incurred to meet certain categories of some sector charters are more uncertain, but should still be non-capital in nature.
- Expenditure incurred for general philanthropic purposes would most likely not be regarded as being incurred in the course of carrying on a trade.

This section investigated the principles of the general deduction formula and the application in general to expenditure related to indirect BEE measures. The application will be applied in more detail in section 3.5 to the identified broad

categories of expenditure, but before such an application, special deductions available in terms of the Act are also considered.

3.4 Special income tax deductions per the Act

Special deductions are considered where the general deduction formula does not allow a deduction, or where a deduction is uncertain (Williams, 2009:528). This section identifies which special deductions should be considered when evaluating (in section 3.5) whether the identified broad categories of expenditure are deductible. Sections 11 to 19 and section 23 of the Act are identified by Van Schalkwyk (2010b:108) as the sections of the Act commonly dealing with deductions. The sections concerned were used as a starting population to determine which sections could potentially be used to claim a deduction for expenditure incurred towards indirect BEE compliance measures. By referring to literature by PwC (2010:48–121), Wilcocks (2010a:133–184) and the Act, the following sections were identified as possibilities for the deduction of expenditure relating to indirect BEE empowerment measures:

- **Section 12H – Learnership allowance:** The allowance is a limited deduction for employers training employees through registered learnership agreements (Wilcocks, 2010b:253). As the allowance is granted in addition to any otherwise deductible expenditure, section 12H does not actually make expenditure deductible (Ibid:254).
- **Section 12I – Additional investment and training allowance:** The allowance is a limited deduction for investments and training related to qualifying Industrial Policy Projects. The applicability of the deduction is limited, as it only applies to approved projects in the manufacturing industry (PwC, 2010:91–94).
- **Section 18A – Donations to public benefit organisations:** A limited deduction is available for donations of money or property to qualifying beneficiaries (Wilcocks, 2010a:157). This deduction can be utilised for qualifying donations as part of socio-economic development or enterprise development programmes (Jack & Harris, 2007:468–469).
- **Capital allowances** include those made in terms of section 11(e), section 13sex and section 15(a). In cases where SARS disallows expenditure for

deduction under section 11(a), due to judging said expenditure capital in nature, a capital allowance could still be claimed. For example, providing an asset to a qualifying enterprise could be deductible under section 11(e), or providing residential accommodation could be deductible under section 13sex or section 15(a) (for mining companies). The current study does not investigate the full extent of potentially applicable capital allowances, as they depend on an endless variety of potential expenditures.

From the above list, it can be seen that the first three special deductions will only be available in limited cases, and that the amounts deductible per year of assessment are limited in different ways. The last deduction (referring to the various sections available for capital allowances) is only available in cases where expenditure was capital in nature – this will also only be in limited instances, as was established in subsection 3.3.5. The broad categories of expenditure towards indirect BEE measures are evaluated against the above special deductions in the following section.

3.5 Application of income tax deduction principles to the identified broad categories of expenditure

The general deduction formula was earlier analysed and applied for expenditure relating to indirect BEE measures in section 3.3. Although the analysis was only done in a general sense, various conclusions were drawn that are applicable to such expenditures. In the current section, the application is made more specific by considering the broad categories of common expenditure, as were identified in Table 2.3. The special deductions that were identified in the preceding section of the present thesis were also considered for each broad category of expenditure. The general conclusion drawn was that expenditures relating to indirect BEE measures are deductible, although there are some issues (refer to subsection 3.3.7) that can cause them not to be deductible. These issues are also considered for each broad category of expenditure in the current section.

3.5.1 General procurement expenditure

General procurement expenditure, which refers to preferential procurement expenditure, includes a range of both operational and capital expenditure. As the category concerned encompasses many expenses, some of them might naturally be deductible (under either the general deduction formula or special deductions) and some might not. As was seen in subsection 2.4.1, it is unlikely that BEE would alter the above, as expenditure would never be incurred for the primary reason of scoring points in the preferential procurement category of the BEE scorecard. According to Kotze (2012), the above opinion is also supported by Mazars. Therefore, the answer to the test of whether the expenditure was incurred in the production of income will not be changed.

The fact that a business might choose a different supplier due to preferential procurement will also not alter the deductibility of the expenditure. The above-mentioned situation will apply similarly to both operational and capital expenditure. In conclusion, the deductibility of expenditure in this broad category will not be altered by the fact that an entity scores points on its BEE scorecard for incurring it. None of the special income tax deductions, as identified in section 3.4, are specifically applicable here. Likewise, the preferential procurement category of the BEE scorecard will not change whether expenditure has an available capital allowance or CGT implications.

3.5.2 Charitable contributions to persons other than employees

The broad category considered in the current subsection refers to expenditure incurred and contributions made towards the enterprise development and socio-economic development categories of the BEE scorecard. In subsection 3.3.7, it was determined that expenditure relating to indirect BEE measures would mostly be deductible per section 11(a), except for four possible issues that could cause them to not be deductible. These issues are considered below in the specific context of this category of expenditure.

The first issue that could preclude a deduction is that only outlays of money or assets can be regarded as 'expenditure or losses'. As the broad category of

expenditure considered in the current section refers only to monetary outlays, it would qualify as expenditure or losses. Non-monetary contributions will be considered under subsection 3.5.3.

Secondly, the reason for making a contribution towards enterprise development or towards socio-economic development determines whether the expenditure is made in the production of income. The common reasons for becoming BEE-compliant, along with a conclusion of whether those reasons qualify as being 'in the production of income', were summarised in Table 3.1. The second (in some cases) and the fourth reasons in said table are not in the production of income. Charitable contributions to persons other than employees will not be deductible if they were made for such reasons. As was discussed in subsection 3.3.4, and as supported by KPMG (2004), expenditure relating to indirect BEE measures will probably qualify as being in the production of income. The decision in *Warner Lambert v C:SARS* is key in the argument for the deduction of costs relating to BEE measures. Even though the case mentioned related to expenditure incurred in order to comply with the Sullivan Code (under the United States Comprehensive Anti-Apartheid Act), the principles could also be applied to expenditure incurred towards compliance with the BBBEE Act (Jack & Harris, 2007:469). The ruling can be used to argue that corporate social responsibility expenditure for BEE purposes is in the production of income (Clegg, 2009:19).

Some further literatures in support of the above view are the recent rulings made by SARS on the subject of expenditure relating to BEE. The Binding Class Ruling issued in 2009 allowed the subsidiaries of a taxpayer to claim deductions for bursaries granted, in order to score points in the socio-economic development category of the BEE scorecard (SARS, 2009:1–2). Even though the ruling in question is not applicable to other taxpayers, it does give some indication of SARS' interpretation of section 11(a) relating to BEE expenditure (PwC, 2009a:2). A second example is the 2012 Binding Private Ruling, in terms of which a taxpayer was allowed to deduct expenditure relating to what was, effectively, an enterprise development project for BEE purposes (SARS, 2012:1–3).

