DRAFT INTERPRETATION NOTE

DATE:

ACT : INCOME TAX ACT NO. 58 OF 1962
SECTION : SECTION 11(*n*A)
SUBJECT : TAX DEDUCTION FOR AMOUNTS REFUNDED TO EMPLOYERS

Preamble

In this Note unless the context indicates otherwise –

- **"IRP5"** means an employees' tax certificate
- **"SDL"** refers to skills development levies as determined in the Skills Development Levies Act, 1999
- **"section"** means a section of the Act;
- "**the Act**" means the Income Tax Act No. 58 of 1962;
- **"UIF"** refers to unemployment insurance fund contributions as determined in the Unemployment Insurance Contributions Act, 2002, and
- any word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides guidance and clarity on the tax implications of amounts that were included in a person's taxable income,[1] and subsequently refunded or repaid.

2. Background

A person may receive remuneration and other similar amounts (for services rendered or to be rendered, or by virtue of employment or the holding of any office) which subsequently have to be repaid, often because of contractual obligations not having been fulfilled or a previous overpayment. These amounts can include, for example, paid maternity or sick leave benefits, or retention bonuses. These amounts are often recovered by an employer, but sometimes in a subsequent year of assessment. There is uncertainty regarding the amount (which has been subject to the withholding or deduction of employees' tax (PAYE)) that has to be refunded, and the related tax implications.

[1] As defined in section 1(1) of the Act.

3. The law

For ease of reference, the relevant sections of the Act applicable to amounts refunded are quoted in **Annexure B**.

4. Application of the law

4.1 Section 11(*n*A) deduction

Section 11(*n*A) was introduced into the Act with effect from 1 January 2009. This section permits a person to take into account as a deduction any amount refunded by him or her in calculating his or her taxable income, in the year of assessment that the amount is refunded, but only if that amount was previously included in his or her taxable income. The amount that would have been used to determine that person's taxable income on receipt thereof would have been the *gross* remuneration, and not the net amount received from the employer (namely, the amount after tax).

Prior to the introduction of section 11(*n*A), there was no provision in the Act under which amounts that were included in taxable income in a previous year of assessment could be reversed or claimed as a deduction. A deduction could not be claimed under section 11(*a*)[2] as a refund is not an expense incurred in the production of income.

Paragraph 2 of the Fourth Schedule to the Act does not provide for the right to refund PAYE when amounts paid to an employee are subsequently refunded. This means that at no stage may an employer refund the tax (that has already been paid over to SARS) to an employee. Any PAYE that has been overpaid because of amounts subsequently recovered by the employer from the employee, will be taken into account by SARS in calculating the employee's taxable income on assessment when the employee claims a deduction.

Example 1 – Gross amount paid recovered from the employee

Facts:

G, an employee of XYZ, receives a retention bonus of R50 000 in year 1. PAYE of R20 000 (assuming a tax rate of 40%) was deducted by XYZ and paid over to SARS. The amount paid into the G's bank account for the retention bonus was R30 000, after tax. In year 2, G does not meet the contractual obligations relating to the retention bonus paid and repays the bonus received in year 1.

Result:

G will be entitled to claim the R50 000 as a deduction on assessment in year 2 under the provisions of section 11(*n*A).

G will effectively be out of pocket by R20 000 after repaying the R50 000 to the employer (because only R30 000 was paid into G's bank account). SARS will take into account the full R50 000 in calculating G's taxable income on assessment when G claims a deduction under section 11(*n*A).

[2] ITC 1823 (2006), 69 SATC 226.

A taxable benefit will arise if the employee is only required to refund the net amount paid, or to refund a lesser amount of what is contractually owed. Paragraph 2(*h*), read with paragraph 13 of the Seventh Schedule to the Act, provides that a taxable benefit arises if an employer releases an employee from the obligation to pay a debt. If, for example, X is contractually required to refund R20 000 but the employer only requires a refund of R5 000, X would effectively be receiving a benefit of R15 000. In other words, the employer would have released X from an obligation to pay R15 000. This amount will, in itself, be regarded as a taxable benefit,[3] and will be subject to tax, even though the employee can only claim a deduction of R5 000 (being the amount actually refunded).

Example 2 – Net amount recovered from the employee – taxable benefit arises

Facts:

G, an employee of XYZ, receives a retention bonus of R50 000 in year 1. PAYE of R20 000 (assuming a tax rate of 40%) was deducted by XYZ and paid over to SARS. The amount paid into the G's bank account for the retention bonus was R30 000, after tax. In year 2, G does not meet the contractual obligations relating to the retention bonus paid and has to repay the bonus received in year 1.

Although G is contractually required to refund an amount of R50 000, XYZ only recovers the net amount of R30 000 from G, thereby releasing G from an obligation to pay R20 000.

