The tax deductibility of donations, with specific reference to donations of property made in kind to public benefit organisations

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Section 18A of the Income Tax Act (Act 58 of 1962), as amended by the Revenue Laws Amendment Act (Act 45 of 2003) entitles a taxpayer (an individual or a legal entity, including a trust) to deduct annual donations to certain public benefit organisations, not exceeding 5% of taxable income. The question arises whether the same tax deduction applies when a taxpayer decides to make a donation in cash as opposed to a donation of property in kind. The aim of this paper is to compare the effect on a taxpayer's taxable income of making a cash donation compared with a donation of property in kind. It appears that the tax deduction in respect of donations is greater when a taxpayer decides to donate an amount in cash rather than a donation of property in kind. The paper shows that, under current legislation, a donation of property made in kind can be structured in such a way that it will provide a taxpayer with an identical tax deduction. It is hoped that current legislation pertaining to the deduction of a donation of property in kind will be amended soon, as the provisions are clearly inequitable in relation to a taxpayer who wishes to donate property in kind rather than a cash amount to a public benefit organisation.

Deduction of donations – an introduction

According to the Tax Exemption Guide for Public Benefit Organisations in South Africa, issued by the South African Revenue Service (SARS) (2004: 9), it is widely accepted that the tax deductibility of donations influences donor behaviour. Government has recognised this, and donations to a limited number of categories of public benefit organisations may be deducted from the taxable income of the donating taxpayer.

The question arises whether the same tax deduction applies when a taxpayer decides to make a donation in cash as opposed to a donation of property in kind. The aim of this paper is to compare the effect on a taxpayer's taxable income of making a cash donation compared with a donation of property in kind.

Research objective and research problem

The research objective of this study is to determine whether a taxpayer qualifies for the same tax deduction when he or she decides to make a donation in cash as opposed to a donation of property in kind.

The paper concentrates on the sections of the South African Income Tax Act (Act 58 of 1962) (the Act) relevant to a taxpayer who wishes to donate either an amount in cash or property in kind to a public benefit organisation.

The paper is limited to a consideration of income tax implications. No value-added tax or other indirect tax implications are taken into account for the purposes of this paper.

Research strategy

The research method followed included the following:

- A review of the Act was carried out in order to analyse the applicable sections in the Act relating to a taxpayer who makes a donation.
- SARS officials at the Law Interpreters division (Brooklyn, Pretoria) were interviewed in October 2003 in order to establish the view of SARS on issues identified in the paper.
- Examples were used to illustrate the effect on a taxpayer's taxable income of making a donation in cash compared with a donation of property in kind.

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The paper is based on current income tax legislation. The most recent law amendments considered in this paper are the Second Revenue Laws Amendment Act (Act 45 of 2003), which was promulgated on 22 December 2003.

The research strategy involved the following steps:

- All the relevant tax provisions that need to be taken into account when making a donation were analysed.
- Examples were set out to illustrate the effect on a taxpayer's taxable income of making a donation in cash or of property in kind.
- The comments received from SARS on the issues identified were set out.
- The paper recommends an alternative approach for taxpayers in order to overcome the inequalities that have been identified in the paper.

Tax provisions relating to donations

All the relevant tax provisions that need to be taken into account when making a donation were analysed as a basis for the rest of the study.

Deduction of the donation

Section 18A of the Act, as amended by the Revenue Laws Amendment Act (Act 45 of 2003) (Department of Finance 2003a), entitles a taxpayer (an individual or a legal entity, including a trust) to deduct annual donations to certain public benefit organisations, not exceeding 5% of his or her taxable income. Before the Revenue Laws Amendment Act was enacted, the allowable deduction was limited to the greater of R1 000 or 5% of the taxpayer's taxable income. The limit of R1 000 was repealed because 5% of taxable income at a tax threshold of R30 000 equals R1 500, and granting a R1 000 deduction serves no purpose, as was explained in the Explanatory Memorandum on the Revenue Laws Amendment Bill (Department of Finance 2003b: 59). The provision for a minimum donation of R1 000 ensured that a taxpayer who incurred an assessed loss would not be denied the benefit of a deduction (Stiglingh, Venter & Hamel 2003a: 95). The scenario of a taxpayer in a loss situation is not addressed at all in the Explanatory Memorandum on the Revenue Laws Amendment Bill (Department of Finance 2003b: 59). It is submitted that a taxpayer in a loss situation will forfeit the deduction of a qualifying donation. The Act contains no provision in respect of the unclaimed portion of donations being carried forward to a subsequent year of assessment.