A third issue identified in subsection 3.3.7 was that expenditure towards BEE measures might, in some cases, be capital in nature. Taxpayers should be able to show, in most cases, that such expenditures are not capital in nature (Ernst & Young, 2011). As described in subsection 3.3.5, some expenditure, for example that which is incurred under certain sector charters, has an elevated chance of being deemed capital in nature by SARS.

The last issue identified that could cause expenditure under this category to not be deductible is where the expenditure is incurred for general philanthropic reasons and is, therefore, not part of an entity's trade. According to Williams (2009:468), expenditure towards BEE indirectly facilitates the carrying on of a trade. An exception where charitable contributions to persons other than employees will not form part of the carrying on of a trade is where said contributions are made purely for philanthropic reasons. In such a case, the expenditures concerned would not be deductible. In other cases, expenditure towards BEE would improve an entity's trading position and would, therefore, form part of its trade (Scholtz, 2009:14).

In summary, it was seen in subsection 3.3.7 that expenditure related to indirect BEE measures should mostly be deductible under the general deduction formula. When specifically considering charitable contributions to persons other than employees, it could be seen above that there are only a few cases where contributions to persons other than employees would not be deductible under the general deduction formula.

With regards to the available special deductions, sections 12H and 12I cannot be utilised here, as they only apply to spending on employees. However, section 18A can definitely be applied here, even though the amount of the deduction might be limited (Jack & Harris, 2007:468). Contributions towards enterprise development and socio-economic development will, however, not always be made to entities qualifying for a section 18A deduction (Jack & Harris, 2007:468–469). Where expenditure under this category is capital in nature, capital allowances would be available. Common capital allowances that could be applicable are

section 11(e), section 13sex or section 15(a), depending on the nature of the incurred expenditure. As was discussed in section 3.4, further expansion of exactly what allowances would be available is beyond the scope of the current study. An expenditure that is capital in nature would also incur the variety of CGT implications per the Eighth Schedule of the Act.

3.5.3 Non-monetary assistance to persons other than employees

This broad category also refers to contributions relating to enterprise development and socio-economic development, but specifically only to non-monetary expenditure. Examples are provided in subsections 2.4.2 and 2.4.4, but typically include contributions in the form of assets, providing discounts or using staff time for mentorship or charitable initiatives. The deduction of expenditure relating to indirect BEE measures was assessed in section 3.3, but is made specific for this broad category of expenditure in the current section.

Except for contributions in the form of assets or quantifiable staff time, other expenditures under the broad category in question do not qualify as 'expenditure or losses' per the general deduction formula (Van Schalkwyk, 2010b:111). Such other activities might score points on the BEE scorecard, but they are not deductible under section 11(a). For contributions in the form of assets, the principles for deduction per section 11(a) are the same as those that apply for regular payments, therefore refer to subsection 3.5.2 in said regard. Contributions in the form of staff time are also evaluated in the same way as is expenditure under subsection 3.5.2 – the deduction will be quantified with reference to hourly rates (Jack & Harris, 2007:336–346). In summary, under this broad category of expenditure, it is only contributions in the form of assets and staff time that can potentially be deducted under section 11(a).

According to section 23B, expenditure can only be deducted once. For example, when contributing staff time to socio-economic development, a deduction can only be claimed once. If all payroll-related expenditure is already deductible, the portion of staff time used towards earning BEE points will not be deductible again.

Once again, sections 12H and 12I cannot be utilised here, as the sections in question only apply to spending on employees. Section 18A can be used for donations of assets (or for the sale of an asset at below market value), but the amount of the deduction is limited to 10 per cent of taxable income (Wilcocks, 2010a:157). Such contributions of assets can, however, only be deducted if the donations are made to entities qualifying for a section 18A deduction, mostly Public Benefit Organisations (Jack & Harris, 2007:468–469). No capital allowances are applicable for expenditure under this broad category.

3.5.4 Monetary expenditure by employers towards skills development of qualifying employees

As explained in subsection 2.4.2, this broad category of expenditure includes such skills development expenditure as bursaries to employees, accredited learning programmes and related expenditure, such as materials and facilities. A key fact in the present instance is that expenditure related to skills development should often be deductible per section 11(a), regardless of the fact that it contributes to a taxpayer's BEE rating (Jones, 2009:2-4).

In *Mobile Telephone Networks Holdings (Pty) Ltd v C:SARS*, expenditure on training employees to implement a new system was allowed as a deduction. According to Croome (2011:12), training expenditure is deductible, if it is a necessary concomitant of the income-earning operation, even though this might not be the only reason for the training concerned. Expenditure in this broad category should, therefore, mostly be deductible under section 11(a), without referring to the BEE benefit. There could, however, be cases where training expenditure is clearly not in the production of income (for example, the training is not even remotely related to the taxpayer's operations) or clearly capital in nature (for example, training that relates to setting up a new income-earning structure). In such cases, the deductibility of skills development due to the BEE scorecard can be considered.

In subsection 3.3.7, it was seen that expenditure relating to indirect BEE measures would mostly be deductible per section 11(a), except for four possible

issues that could cause it to not be deductible. The four potential issues are applied to monetary expenditure by employers towards skills development of qualifying employees below:

- Expenses under this category will qualify as expenditure or losses.
- An expense has to be in the production of income. Per Table 3.1, it was seen that all the common reasons for becoming BEE-compliant qualify as in the production of income, except for the second reason (in some cases) and the fourth reason concerned. This requirement was discussed in more detail in subsection 3.5.2 above and applies similarly in the present instance. For example, expenditure towards skills development of qualifying employees incurred only for social good, rather than for it having any benefit to the business, would not be in the production of income.
- The circumstances mentioned in subsection 3.3.5, where expenditure might be capital in nature, do not apply to skills development.
- Skills development expenditure should mostly be related to the taxpayer's trade. In instances where this is not the case, the expenditure will also not be in the production of income, as it would have been incurred for general philanthropic purposes, as was mentioned under the second bullet point above.

From the above it can be seen that the only issue applicable to this broad category of expenditure is whether expenditure is incurred for general philanthropic reasons, rather than for a business reason.

In summary, expenditure in this broad category will often be deductible purely because most skills development expenditure inherently qualifies for deduction under section 11(a). For those skills development expenditures that are not deductible in such a way, the second option is to consider whether they are deductible owing to their contribution to the BEE scorecard. The conclusion made above was that skills development expenditure that is incurred to become BEE-compliant will be deductible under section 11(a), except where the reason for becoming BEE-compliant was purely for transformation and general philanthropic good.