Result:

G will only be entitled to claim R30 000 as a deduction in year 2, as only R30 000 is repaid to XYZ. On the assumption that no other income is declared or deductions claimed, G will receive a refund of R12 000 (40% of R30 000) from SARS in year 2.

G is, however, contractually bound to refund R50 000, which means that G's employer has released G from an obligation to pay R20 000. As such, XYZ will have to include a taxable benefit of R20 000 in G's hands and (once again assuming a tax rate of 40%) deduct PAYE of R8 000 in year 2.

Example 3 – Section 11(*n*A) deduction

Facts:

In the 2013 year of assessment, X was granted paid sick leave of 45 days. In January 2014, the employer rejected 30 days of sick leave and required X to pay back R20 000 for the 30 days leave regarded as excessive (unpaid leave). X's total income (before any deductions) for the 2014 year of assessment was R240 000. The employer withheld PAYE of R36 328.

[3] In terms of paragraph 2(*h*), read with paragraph 13 of the Seventh Schedule to the Act.

Result:

In the 2014 year of assessment, X would be entitled to a deduction of R20 000. X's tax liability on assessment will be determined as follows:

	R
Income	240 000
Less: Section 11(*n*A) deduction	(20 000)
Taxable income	220 000
Normal tax on R220 000 [R29 808 + 25% of (R220 000 – R165 600)]	43 408
Less: Primary rebate	(12 080)
Net normal tax due	31 328
Less: PAYE withheld by employer	(36 328)
Refund due to X	**(5 000)**

Example 4 – **Section 11(*n*A) deduction**

Facts:

In January 2013, employer B granted employee C a bursary. The agreement was such that C was required to remain in the employer's employment for a minimum of one year following the year of study. C resigned on 27 February 2014. As C had been in breach of contract (in that C did not remain in employment for at least one year following the year of study) C was required to pay back R60 000 for the bursary received. C's total income for the 2014 year of assessment was R360 000, before any deductions. The employer withheld PAYE of R71 485,50.

Result:

2013 year of assessment

C's tax assessment will remain as is.

2014 year of assessment

The employer will make no adjustment to C's IRP5 relating to the amount refunded. C will be entitled though, to claim a deduction under section 11(*n*A) on assessment.

C's IRP5 would show income of R360 000 and PAYE of R71 485,50. On assessment, C will be entitled to claim a deduction of the R60 000 that was refunded to the employer.

	R
Income	360 000,00
Less: Section 11(*n*A) deduction	(60 000,00)
Taxable income	300 000,00
Normal tax on R300 000 [(R53 096 + 30% of (R300 000 – R258 750)]	65 471,00
Less: Primary rebate	(12 080,00)
Net normal tax	53 391,00
Less: PAYE already paid	(71 485,50)
Refund due *to* C on assessment	**(18 094,50)**

The deduction of the amount paid back to the employer must be reflected in the field of the ITR12 annual income tax return dealing with deductions. For more information, refer to the *ITR12 Comprehensive Guide*, available on the SARS eFiling website **www.sarsefiling.co.za**.

4.2 Documentation required to prove that an amount was refunded

In order to be able to claim a deduction under section 11(*n*A), satisfactory proof must be provided to show that the amount was previously included in taxable income and subsequently refunded to the employer. Such information and documentation is required in the event that SARS conducts a compliance verification or audit.[4] The employer is the only person who can confirm that the amount was actually repaid. The employer must therefore provide the employee with some kind of evidence that the amount was previously included in income and was subsequently repaid. It is acceptable for an employer to provide a letter, a sample of which is included in **Annexure A**.

4.3 UIF and SDL consequences for the employer

There is no provision for the refund of UIF and SDL if amounts against which levies and contributions have been determined, are refunded to the employer. The rationale behind this approach is that both UIF contributions and SDL levies are calculated on "remuneration" as defined in the Fourth Schedule to the Act.[5] Despite an amount having to be refunded to the employer by the employee, that amount nevertheless remains "remuneration" that has been received by or has accrued to the employee and that has been paid or is payable by the employer. The recovery of this amount does not result in a reduction in the remuneration received or accrued in that particular year of assessment, but merely results in the employee being entitled to a deduction of that amount under section 11(*n*A) in the year that the recovery takes place. As a result of this, no change will be made to the leviable amount for SDL purposes or to the remuneration for UIF purposes on amounts subsequently recovered from the employee by the employer.

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4 As provided in section 31, read with section 40 of the Tax Administration Act No. 28 of 2011.