No claim for a deduction for any donation is allowed unless the claim is supported by a receipt issued by the public benefit organisation concerned in accordance with section 18A(2) of the Act. Annexure I of the Tax Exemption Guide for Public Benefit Organisations in South Africa (SARS 2004: 39) provides an example of such a receipt.

The 'taxable income' contemplated in the section is the donor's taxable income as calculated before allowing a deduction for medical expenses and the deduction of the donation (see section 18A(1)(*c*) of the Act).

According to section 18A(1) of the Act, the allowable deduction is in respect of *bona fide* donations in cash or of property made in kind, actually paid or transferred during the year of assessment, to any

- public benefit organisation approved by the Commissioner under section 30; or
- institution, board or body contemplated in section 10(1)(*c*A)(i)

  which –
- carries on in the Republic any public benefit activity contemplated in Part II of the Ninth Schedule.

This approval of a public benefit organisation is subject to the condition that the section 18A public benefit activities are ring-fenced, and to certification by an auditor that the donations for which tax-deductible receipts have been issued have indeed been utilised solely in carrying out such public benefit activities. The public benefit activities that qualify for section 18A approval must be carried out in South Africa (SARS 2004: 10).

Conduit funds providing funds or assets to public benefit organisations listed in Parts I or II of the Ninth Schedule also qualify for section 18A approval. The conduit fund will qualify if, during the year of assessment, the fund distributes or incurs the obligation to so distribute at least 75% of the funds received during its preceding year of assessment by way of donations for which tax deductible receipts were issued. The Commissioner may, on good cause shown, and subject to conditions, either generally or in a particular instance, waive, defer or reduce the organisation's obligation to make this distribution, having regard to the public interest and the purpose for which the organisation wishes to accumulate the funds (section 18A(1)(*b*)

of the Act). Income generated by donations received is not required to be distributed (Meyerowitz 2003: 12–50).

Value of the donation

When a taxpayer makes a donation in cash, the amount of the qualifying deduction can easily be determined (being the actual amount donated). Where property in kind is donated, however, section 18A(3) of the Act determines the amount that qualifies for a possible deduction. This section of the Act has four subsections dealing with different types of donation of property in kind.

The amount of the deduction allowed depends on the type of property:

- If it is trading stock (including a financial instrument which is trading stock and livestock or fresh produce of farmers), the deduction is the lower of
  - the market value (fair market value for financial instruments) on the date of the donation; or
  - the amount taken into account in respect of the value of the trading stock for the purposes of section 22(8) or paragraph 11 of the First Schedule of the Act (section 18A(3)(*a*)).
- If it is an asset used by the taxpayer for the purpose of his trade, the deduction is the lower of
  - the fair market value on the date of the donation; or
  - the cost to the taxpayer of such property, less any allowance deducted from the income of the taxpayer under the provisions of the Act in respect of that asset (section 18A(3)(*b*) of the Act).

  According to Huxham & Haupt (2004: 168), the amount of the donation where a taxpayer donates trading assets is deemed to be the lower of the cost of the asset less any tax allowances (the tax value), or the fair market value of the asset on the date of the donation.
- If it is another asset (not trading stock or a business asset), the deduction is the lower of
  - the fair market value on the date of the donation; or
  - the cost to the taxpayer of such property, less any reasonable depreciation in the case of movable property which has deteriorated in condition (section 18A(3)(*c*) of the Act).

  Section 18A(3)(*c*) of the Act specifies that the depreciation allowance must be calculated in the manner contemplated in section 8(5)(*b*B)(i), which refers to depreciation using the 20% reducing balance method.
- If it is property purchased, manufactured, erected, assembled, installed or constructed by or on behalf of the taxpayer, the deduction is the lower of
  - the fair market value on the date of the donation; or
  - the cost to the taxpayer of such property (section 18A(3)(*d*) of the Act).

The amount qualifying for the possible deduction is still subject to the 5% limitation of a taxpayer's taxable income in terms of section 18A (see section on deduction of the donation).

Other income tax provisions to consider when making a donation

Section 22(8) – 'non-trade' disposal of trading stock

In terms of section 22(8) of the Act, where a taxpayer has applied trading stock for the purposes of making any donation, and the cost price of such trading stock has been taken into account in the determination of the taxable income of the taxpayer for any year of assessment, the taxpayer is deemed to have recovered or recouped an amount equal to the amount that has been taken into account for that year of assessment in respect of the value of that trading stock (the lower of the cost or the market value of such stock).