With regards to the available special deductions identified in section 3.4 above, only two of those are applicable to expenditure included in this broad category of expenditure. An allowance can be claimed under section 12H when skills development activities are performed by means of registered learnership agreements (Woolley, 2005:69). Section 12H does not actually allow expenditure to be deducted, but, instead, grants a fixed allowance (Wilcocks, 2010b:253). Training expenditure that is related to a qualified Industrial Policy Project can be deducted under section 12I, but only up to a certain monetary limit per employee (PwC, 2010:91–94). Section 18A is not applicable in the present instance, as employees would not qualify as beneficiaries. No capital allowances are available for expenditure of a capital nature under this category and there are no CGT implications.

3.5.5 Non-monetary assistance by employers towards skills development of qualifying employees

Expenditures under this broad category are those that score points under the skills development category of the BEE scorecard, but that are not cash expenditures. The only example given in the Codes of Good Practice of how such expenditure would be quantified is as a percentage of payroll for time spent on skills development (South Africa, 2007:55–56). Payroll expenditure would almost always already be deductible under section 11(a). No additional deduction would therefore be obtained, as an expenditure can only be deducted once, according to section 23B of the Act. In the rare cases where payroll expenditure is not already deductible, the percentage that was allocated to BEE skills development will follow the same principles for deduction as per those already covered in subsection 3.5.4.

An allowance can be claimed under section 12H when skills development activities are performed by means of registered learnership agreements. The section 12I deduction for training expenditure for qualifying Industrial Policy Projects can be utilised even in the case of non-monetary expenditure (Wilcocks, 2010b:258). This would be, for example, a portion of the payroll costs of employees presenting training. The section 18A deduction is not available for

expenditure to the benefit of employees. There are also no capital allowances available for any expenditure under this broad category.

3.5.6 BEE verification expenditure

This category of expenditure refers to fees charged by BEE verification agencies (e.g. Empowerdex) to verify the points awarded on a company's BEE scorecard. Such expenditure can include consulting expenditure to the verification agency and the fee for performing the actual verification of the BEE scorecard. The deduction of expenditure relating to indirect empowerment measures of BEE has been considered in a general sense in section 3.3, with the conclusion that such expenditure would mostly be deductible. The four potential issues identified in subsection 3.3.7 are now considered below:

- Expenses for BEE verification qualify as expenditure.
- Most reasons for wanting to become BEE-compliant would qualify as being in the production of income, as summarised in Table 3.1. The exception mentioned for the second reason in said table is not applicable in the present instance, as BEE verification is never excessive – it is always a necessary expenditure made to achieve BEE compliance. The fourth reason given in Table 3.1 is also not applicable here, as an entity would not pay for BEE verification purely for philanthropic reasons. In conclusion, BEE verification expenditure is regarded as having always been made in the production of income.
- BEE verification expenditure forms part of operating an entity's income-earning operation, as it is an annually recurring fee that is paid to achieve BEE compliance (Bowman Gilfillan, 2005:6). The expenditure would, therefore, not be regarded as being capital in nature, unlike, for example, consulting to create BEE structures (Ernst& Young, 2006).
- Expenditure to a verification agency occurs in the course of carrying on a trade, as an entity would only enter into such expenditure if it obtained some benefit thereby (De Klerk, 2008:43). An entity would never pay to have its scorecard verified for general philanthropic purposes.

In summary, the exceptions identified in subsection 3.3.7 are not applicable in the present instance – BEE verification expenditure is deductible under the general deduction formula. The special deductions that were identified in section 3.4 cannot be utilised for the deduction of BEE verification expenditure.

3.6 Conclusion

Based on findings in the current chapter, it can be concluded that expenditure relating to indirect BEE empowerment measures should mostly be deductible per section 11(a) of the Act. Four potential issues were identified that could cause such expenditure to not be deductible – refer to subsection 3.3.7. Notable amongst these potential issues is the fact that expenditure relating to indirect BEE measures will only be deductible if the reasons for becoming BEE fall within the production of income. The common reasons for becoming BEE were identified in section 2.5 and were summarised in Table 3.1 above, together with the conclusion that was drawn regarding whether they will qualify as being in the production of income. This summary can be used as a general guide of when expenditure related to indirect BEE measures will be regarded as being in the production of income. The taxpayer's subjective intention will, however, have to be assessed in each individual scenario (Williams, 2009:446).

The approach then followed was to consider the available deductions for each broad category of expenditure relating to indirect BEE measures. A summary of the main findings in section 3.5 (covering section 11(a) and the available special deductions) is presented in Table 3.2 that follows.

Table 3.2: Deductibility of expenditure under each broad category

	Broad categories of expenditure relating to indirect BEE measures	Special income tax deductions per the Act	General income tax deduction formula per the Act (section 11(a))
1	General procurement expenditure	None.	<i>Deductible in most cases</i> The deductibility of this expenditure is not influenced by BEE.
2	Charitable contributions to persons other than employees	Section 18A, but only for donations to a PBO and limited to 10 per cent of taxable income. Capital allowances, such as section 11(e), section 13sex or section 15(a), are possibly available where capital in nature.	<i>Deductible in most cases</i> This expenditure is deductible, except where it is not in the production of income (either because it is excessive or because it is incurred only for general philanthropic reasons) or in cases where the expenditure is capital in nature.
3	Non-monetary assistance to persons other than employees	Section 18A, but only for donations to a PBO and limited to 10 per cent of taxable income.	<i>Deductible in some cases</i> Only quantifiable contributions of assets or staff time are considered for deduction and only in cases as per those mentioned in the previous row of the current table.
4	Monetary expenditure by employers towards skills development of qualifying employees	Section 12H, but only for employees with registered learnerships; or section 12I, but only for qualifying Industrial Policy Projects.	<i>Deductible in most cases</i> Deductible, except for where the aim is purely philanthropic, but this expenditure will likely be deductible regardless of BEE.
5	Non-monetary assistance by employers towards skills development of qualifying employees		<i>Deductible in all cases</i> A percentage of payroll expenditure can be deducted, but would likely have been deductible regardless of BEE.
6	BEE verification expenditure	None.	<i>Deductible in all cases</i>

The conclusions summarised in Table 3.2 above are not an exhaustive representation of the findings reached. The full conclusions can be found in sections 3.3 to 3.5. This summary is used in Chapter 4 to formulate best practice guidelines for the deduction of expenditure related to indirect BEE measures.

