

**AN ANALYSIS OF THE INCOME TAX CONSEQUENCES RESULTING FROM  
IMPLEMENTING THE INCOME TAX BILL (2012) IN ZIMBABWE**

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by

**RUMBIDZAI KANYENZE**

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## **DECLARATION**

I, Rumbidzai Kanyenze certify that the attached half-thesis is my own work, except where specifically indicated otherwise by way of acknowledgement, accompanied by the appropriate reference. I hereby declare that this work has not been submitted for a degree at any other university.

**STUDENT NAME** : Rumbidzai Kanyenze

**STUDENT NUMBER** : 608K3658

**SIGNATURE** :

**DATE** : 15/12/2014

## ABSTRACT

The Income Tax Bill (2012) proposes certain changes to the existing Income Tax Act that will impact on the method used to determine the taxable income of a taxpayer in Zimbabwe. Therefore, it is important to understand the tax consequences the Income Tax Bill creates for the taxpayer. The research aimed to elaborate on and explain the tax consequences that will arise as a result of applying the Income Tax Bill in Zimbabwe. The research was based on a qualitative method which involved the analysis and the interpretation of extracts from legislation and articles written on the proposed changes.

The current “gross income” of a taxpayer consists of amounts earned from a source within or deemed to be from within Zimbabwe. The proposed changes to the Act will change the tax system to a residence-based system, where resident taxpayers are taxed on amounts earned from all sources. Therefore, the driving factor which determines the taxability of an amount will become the taxpayer’s residency. Clause 2 of the proposed Act provides that income earned by a taxpayer should be separated into employment income, business income, property income and other specified income. This will make it unnecessary to determine the nature of an amount because capital amounts will be subject to income tax. The current Act provides for the deduction of expenditure incurred for the purpose of trade or in the production of income. Section 31(1)(a) of the proposed Act will restrict permissible deductions to expenditure incurred in the production of income. Consequently, expenditure not incurred for the purpose of earning income will no longer be deductible when the Income Tax Bill is implemented.

The proposed Income Tax Act will increase the taxable income of a taxpayer as it makes amounts that are not currently subject to tax taxable, whilst restricting the deductions claimable.

### **Key words:**

*Income*

*Income Tax Act Zimbabwe*

*Income Tax Bill (2012) Zimbabwe*

*Source-based tax system*

*Residence-based tax system*

*Classes of income*

*In the production of income*

*Permissible deductions*

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# **CHAPTER ONE: Introduction**

## **1.1 OVERVIEW**

This chapter will set out the nature of the problem to be addressed in this research, indicate the goals this research aims to achieve, explain the research methods and design used to achieve the goals set and provide an outline of the subsequent chapters.

## **1.2 NATURE OF THE PROBLEM**

The Zimbabwe Congress of Trade Unions (2014) indicates that of the USD1,735 billion collected by the government during the period of January to June 2014, USD1,629 billion, which constitutes 93.9 per cent of the total revenue collected, was from tax revenue whilst revenue from other sources contributed USD106 million (6.1 per cent). Evidently, tax is the main source of income for the government of Zimbabwe.

John and Pamela (2003, in Bonu & Pedro: 2009) recognise that there is a direct relationship between the tax policy of a country and its long-term economic growth. This direct relationship between the tax policy and the long-term economic growth of a country indicates that income tax plays a pivotal role in the success of any given economy. Consequently, the government will aim to impose income tax policies that contribute to the achievement of economic growth in the country. Bonu and Pedro (2009) state that income tax plays a significant role in the generation of income and the allocation of revenue in a country. This is because income tax is a major source of income for a country and determines the quantity of resources available for distribution in the economy.

Economists warn that Zimbabwe's national budget for 2015 is under threat due to the government continuously failing to meet revenue targets, as international commodity prices have weakened and companies are closing due to the high cost of doing business in the country (Chawafambira: 2014). That the country is failing to achieve its revenue collection targets in respect of its main source of income does not help to ease the country's cash flow problems. Given the financial challenges the country is facing, it is understandable for the government to take measures that seek to increase revenue collected. However, one can

question to what extent the government should increase its revenue at the expense of the taxpayer.

Bonu and Pedro (2009) also acknowledge that taxes have a direct influence on the savings of taxpayers. The funds available for living expenses or business expenses and investments will depend on the amount at the taxpayers' disposal after settling their tax liability. Clearly, the tax paid by an individual or company will reduce the funds available for other activities. The adjustments made to the current Income Tax Act as a result of implementing the Income Tax Bill (2012) in Zimbabwe will affect how the taxable income of a taxpayer is determined and therefore the disposable income of the taxpayer. This makes it essential to understand the income tax consequences that will arise as a result of implementing the Income Tax Bill (2012).