5 Section 3(4) of the Skills Development Levies Act of 1999 refers to a "leviable amount" based on "remuneration" as defined in the Fourth Schedule to the Act. Section 6 of the Unemployment Insurance Contributions Act of 2002 refers to UIF contributions based on "remuneration" as defined in the Fourth Schedule to the Act.

5. Conclusion

Amounts which have been received by or accrued to an employee may subsequently be recovered by the employer in another year of assessment. Whilst the Act does not permit the employer to refund taxes paid retrospectively, the Act does permit a deduction of the amount repaid by the employee in the year that the amount became repayable. This has the effect of reducing the employee's taxable income (on assessment) in the year of recovery.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

Annexure A – Sample letter from employer to employee

The following is a sample letter that should be issued by the employer to an employee on a formal letterhead if amounts, which were previously included in an employee's taxable income, are required to be refunded.

Employer XYZ
Employer Tax Reference (PAYE) Number
Employer Address

Employee X
Employee Salary Number
Employee Tax Reference Number
Employee ID or Passport Number
Employee Physical Address

Date

RECOVERY OF AMOUNT FROM EMPLOYEE

During the 20…….. year of assessment an amount of R……. was paid to Employee X…….. relating to …….. (nature of the payment, e.g. retention bonus). The amount was included in his/her gross income, PAYE was deducted and paid to SARS.

It is hereby confirmed that the employee was required to refund R……. of the amount above. It is hereby confirmed that the employee refunded the amount as follows:

Date/s refunded 1) _____
2) _____

Employer XYZ

Annexure B – The law

Section 11(*n*A)

11. General deductions allowed in determination of taxable income.—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—

(*n*A) so much of any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount received or accrued in respect of or by virtue of any employment or the holding of any office as was included in the taxable income of that person and is refunded by that person;

Paragraph 2(*h*) of the Seventh Schedule to the Act

2. For the purposes of this Schedule and of paragraph (*i*) of the definition of "gross income" in section 1 of this Act, a taxable benefit shall be deemed to have been granted by an employer to his employee in respect of the employee's employment with the employer, if as a benefit or advantage of or by virtue of such employment or as a reward for services rendered or to be rendered by the employee to the employer—

(*h*) the employer has, whether directly or indirectly, paid any debt owing by the employee to any third person (other than an amount in respect of which item (*i*) or (*j*) applies), without requiring the employee to reimburse the employer for the amount paid or the employer has released the employee from an obligation to pay any debt owing by the employee to the employer: Provided that where any debt owing by the employee to the employer has been extinguished by prescription the employer shall be deemed to have released the employee from his or her obligation to pay the amount of such debt if the employer could have recovered the debt owing or caused the running of the prescription to be interrupted, unless it is shown to the satisfaction of the Commissioner that the employer's failure to recover the debt owing or to cause the running of the prescription to be interrupted was not due to any intention of the employer to confer a benefit on the employee; or

Paragraph 13 of the Seventh Schedule to the Act

13. (1) The cash equivalent of the value of the taxable benefit derived by reason of the payment of any amount by an employer in the circumstances contemplated in paragraph 2(*h*) shall be an amount equal to such amount and the cash equivalent of the benefit to an employee by reason of his release from the obligation to pay an amount owing, as contemplated in the said paragraph, shall be an amount equal to the amount that was owing.

(2) No value shall be placed under this paragraph on the value of any taxable benefit derived by reason of the fact that an employer has paid—

(*a*) . . . . . .

(*b*) subscriptions due by his or her employee to a professional body, if membership of such body is a condition of the employee's employment;

(*b*A) insurance premiums indemnifying an employee solely against claims arising from negligent acts or omissions on the part of the employee in rendering services to the employer; or

(*c*) any portion of the value of a benefit which is payable by a former member of a non-statutory force or service as defined in the Government Employees Pension Law, 1996 (Proclamation No. 21 of 1996), to the Government Employees' Pension Fund as contemplated in Rule 10(6)(*d*) or (*e*) of the Rules of the Government Employees Pension Fund contained in Schedule 1 to that Proclamation.

(3) Where—

(a) in consideration for the grant by any employer (hereinafter referred to as the former employer) to an employee of any bursary, study loan or similar assistance, the employee assumed an obligation to render services to the former employer for an agreed period;

(b) in consequence of the employee having terminated his services with the former employer before the expiry of the said period and having taken up employment with another employer (hereinafter referred to as the present employer), the employee thereupon became liable to pay an amount to the former employer;

(c) such amount was paid to the former employer on the employee's behalf by the present employer; and

(d) the employee has in consideration for such payment by the present employer assumed an obligation to render services to the present employer for a period which is not shorter than the unexpired portion of the period during which he had been obliged to render services to the former employer,

no value shall be placed under this paragraph on the value of any taxable benefit derived by reason of the payment referred to in item (*c*).