The objective of the current study was to investigate the deductibility of expenditure relating to indirect BEE empowerment measures and to formulate best practice guidelines regarding such deductibility. In the present chapter, the deductibility of such expenditure has first been considered in a general sense and then specifically for the identified broad categories of expenditure. The findings made have been summarised in Table 3.2 above. The principles identified and the conclusions reached in the chapter were used when formulating the best practice guidelines in Chapter 4. Best practice guidelines consist of factors to consider when determining whether expenditure is deductible for tax purposes.

Chapter 4: Best practice guidelines for the deduction of expenditure relating to indirect empowerment measures of BEE

4.1 Introduction

The deductibility of expenditure under each broad category relating to indirect empowerment measures of BEE was considered in Chapter 3. A further objective of the current study was to formulate related best practice guidelines regarding the deductibility of such categories of expenditure. The best practice guidelines offer guidance regarding factors that require consideration when determining whether expenditure is deductible.

The best practice guidelines in the current chapter do not provide an exhaustive guide to the deductibility of expenditure in all cases, but are rather aimed at expanding upon the conclusions reached in Chapter 3. In Chapter 3, instances were submitted in which the deductibility of expenditure is uncertain (summarised in Table 3.2). The guidelines in the present chapter elaborate on the factors that influence those areas of uncertainty, as well as on actions by a taxpayer that can have an effect on the deductibility of expenditure. The guidelines also include some considerations for scenarios where deductibility is already fairly certain, for example actions that could preclude a deduction and that should therefore be avoided. The literature review also identified various opinions on when expenditure relating to indirect empowerment measures of BEE is deductible. Pertinent recommendations included in the opinions concerned have also been included below.

The proposed guidelines can assist taxpayers in determining which expenditure can and which cannot be deducted and under which circumstances. The guidelines could be considered, for example, when developing a strategy for becoming BEE-compliant. Furthermore, the guidelines can assist with actions that should either be taken or avoided in order to provide a taxpayer with the prospect for the deductibility of expenditure incurred.

The methodology used to structure the best practice guidelines was the same as that which was used for the deductibility of expenditure in Chapter 3. Firstly, general guidelines were formulated for any expenditure related to indirect BEE measures. Secondly, specific best practice guidelines were formulated, per the broad categories of expenditure that were identified in Chapter 2, and were used throughout the current study.

4.2 General best practice guidelines for the deduction of expenditure relating to indirect BEE measures

The following are proposed general best practice guidelines that all taxpayers should consider when deducting expenditure relating to BEE measures and when planning on incurring such expenditure.

4.2.1 In the production of income

Section 82 of the Act provides that the burden of proof that a deduction is permissible falls upon the taxpayer (Goldswain, 2009:63). A potential issue that was identified in subsection 3.3.7 for most broad categories of expenditure was that the expenditure has to be in the production of income. Based on the aforementioned section 82, the onus falls on the taxpayer to show that expenditure is incurred in the production of income. A taxpayer would have to be able to prove that the reason for incurring expenditure to become BEE-compliant is in the production of income (Ntombela, 2006). Table 3.1 in the previous chapter provides general guidelines as to which common reasons are in the production of income. The taxpayer should be cognisant of both the subjective and objective tests involved, as was discussed in subsection 3.3.4 (Williams, 2009:446). For example, in *Joffe & Co (Pty) Ltd v CIR*, the taxpayer could not discharge this onus and could not show that the act that had led to the expenditure was an inevitable concomitant of its trade (Goldswain, 2009:63).

To determine the purpose of expenditure, one must establish the intentions of a company, as reflected by the decisions and actions of its directors (Saleem, 2004:35). For example, if the minutes of directors' meetings show that expenditure

to become BEE-compliant was incurred for marketing purposes, this would provide some evidence towards the taxpayer's onus of proof per section 82 (Ernst & Young, 2011). Other tangible evidence that can assist with the burden of proof are formal actions of the company, such as a written policy on BEE and transformation, or the active marketing of the entity's BEE status, which will be expanded on further in section 4.3. According to Jooste (2010), 'companies should clearly document that the corporate social responsibility expenditure is incurred for the specific purpose of improving or maintaining their BEE rating'.

The guideline derived here is that the taxpayer should be able to prove what the reason for incurring expenditure was and that said reason was in the production of income. Taxpayers that want to claim a deduction for expenditure should avoid incurring expenditure for reasons not in the production of income, such as purely philanthropic reasons (Table 3.1). Furthermore, taxpayers should ensure that they can prove that expenditure was incurred for a reason in the production of income, such as by means of documenting it as such in the minutes of directors' board meetings (Ernst & Young, 2011). This guideline should be considered at an early stage when planning how to become BEE-compliant in a cost-effective manner (Thersby, 2006:5–6). As was shown in *Sub-Nigel Ltd v CIR*, a taxpayer does not need to show that expenditure will lead to income in the current year, but only that it will do so at some stage in the future (Williams, 2009:448).

It is further submitted that expenditure relating to 'fronting' is not deductible. Fronting is the unlawful practice of misrepresenting or of manipulating an entity's BEE status (Standard Bank, 2008:5). The amendments currently proposed for the BBBEE Act include more stringent measures to combat fronting (Department of Trade and Industry, 2011). Therefore, expenditure incurred towards fronting, rather than towards legitimate BEE measures, would not be in the production of income, as it could lead to a loss of income in various forms.

4.2.2 Excessive expenditure

In addition to the general best practice guidelines submitted in the previous section, 'excessive expenditure' has also been identified as being a potential issue precluding a deduction of expenditure relating to indirect BEE measures.

Expenditure that is regarded as excessive can be disallowed as a deduction by SARS (Edward Nathan Sonnenbergs, 2011). The reason for such expenditure not being deductible is often that it is not incurred in the production of income, or it is not expended for the purposes of a trade. A taxpayer would have to be able to show evidence that the relevant expenditure had a legitimate business purpose and that the amount is comparable to industry norms for it to be regarded as deductible (Ibid , 2011).

The concept of 'excessive expenditure' also has a specific meaning in the context of expenditure relating to BEE. As was summarised in Table 3.1, expenditure is not in the production of income when it is excessive for the entity to derive income from its BEE rating (subsection 4.3.2). The general guideline derived from the above is that taxpayers should avoid incurring expenditure towards indirect BEE measures in excess of what is required for their BEE compliance. Entities should, therefore, avoid incurring expenditure that:

- is inflated or in excess of the market value of the goods or services received (Ibid, 2011);
- is in excess of what is required to reach a level-1 BEE rating, as no further points can be scored on the scorecard for such expenditure (Empowerdex, 2009) (for example, where a QSE incurs expenditure leading to a score higher than the maximum of 100 on its BEE scorecard);
- is in excess of what is required to score the maximum number of points in a particular category of the scorecard (as the number of points per category of the BEE scorecard is limited (refer Table 2.1), entities should rather focus on scoring points in different categories) (EconoBEE, 2009); or
- has the goal of achieving a higher BEE rating than the entity actually requires (Ferreira & De Villiers, 2011:36). If an entity incurs incremental expenditure to reach a higher BEE rating, but cannot show any increased

income, prospect of future income or marketing benefits due to the increased rating, the incremental expenditure concerned would not have been incurred in the production of income (KPMG, 2004).