Section 8(4)(k) of the Act – taxing allowances previously claimed

Section 8(4)(*k*) comes into operation when a person donates an asset. Section 8(4)(*k*) applies when the asset is one on which a tax deduction or an allowance has been granted to the taxpayer in terms of sections 11 to 20 and sections 24D, 24F, 24G and 27(2)(*b*) and (*d*) of the Act. According to section 8(4)(*k*), a taxpayer who donates an asset, for which an allowance has been granted as already discussed, is deemed to have recovered or recouped an amount equal to the market value of such asset on the date of such donation.

Arendse, Coetzee, Jordaan, Kolitz, Stein & Stiglingh (2003: 224) state that section 8(4)(*k*) is

ambiguous. However, they add that the Explanatory Memorandum on the Income Tax Bill, 1993 makes the point that, although the market value of the asset is deemed to have been recouped, the actual inclusion in income is still governed by section 8(4)(*a*) (the general recoupment section). The result is that the amount actually subjected to tax is limited to the extent of the deductions or allowances previously granted.

Paragraph 11(1)(a) of the Eighth Schedule donation equals a capital gains tax event

In addition, with the introduction of capital gains tax, a donation is also specifically included in the definition of a disposal (paragraph 11(1)(*a*) of the Eighth Schedule to the Act). A taxpayer must therefore include the market value of the donation, being the proceeds of the disposal, where the disposal took the form of a donation (paragraph 38(2)(*a*) of the Eight Schedule to the Act). Any capital gain or loss is disregarded, however, if the donation is made to a public benefit organisation (paragraph 62 of the Eighth Schedule to the Act).

Donations tax implications of a donation

In terms of section 54 of the Act, donations tax is payable on the value of any property disposed of as a donation by a resident. The current rate of donations tax is 20% (section 64 of the Act). In terms of section 56(*h*) of the Act, certain donations made by a resident are specifically exempt from the payment of donations tax, including donations to any institution, council or body referred to in section 10(1)(*c*A). No donations tax is therefore payable on a donation to any public benefit organisation approved in terms of section 30(3) of the Act.

Summary

The treatment of donations of property made in kind can generally be divided into two groups, which are summarised as follows:

- Donations of trading stock and property purchased, manufactured, erected assembled, installed or constructed – it is clear that a taxpayer making a donation of property in kind (trading stock or property purchased, manufactured, erected assembled, installed or constructed) is taxed on the lower of cost or market value in terms of section 22(8), and that the qualifying amount in terms of section 18A of the Act is exactly the same amount, namely the lower of the market value or the cost of the stock item (the taxpayer will generally be in the same position if he or she donates trading stock or an amount of cash or she same value).
- Donations of trade and non-trade assets – a taxpayer who wishes to donate trade or non-trade assets on which a tax deduction or an allowance has been granted (in terms of sections 11 to 20 and sections 24D, 24F, 24G and 27(2)(*b*) and (*d*) of the Act) is taxed in terms of section 8(4)(*k*). The taxpayer is deemed to have recovered or recouped an amount equal to the market value of such an asset. The qualifying amount in terms of section 18A is, however, only the tax value of the particular asset.

The effect on a taxpayer's taxable income of making a donation in cash or of property in kind consisting of an asset (both trade and non-trade) will be illustrated in the next section by means of examples. The examples deal only with trade assets, but apply equally to non-trade assets.

Practical examples

The following examples illustrate the effect on a taxpayer's taxable income of making a donation in cash or of property in kind:

Example 1

A taxpayer owns a vehicle, which he bought three years ago at the beginning of his financial year for R120 000. He brought the vehicle into use immediately in his business. The market value of the vehicle at the end of the third year equals R80 000. The taxpayer claimed wear and tear on this vehicle for the three years in terms of section 11(*e*) (Practice Note 19) at 20% annually.

	Rand
Cost price	120 000
Wear and tear allowed (a section 11(*e*) deduction): Year 1	(24 000)
Wear and tear allowed (a section 11(*e*) deduction): Year 2	(24 000)
Wear and tear allowed (a section 11(*e*) deduction): Year 3	(24 000)
Tax value	**48 000**

The taxpayer decides to make a donation to an approved public benefit organisation. He can either donate R80 000 cash (Scenario 1) or donate this particular vehicle valued at R80 000 (Scenario 2) to the approved public benefit organisation. The taxpayer obtains the necessary receipt from the public benefit organisation (as required by section 18A of the Act) and seeks to deduct the donation from his taxable income.