4.2.3 Capital in nature

Another requirement of section 11(a) that was identified in subsection 3.3.7 as a potential issue is whether expenditure relating to BEE measures is capital in nature. Taxpayers should be aware that they have an onus to prove that expenditure was not capital in nature and should consider this onus when planning what expenditure to incur (Ernst & Young, 2011).

Certain expenditures under sector charters have a greater chance of being classified as capital in nature, for example expenditure towards integrated development plans for mining communities, under the mining sector charter (KPMG, 2004). Taxpayers can refer to further details of the types of expenditure required by the mining sector charter relating to mine community development, housing and living conditions and sustainable development (Department of Trade and Industry, 2010:4–5). Whereas giving guidance for all possible expenditures under sector charters is beyond the scope of the current study, taxpayers should consider that expenditures such as the above would be likely to have a higher risk of being capital in nature. If, for example, an asset were to be acquired for the purpose of achieving one of the indirect BEE empowerment objectives, the expenditure concerned may not be deducted in full in the year in which the asset was acquired.

Abundant literature is available that taxpayers can use as guidelines to determine whether their expenditure is capital in nature. The seminal case in this regard is *New State Areas Ltd v CIR*, which established the principle that expenditure is non-capital in nature if it is a cost of performing the income-earning operations, rather than being a cost of establishing, or improving, the income-earning structure of an entity (Williams, 2009:209–210). Another general guideline obtained from the aforementioned case is that recurring expenditure is indicative of a non-capital nature; however, the purpose and effect of expenditure are also

considered. Expenditure to acquire assets of an enduring benefit is indicative of a capital nature (PwC, 2010:50).

Taxpayers should be able to show, in most cases, that expenditure towards indirect BEE measures is not capital in nature (Ernst & Young, 2011). Such reasoning is supported by *Warner Lambert v C:SARS*, in which case it was held that expenditures forming part of a social responsibility programme were not capital in nature, as they were to protect the taxpayer's income (Williams, 2009:463). This guideline is expanded on in subsection 4.3.2 below, together with considerations regarding capital allowances and CGT implications that could be applicable.

4.2.4 Section 23H limitation of deductions for prepaid expenditure

Even in cases where expenditure is not capital in nature, it could still have a benefit attached in both current and future years. In such cases, the deduction allowed in the current year of assessment could be limited by section 23H (Louw, 2012:2). An example of such a case is that of the applicant in a 2012 binding private ruling by SARS (Louw, 2012:2). As a general guideline, taxpayers should be aware that section 23H could limit the amount deductible in respect of prepaid expenditure in the current year if expenditure is incurred that impacts the taxpayer's BEE scorecard for future years.

4.2.5 SARS binding rulings

Given the fact that there is no tax certainty on whether expenditure relating to indirect BEE measures can be deducted, the two rulings relating to BEE published by SARS offer valuable guidance (Clegg, 2009:17). Although the rulings are not binding for taxpayers other than the applicants, taxpayers with similar circumstances can use them as an indication of how the law will be applied (De Swardt, 2010:1005). A taxpayer could also consider applying to SARS for a ruling on deductions of expenditure incurred, or on planned expenditure relating to BEE measures. Making such an application could be especially beneficial in cases where there is uncertainty around some of the potential issues, as was identified in subsection 3.3.7. Taxpayers should also take note of any future rulings

published by SARS, as such rulings can provide additional guidance on what expenditures will be allowed as deductions.

4.2.6 Legal advice

According to Jack and Harris (2007:469), reactive tax strategies are not effective for deductions related to BEE. Taxpayers should be aware of the tax issues around the deduction of expenditure relating to BEE measures, especially due to the uncertain tax position (Ibid, 2007:469). Businesses planning on incurring such expenditure should consider the tax implication at the outset and consider obtaining legal advice regarding their particular situation (Kotze, 2012). Tarrant (2007:18) has also suggested that taxpayers 'do their homework' when claiming a tax deduction based on the result of *Warner Lambert SA (Pty) Ltd v C:SARS*. Obtaining legal advice on the deductibility of planned expenditure would be prudent in appropriate circumstances.

4.2.7 Documentation requirements

A requirement of the Codes of Good Practice is that expenditure needs to be substantiated by an invoice or by an appropriate internal accounting record in order to score points on the BEE scorecard (Jack & Harris, 2007:285). A taxpayer would need to keep similar records of expenditure when submitting their tax returns.

4.2.8 Quantification of deductions

Section 11(a) requires that expenditure be quantifiable, as established in *Pyott Ltd v CIR*. A possible difficulty with the deduction of expenditure relating to indirect empowerment measures of BEE is the use of formulae to calculate empowerment points for the purpose of the BEE scorecard. The amounts per these formulae do not always represent the amount paid to beneficiaries and should, therefore, not be used when completing an entity's tax return (Jack, 2009). The correct quantification of a deduction is the amount that was actually incurred (PwC, 2010:49).

A final consideration when measuring the deduction allowable is that expenditure could be apportioned. In *SIR v Guardian Assurance Holdings (SA) Ltd* only the portion of expenditure that was incurred in the production of income was allowed as a deduction (Williams, 2009:232). The same could similarly apply where a dual purpose is the cause of expenditure towards BEE measures. Therefore, an apportionment of expenditure may also be required.

4.3 Specific best practice guidelines relating to broad categories of expenditure

4.3.1 General procurement expenditure

In Table 3.2 it was submitted that expenditure in this broad category will be deductible in most cases. As was noted in Chapter 3, BEE requirements will not change this situation. Any further guidelines (apart from those in 4.2) on the deductibility of expenditure in this category are therefore not deemed necessary.

4.3.2 Charitable contributions to persons other than employees

Charitable contributions to persons other than employees have been found to be deductible, except where they are not in the production of income, or where they are capital in nature.

A taxpayer has the onus to show that expenditure is in the production of income (Goldswain, 2009:63). In subsection 3.5.2 it was concluded that there are two scenarios where the above could be problematic – where the expenditure is excessive, or where it is incurred for general philanthropic reasons.

It has been submitted that expenditure towards indirect BEE measures is only deductible to the extent that it is not excessive. Considerations around this concept are explained in subsection 2.5.6 – it essentially refers to expenditure that is in excess of what the entity requires to generate income from having a BEE rating. Such expenditure includes expenditure in excess of what is needed to achieve a level-1 BEE rating, the maximum number of points in a category of the scorecard, or the highest BEE rating that would add any benefit to the business

concerned (Empowerdex, 2009). Expenditure in excess of the specified levels would not be in the production of income (KPMG, 2004).

The determination of whether expenditure is excessive depends on the type of expenditure being incurred. For example, expenditure in the socio-economic development category of the BEE scorecard scores the maximum number of points for this category when it comprises 1 per cent of an entity's net profit after tax for the year (South Africa, 2007:73). Any contributions beyond said level would clearly be excessive, as no further points would be scored on the BEE scorecard. Further examples of the matter were provided in subsection 4.2.2 above.

When preparing a tax return, taxpayers should carefully assess what their purpose for incurring each expenditure was, as expenditure towards scoring points on the BEE scorecard could be for one purpose, up to a certain point, and thereafter for another purpose (Clegg, 2009:18–19).

Where a taxpayer cannot show that expenditure has been incurred in order to increase its BEE rating, or cannot show that the reason for an increase in BEE rating is in the production of income, the expenditure will not be deductible. This would, for example, be the case when incurring expenditure for purely philanthropic reasons (Ernst & Young, 2011). A taxpayer would have to consider how its motives could be proven, if necessary, as was described in section 4.2. For example, if an entity decides to incur enterprise development expenditure in order to score points on the BEE scorecard, the decision pertaining thereto could be documented as part of the directors' minutes of meetings, or as part of the company's policy on BEE and transformation (Ibid, 2011).

A taxpayer is also required to be able to show that expenditure incurred to increase its BEE rating is ultimately in the production of income, as was summarised in Table 3.1. According to Ernst & Young (2011), SARS should allow such expenditure, in most cases. Expenditure can be in the production of income, even if the motive for the expenditure is partially a non-business reason, such as in support of philanthropic work (Clegg, 2009:17). The required proof of the motive

can take the form of showing, for example, new contracts gained or tenders submitted for work to clients that require a certain BEE level. The proof could also be provided by way of showing increased revenue, due to having achieved a higher BEE rating, or by way of showing budgets or strategies for new income that can be obtained due to the business having acquired a higher BEE rating (Sartorius & Botha, 2008:443). In cases where it is harder for an entity to show a direct link between a higher BEE rating and increased income, an argument could be made that the higher BEE rating will lead to future income, as can be seen in the study performed by IQUAD and KPMG (2010:4).

PwC (2004) has stated that expenditure relating to BEE would only be deductible if it could clearly be shown that BEE compliance was needed to earn or to protect income. Such a contention further supports the above guidelines that a taxpayer should, where possible, strive to have tangible evidence in place of increased income due to having a BEE rating. Furthermore, given the lack of tax certainty regarding the deductibility of expenditure relating to indirect empowerment measures of BEE, it would be safer if a taxpayer were to prove a link between its expenditure and income. This lack of tax certainty also means that the rulings issued by SARS, even though they are not binding, could be considered, as they offer some indication as to the intention of the tax authority (De Swardt, 2010:1005).

The Binding Class Ruling issued in 2009 deals with expenditure that falls in the socio-economic development category of the BEE scorecard. In said ruling, the applicant's directors took a decision at a board meeting to launch a programme to increase its BEE rating (SARS, 2009:1–2). The policy put in place by the taxpayer, therefore, clearly showed a link between the expenditure and the intention to produce income. In the 2012 Binding Private Ruling (approving the deduction of expenditure towards an enterprise development project for BEE purposes), the applicant had contracts in place with all the entities to which it was contributing enterprise development funds. The applicant could also clearly show that the expenditures concerned had been incurred for a business reason, as they were budgeted for, and managed, as a separate cost centre (SARS, 2012:1–3).

The aim of the project was documented as increasing the applicant's BEE rating, so as ultimately to be able to increase income (Ibid, 2012:1–3). The steps taken by the applicants in the above rulings should be considered as guidelines for all taxpayers wishing to deduct expenditure towards indirect BEE measures.

The second obstacle to the deductibility of charitable contributions to persons other than employees is whether the expenditure is capital in nature. The conclusion reached (Table 3.2) is that a taxpayer should be able, in most cases, to show that expenditure under this broad category is not capital in nature (Ernst & Young, 2011). This is based on expenditure towards BEE compliance being an annual requirement and therefore a recurring expenditure (Bowman Gilfillan, 2005:6). General guidelines that can be applied for the issue of 'capital in nature' were submitted in subsection 4.2.3, together with considerations of when expenditure might be capital in nature. Additional legal counsel should be considered for the tax implications of expenditure identified as having a higher likelihood of being capital in nature, as well as for an investigation of whether capital allowances would be available for the expenditure. A record of expenditure incurred should still be kept, as the costs involved could be deducted as base cost when calculating any eventual CGT, or used for the calculation of capital allowances (Standard Bank, 2012). Expenditure that is capital in nature is not deductible per section 11(a), but capital allowances such as section 11(e), section 13sex or section 15(a) could be available. Section 15(a) is only available for mining operations, and should be read together with section 36 (Van Zuydam, 2008:17). The taxpayer should consider the nature of the expenditure to determine which capital allowances are applicable.

A section 18A deduction can be claimed for contributions under this broad category. Taxpayers should take note of the specific requirements in terms of qualifying beneficiaries and documentation that must be obtained, per section 18A of the Act. In essence, a qualifying section 18A receipt should be obtained from the person to whom the donation is made.

4.3.3 Non-monetary assistance to persons other than employees

In subsection 3.5.3 it was concluded that only contributions in the form of assets or staff time (that can be quantified) can be deducted under this broad category of expenditure.

When making a contribution in the form of an asset to persons other than employees, the value of the deduction per section 11(a) is the market value (Van Schalkwyk, 2010b:111). A taxpayer would have to take care not to overstate the value (in an attempt to claim a larger deduction), as the fair market value between arm's-length parties has to be used.

For assistance in the form of staff time, the amount of time spent would have to be quantifiable in order to be deductible (Ibid, 2010b:111). The Codes of Good Practice prescribe that employees' hourly rates be used to quantify assistance in the form of staff time spent (Jack & Harris, 2007:336–346). It follows that a taxpayer would have to keep records of the amount of time spent by employees in such manner. As was previously noted, section 23B prohibits more than one deduction for the same expenditure. For example, if all payroll-related expenditure has already been deducted, the time spent assisting persons other than employees cannot be deducted again.