Assuming that the taxable income of the taxpayer before this donation equals R2 500 000, the effect of the donation is as follows:

	Scenario 1 Donate R80 000 in cash Rand	Scenario 2 Donate vehicle valued at R80 000 Rand
Taxable income before donation	2 500 000	2 500 000
Plus section 8(4)(*k*) recoupment Market value (limited to original cost price) less tax value: (R80 000 – R48 000)	n/a	32 000
	2 500 000	2 532 000
Less section 18A deduction in respect of donation made to a public benefit organisation:		
Qualifying deduction: Scenario 1 R80 000 cash, limited to 5% of R2 500 000 (taxable income before this deduction) = R125 000	80 000	
Qualifying deduction: Scenario 2 The lower of: ● the tax value of the asset (R48 000); or ● the fair market value (R80 000).		
R48 000, limited to 5% of R2 532 000 (taxable income before this deduction) = R126 600		48 000
Final taxable income	**2 420 000**	**2 484 000**

The difference of R64 000 (R2 484 000 – R2 420 000) consists of two amounts:

- R32 000 recoupment in terms of section 8(4)(*k*); and
- R32 000 (R80 000 – R48 000) in terms of section 18A in respect of donations made, if the taxpayer decides to donate an amount in cash rather than of property in kind (the vehicle) to the public benefit organisation.

Taxpayers who donate cash instead of property in kind (by means of a trading asset) with the same market value therefore receive a much greater tax advantage.

Example 2

Where a taxpayer identifies a particular asset as redundant in a business, that particular asset might be identified as a suitable donation to a public benefit organisation. One can compare this to a situation in which the taxpayer decides to sell the asset and then donates the cash generated by the sale, instead of donating the asset itself. One can examine these possibilities assuming the same details as in example 1, but with Scenario 1 representing the situation in which the taxpayer sells the vehicle for R80 000 (the market value) and Scenario 2 representing the situation in which the taxpayer donates the vehicle itself.

Assuming once again that the taxable income of the taxpayer before this donation equals R2 500 000, the effect of the donation is as follows:

	Scenario 1 Sell the vehicle and donate R80 000 in cash Rand	Scenario 2 Donate vehicle valued at R80 000 Rand
Taxable income before donation	2 500 000	2 500 000
Plus section 8(4)(*a*) recoupment Selling price (limited to original cost price) Less tax value: (R80 000 – R48 000)	32 000	
Plus section 8(4)(*k*) recoupment Market value (limited to original cost price) Less tax value: (R80 000 – R48 000)		32 000
	2 532 000	2 532 000
Less a section 18A deduction in respect of a donation made to a public benefit organisation:		
Qualifying deduction: Scenario 1 R80 000 cash limited to 5% of R2 532 000 (taxable income before this deduction) = R126 600	80 000	
Qualifying deduction: Scenario 2 The lower of: ● the tax value of the asset (R48 000); or ● the fair market value (R80 000). R48 000 limited to 5% of R2 532 000 (taxable income before this deduction) = R126 600		48 000
	2 452 000	2 484 000
Capital gains tax Proceeds (R80 000 – R32 000) less Base cost (R120 000 – R72 000) = Rnil	nil	n/a
Final taxable income	**2 452 000**	**2 484 000**

The difference of R32 000 (R2 484 000 – R2 452 000) consists of one amount, namely, R32 000 (R80 000 – R48 000), in terms of section 18A, for donations made when a taxpayer decides to donate cash rather than property in kind (the vehicle) to the public benefit organisation.

Taxpayers who donate cash realised from the sale of a redundant asset instead of property in kind (by means of a trading asset) with the same market value, therefore still receive a greater tax advantage. This clearly does not make sense. In an effort to clarify this inconsistency, SARS was approached for comment.

Comment from SARS

The anomaly of receiving a greater tax deduction when a taxpayer decides to donate an amount in cash, compared with a donation of property in kind, was pointed out to SARS. An official from the SARS Law Administration division, in an e-mail dated 31 October 2003, commented as follows:

> Section 8(4)(*k*) was designed to achieve the same result that a person would have if the asset was sold for cash and the cash was donated. In other words it is designed to prevent people escaping recoupment by donating assets instead of cash.
>
> I suspect that tax value was allowed in terms of section 18A to avoid giving a double deduction for the same asset. For example, if I bought an asset for R100, depreciated it fully and then donated it when its market value was R100, had market value been allowed I would have had R200 as a deduction (R100 as depreciation, and R100 under section 18A). However, the use of tax value now seems wrong since section 8(4)(*k*) was introduced. It's probably something that needs to be amended.

The response received from SARS indicates that the current provisions, relating to the deduction of a donation of property made in kind in section 18A, are outdated and need to be amended. In the next section, an alternative approach to overcome these inequalities for taxpayers wanting to make a donation of property in kind is proposed.

What can be done in the interim?