Other than the specific considerations mentioned here, the guidelines in section 4.2 and subsection 4.3.2 also apply for expenditure under this broad category. The considerations for utilising a section 18A deduction under this category are similar to those that were discussed in the previous subsection. Furthermore, section 18A only permits donations in the form of cash or property in kind (Wilcocks, 2010a:157). Contributions in the form of the amount of staff time spent would, therefore, not qualify for a section 18A deduction.

4.3.4 Monetary expenditure by employers towards skills development of qualifying employees

Expenditure towards skills development for employees will be deductible in most cases, regardless of BEE (Croome, 2011:12). In cases where such expenditures are not deductible, taxpayers should be aware that they might become deductible due to the BEE scorecard, as discussed in subsection 3.5.4.

Skills development expenditure that contributes to the BEE scorecard was identified as always being deductible, except where the expenditure involved was not incurred in the production of income. An instance of such could, for example, be where the expenditure was excessive, as was discussed, in a general sense, in section 4.2. It could also be because the skills development expenditure was incurred for purely philanthropic purposes (i.e., not for a business reason).

Table 3.1 can be used as a guide to what reasons for becoming BEE-compliant are regarded as being in the production of income. Again, it should be noted that the taxpayer would have the onus of showing that this expenditure was incurred in the production of income, in other words for a business reason (Ernst & Young, 2011). For example, if the taxpayer can show that new contracts were obtained due to achieving a higher BEE rating, expenditure towards achieving the rating would be in the production of income (Jack & Harris, 2007:468). Therefore, skills development expenditure (that would otherwise not have been deductible) can become deductible if the taxpayer can show that the expenditure was in the production of income. In other words, the taxpayer should be able to show that the skills development expenditure was incurred in order to become BEE-compliant (objective test) and that becoming BEE-compliant was in the production of income (subjective test).

A section 12H or section 12I allowance can possibly be claimed for activities under this broad category. This can only be done if the various requirements of the respective sections have been met – taxpayers should, therefore, first determine whether such is the case. For example, when claiming a section 12I

allowance, the project first needs to have been approved by the South African Department of Trade and Industry (PwC, 2010:91).

4.3.5 Non-monetary assistance by employers towards skills development of qualifying employees

As was concluded in Table 3.2, non-monetary assistance towards skills development for employees can be deducted. This expenditure would have to be quantified as was described in subsection 4.3.3, but would most likely already have been deductible, regardless of BEE.

The general best practice guidelines are still applicable here, as an entity still has the onus to show that expenditure under this category was incurred in the production of income. As was described in subsection 4.3.4, showing the above involves indicating that the expenditure had a business reason, rather than that it was incurred purely for general philanthropic reasons. To iterate the previous paragraph, this argument for deductibility is only required where expenditure under this broad category is not already deductible, regardless of BEE.

The special deductions and associated guidelines applicable to this broad category of expenditure are the same as those that were discussed under subsection 4.3.4.

4.3.6 BEE verification expenditure

Expenditure towards having a BEE scorecard verified should be deductible in all cases. The guidelines provided in section 4.2 should still be followed, especially those related to showing that the act of becoming BEE-compliant was in the production of income. Verification expenditure should be easier to relate to the production of income than other expenditure. For example, even if an entity has only one client that requires a BEE rating, the entity still needs to have its scorecard verified (Steyn, 2011). The verification expenditure can then easily be said to be in the production of income. The verification expenditure considered in the current study refers to the cost of verifying a BEE scorecard, as well as to consulting expenditure related to such verification. It should be noted that other

consulting costs could also be incurred, for example those incurred in creating a new BEE ownership structure (Beukes, 2011b:2–3). As such expenditure does not relate to the indirect categories of the BEE scorecard, it does not fall within the scope of the current study.

4.4 Summary

The best practice guidelines in the present chapter have been largely aimed at deductions for the less certain areas relating to the indirect empowerment measures of BEE, being those issues that were identified in Chapter 3. The best practice guidelines, in addition to the conclusions reached on deductibility in Chapter 3, can assist taxpayers when determining when expenditure towards indirect BEE measures can be deducted from their taxable income. Furthermore, the current chapter offered guidance that can be used when planning expenditure, as well as guidelines on actions that could influence the deductibility of such expenditure. A summary of the general best practice guidelines, as well as of the specific guidelines per broad category of expenditure, is given in Table 4.1 below.

Table 4.1: Summary of best practice guidelines

	Broad categories of expenditure relating to indirect BEE measures	Specific best practice guidelines relating to broad categories of expenditure	General best practice guidelines
1	General procurement expenditure	<ul style="list-style-type: none"> No specific guidelines. 	<ul style="list-style-type: none"> Production of income: <ul style="list-style-type: none"> Only deductible if intention to produce income can be proved. (Use Table 3.1 as guideline.) Taxpayer has onus to prove its intention, for example by showing: documented minutes of board meetings; proof that philanthropic work led to new contracts; a written BEE policy; a strategy of how compliance with BEE will translate to future profits; the management of BEE expenditure as a cost centre; or active marketing of its BEE status. Expenditure incurred towards 'fronting' is not deductible. Excessive expenditure towards BEE is not deductible. Examples of such expenditure would be expenditure that is in excess of: <ul style="list-style-type: none"> the market value of goods or services received; what is required for a level-1 BEE rating; what is needed for the maximum number of points in a BEE scorecard category; and a BEE rating that would add any benefit to the entity. Capital in nature: <ul style="list-style-type: none"> Recurring expenditure indicates a non-capital nature and expenditure with an enduring benefit indicates a capital nature. Certain expenditure under the mining sector charter (and possibly under other sector charters) that affects BEE scorecards over multiple years is more likely to be capital in nature.
2	Charitable contributions to persons other than employees	<ul style="list-style-type: none"> Specifically problematic areas are expenditure that is excessive or that is incurred for philanthropic purposes, in which case apply general best practice guidelines. Expenditure that is capital in nature is not deductible per section 11(a), but has possible CGT and capital allowance implications. Section 18A requires certain documentation. 	
3	Non-monetary assistance to persons other than employees	<ul style="list-style-type: none"> Quantify non-monetary assistance at fair value. Section 23B prohibits multiple deductions for one expenditure, such as payroll expenditure already deducted. Section 18A requires certain documentation and is only allowed for donations of cash or property in kind (therefore not staff time). 	
4	Monetary expenditure by employers towards skills development of qualifying employees	<ul style="list-style-type: none"> Expenditure under this category is most likely already deductible, regardless of BEE. Where not already deductible, the taxpayer must prove that expenditure towards BEE was in the production of income. Sections 12H and 12I are only allowed for approved projects. 	