When a taxpayer wants to make a donation to a public benefit organisation in the form of property in kind and obtain the same tax deduction as he or she would be allowed when making a donation in cash, he may prefer to sell the specific asset to the public benefit organisation at market value. The public benefit organisation then pays the selling price in cash to the taxpayer, who donates the exact amount to the public benefit organisation (for which he receives a valid section 18A receipt).

The only problem with this suggestion is that SARS may enforce the provisions of section 103(1) in relation to this transaction.

Section 103(1) of the Act reads as follows (author's emphasis):

> Whenever the Commissioner is satisfied that any **transaction**, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property) –
>
> *(a)* has been entered into or carried out which has the effect of avoiding **tax**, duty or levy imposed by this Act or any previous Income Tax Act, or **reducing the amount thereof**; and
>
> *(b)* having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out
>
> (i) was entered into or carried out
>
> *(aa)* in the case of a transaction, operation or scheme in the context of business, in a manner which would **not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit**; and
>
> *(bb)* in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item *(aa)*, by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
>
> (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length

under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

(c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.

Before the Commissioner can apply the provisions of section 103(1) to set aside a transaction or act in such a manner as to prevent the avoidance of tax, all of the preceding requirements must be present:

- There must be a transaction, operation or scheme.
- It must have the effect of avoiding or postponing liability for tax.
- The manner in which a business transaction is entered into must be one that would not normally be employed for *bona fide* business purposes (the business purpose test or the abnormality test and an abnormal rights test) – according to Stiglingh, Venter & Hamel (2003b: 345), the manner in which a business transaction is entered into must be one that would not normally be employed for *bona fide* business purposes (according to the business purpose test or the abnormality test and an abnormal rights test, which requires an element of abnormality in either the transaction, operation or scheme or in the rights or obligations arising from it).
- Its sole or main purpose must have been to obtain a tax benefit (this includes any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed under the Act or any other law administered by the Commissioner).

The onus of proof that the sole or main purpose was not tax avoidance, however, rests upon the taxpayer himself. If the Commissioner is satisfied that the conditions are met, as described, he determines a taxpayer's tax liability as if the transaction had not been entered into or in such manner as in the circumstances the Commissioner deems appropriate for the prevention or diminution resulting from the reduction of tax.

When a taxpayer sells a specific asset at market value to a public benefit organisation for cash and in turn donates exactly the same amount to that public benefit organisation (for which he receives a valid section 18A receipt) as already suggested, there is a **transaction** with the effect of **reducing the amount of tax** payable. The third requirement of being **abnormal** in either the transaction, or the rights or obligations arising from it, might be debatable. There have not been many cases dealing with the application of section 103(1), but all these clearly show that each case must be decided on its own merits and according to its own particular circumstances (Stiglingh et al. 2003b: 346).

In conclusion, the four canons of taxation (first formulated by Adam Smith in 1776 in *The Wealth of Nations*) are summarised as follows by Huxham & Haupt (2004: 2):

(i) The subjects of every State ought to contribute towards the support of the government, as nearly as possible in proportion to their abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate.

(ii) The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor.

(iii) Every tax ought to be levied at the time, or in the manner in which, it is most likely to be convenient for the contributor to pay it.

(iv) Every tax ought to be so contrived as to both take out, and keep out, of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

The Katz Commission (1987: 55) also distinguished between horizontal and vertical equitability. Horizontal equitability determines that similar individuals or persons in the same situation must be treated equally. Vertical equitability, however,

means that persons in different situations must carry different tax liabilities (individuals with a higher level of economic prosperity must carry a higher tax burden).

In the modern context, these principles must also include the broader principles of social justice (Stiglingh et al. 2003a: 3).

From the discussion in this paper, it is clear that the provisions relating to a taxpayer who wishes to donate a depreciable asset instead of a cash amount to a public benefit organisation are in conflict with the basic principles of taxation.

Conclusion

This paper shows that the tax deduction in respect of donations is greater when a taxpayer decides to donate an amount in cash rather than of property in kind.

SARS responded in this regard by agreeing that the current provisions relating to the deduction of a donation of property made in kind in section 18A are outdated and need to be amended.

The paper shows that, under current legislation, a donation of property in kind can be structured in such a way that it will provide a taxpayer with an identical tax deduction as when donating cash.

The paper concludes with a statement that the provisions relating to a taxpayer who wishes to donate a depreciable asset instead of a cash amount to a public benefit organisation are in conflict with the basic principles of taxation.

It is hoped that the current legislation pertaining to the deduction of a donation of property made in kind will be amended soon, as the provisions are clearly inequitable towards a taxpayer who wishes to donate a depreciable asset rather than cash to a public benefit organisation.

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