5	Non-monetary assistance by employers towards skills development of qualifying employees	<ul style="list-style-type: none"> • Expenditure under this category is most likely already deductible, regardless of BEE. • Where not already deductible, the taxpayer must prove that expenditure towards BEE was in the production of income. • Quantify non-monetary assistance at fair value. • Sections 12H and 12I are only allowed for approved projects. 	<ul style="list-style-type: none"> - CGT implications and capital allowances (such as sections 11(e), 13sex or 15(a)), where expenditure is capital in nature, require consideration.
6	BEE verification expenditure	<ul style="list-style-type: none"> • Deductible if any benefit can be shown from any expenditure towards BEE. • Consulting expenditure related to direct empowerment measures is not necessarily deductible. 	<ul style="list-style-type: none"> • Deductions for prepaid expenditure could be limited per section 23H (where expenditure affects the BEE scorecard for future years). • SARS binding rulings: <ul style="list-style-type: none"> - Published rulings are not applicable to all taxpayers, but should be considered where similar circumstances are present. - Taxpayers can apply for a ruling on whether their specific expenditure is deductible. • Legal advice is recommended before incurring expenditure of which the deductibility is uncertain. • Documentation, such as an invoice or internal accounting record, is required for the BEE scorecard and for any deduction per section 11(a). Additional documentation could be required to prove the taxpayer's intention of producing income. • Deductions should be quantified correctly, as the amount actually incurred. Apportionment is possible where, for example, only a portion of expenditure was incurred in the production of income.

Chapter 5: Conclusion

The objectives of the current study were to determine whether expenditure relating to indirect empowerment measures of BEE is deductible and to formulate best practice guidelines for the deduction of such expenditure. Consideration of the various factors that can influence whether such expenditure is deductible was included. Further aspects that were explored were the different categories of expenditure towards indirect empowerment measures of BEE, the different situations where such expenditure could be incurred and possible CGT implications thereof. The methodology followed entailed first considering the requirements of the BEE scorecard, the types of expenditure and the reasons for incurring expenditure towards indirect empowerment measures (Chapter 2). The deduction of such expenditure was then considered in a general sense and specifically for each broad category of expenditure (Chapter 3). The result was the formulation of the best practice guidelines that were provided in Chapter 4.

As was described in Chapter 2, BEE compliance is measured using the BEE scorecard provided by the South African Department of Trade and Industry (Standard Bank, 2008:11). Common expenditure incurred to achieve points in the indirect empowerment categories of the BEE scorecard was grouped into six broad categories of expenditure (Table 2.3), based on examples of expenditure identified through the available literature. The broad categories were used to separately consider the deductibility of the different kinds of expenditure. In Table 2.4, the different reasons for entities incurring expenditure towards indirect BEE measures were submitted, as the reason for incurring expenditure can influence whether such expenditure is in the production of income (Van Schalkwyk, 2010b:110). Of the common reasons for complying with BEE requirements, it was found that only expenditure that is excessive or that is incurred for philanthropic purposes would not be regarded as being incurred in the production of income (Table 3.1). If expenditure is not incurred in the production of income it would consequently not be deductible for tax purposes

Chapter 3 expands on the identified categories of expenditure and on the reasons for incurring expenditure. The deductibility of such expenditure was investigated by applying the requirements of the possible tax deductions available. Expenditure relating to indirect empowerment measures of BEE is submitted as generally being deductible per section 11(a), although there are various requirements that still need to be met. Specifically, four issues were identified in subsection 3.3.7 that could preclude expenditure towards indirect BEE measures from being deductible. Notable amongst these issues is that expenditure has to be in the production of income in order for it to be deductible – it is submitted that this would be the case for most expenditure relating to indirect empowerment measures. A further identified issue is that only non-capital expenditure is deductible per section 11(a). This should be the case for most expenditure, except for certain expenditure required by sector charters (KPMG, 2004).

In addition to section 11(a), special income tax deductions were identified in section 3.4 that could be applicable in certain circumstances. Sections 12H, 12I and 18A can be utilised, but only for certain types of expenditure and only in qualifying circumstances. Capital allowances, such as sections 11(e), 13sex or 15(a), can be claimed in cases where expenditure is capital in nature. A summary was presented in Table 3.2 of whether expenditure under each broad category can be deducted per section 11(a) and whether any special income tax deductions are available. Table 3.2, together with the detailed considerations in Chapter 3, can be used as a guide by taxpayers to see whether expenditure relating to indirect BEE measures can be deducted.

Best practice guidelines were formulated in Chapter 4, based on the literature examined and the conclusions reached in Chapter 3. The best practice guidelines elaborate on factors that influence areas of uncertainty, as well as actions by a taxpayer that can affect the deductibility of expenditure. One of the important general best practice guidelines is that the onus is on the taxpayer to show (through one of the ways described in Table 4.1, such as documented minutes of board meetings) that expenditure was in the production of income.

Taxpayers should also note that excessive expenditure is not in the production of income. Another important general best practice guideline is that recurring expenditure indicates a non-capital nature and that expenditure with an enduring benefit indicates a capital nature. This is especially relevant for certain expenditure that is required by the mining sector charter, since the expenditure concerned is more likely to be capital in nature than other expenditure (KPMG, 2004).

Moreover, specific best practice guidelines were submitted for each broad category of expenditure (Table 4.1). The specific best practice guidelines for a category should be considered when incurring expenditure in that category. One of these guidelines relates to the applicability and requirements of the identified special deductions, as considered for each broad category of expenditure (section 4.3). Furthermore, specific best practice guidelines were formulated for non-monetary expenditure, with such expenditure requiring quantification at fair value. In addition to guidelines relating to expenditure towards the categories of the BEE scorecard, it is submitted that expenditure incurred to have a BEE scorecard verified would be deductible in all cases. The remainder of the guidelines in Table 4.1, together with the details provided in Chapter 4, should also be considered by taxpayers who have incurred, or who are planning on incurring, expenditure towards indirect BEE measures.

In summary, even though expenditure towards indirect BEE measures has been found to be deductible in most cases, there are exceptions of which taxpayers should be aware. The proposed best practice guidelines include guidance that should ideally be considered before incurring expenditure towards indirect BEE measures. The guidelines include examples of actions that should be taken to increase the likelihood of expenditure towards indirect BEE measures being deductible.

Further research is suggested to examine the full extent of CGT implications and the available capital allowances, where expenditure towards BEE measures is capital in nature. The current study has only highlighted certain types of

expenditure under the mining sector charter that is likely to be capital in nature (KPMG, 2004). Further research could include a thorough investigation of the nature and deductibility of expenditure incurred based on other sector charters.

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