Phiri (2014) acknowledges that the tax rates applied in Zimbabwe are at a record high. This means that in comparison with other countries, the tax rates applied in Zimbabwe are very high. Therefore, applying the excessively high tax rates together with the widening of the tax base will place a heavy burden on the taxpayer and may result in the taxpayer having a very low level of disposable income, which may reduce the taxpayer's standard of living and stunt economic growth. Shiri (2013) also indicates that the Income Tax Bill will result in the tax base in Zimbabwe being widened. The Zimbabwe Congress of Trade Unions (2014) points out that the government is spending more than the budgeted expenditure. Widening the tax base will achieve its objective only if the government reduces its expenditure and stays within the budgeted amount for expenses.

Musarurwa (2014) is of the opinion that tax evasion has become very common in Zimbabwe. This indicates that it is highly likely that tax evasion will increase when the proposed new Income Tax Act is applied in Zimbabwe and this will undermine the objectives the change aims to achieve. Therefore, it is important for the government to mitigate the risk of increasing tax evasion by taking steps that promote tax compliance. It can be submitted that tax compliance can be promoted by educating prospective and current taxpayers on the importance of fulfilling their tax obligations. Furthermore, the government should be more transparent by showing the taxpayers how their funds are being used by providing essential services that are of a good quality at a reasonable price, that the country is growing economically and that debts are being serviced.

Chinamasa (2014) acknowledges that the current situation (January-September 2014) is not sustainable, where 92.5 per cent of revenues go towards recurrent expenditures, with employment costs taking up 81.5 per cent, and only 7 per cent remaining for capital development.

The Income Tax Act currently applied in Zimbabwe was enacted in 1967 (Explanatory Memorandum for the Income Tax Bill, 2012). The Explanatory Memorandum for the Income Tax Bill (2012) explains that the Income Tax Bill will replace the current Income Tax Act. In terms of clause 1 of the Income Tax Bill (2012), the date of commencement is 1 January 2013. Certain factors have caused the implementation of the Income Tax Bill (2012) to be delayed. The Zimbabwean (2013) reports that the Income Tax Bill was gazetted on the 30<sup>th</sup> of November 2012 but had not yet been presented to the Parliamentary Legal Committee by the 14<sup>th</sup> of January 2013. The Herald (2013) pointed out that the Government Gazette published in November 2013 reported that the clerk of Parliament had submitted the Income Tax Bill to the President of Zimbabwe for him to assent to the Bill. According to the Zimbabwe Situation (2013), the President withheld his approval to the Bill and presented it to the Parliament for reconsideration on the 4<sup>th</sup> of December 2013. Murwira (2014) quotes an official who acknowledged that there is no constitutional provision that gives the Parliament a deadline by which to dispose of Bills returned by the President for reconsideration. The absence of a constitutional provision that provides a time-frame for the Parliament to dispose of a Bill returned to it by the President for reconsideration implies that the Income Tax Bill could be promulgated as an Act at any time in the future.

Clause 1 of the Income Tax Bill (2012) states that the Income Tax Bill will be known as the Income Tax Act (Chapter 23:13) when the Bill is implemented. The repeal and replacement of the current Income Tax Act by the Income Tax Bill will render some of the principles contained in the current Income Tax Act obsolete and will create new tax consequences for taxpayers.

Section 8(1) of the current Income Tax Act (Chapter 23:06) defines gross income as the total amount received by a taxpayer from a source within Zimbabwe or obtained from a source deemed to be within Zimbabwe, excluding receipts or accruals of a capital nature, unless they are specified in the provisions of paragraph (a) to paragraph (s) of the gross income definition. It is clear from the gross income definition that taxpayers are presently subject to income tax only on income from a source within or deemed to be within Zimbabwe. This

implies that the current Income Tax Act (Chapter 23:06) applies the source-based tax system. Establishing the source of income earned by a taxpayer is therefore presently essential when determining the taxability of an amount.

In contrast with section 8(1) of the current Income Tax Act, section 2 of the proposed new Income Tax Act (Chapter 23:13) defines gross income as income earned from all sources, before separating it into employment income, business income, property income or other income. The term “all” in the new gross income definition indicates that the world-wide income earned by a taxpayer will be subject to income tax instead of income earned from within the boundaries of Zimbabwe. This is consistent with the Explanatory Memorandum for the Income Tax Bill (2012) acknowledging that a shift from applying the source-based tax system to a residence-based tax system, where the income earned by a taxpayer resident in Zimbabwe from all geographical sources will be subject to income tax, is a major principle contained in the Income Tax Bill. Implementing the residence-based tax system in Zimbabwe will render the source of income for resident taxpayers irrelevant. However, the shift will not affect the method used to determine the taxability of amounts earned by taxpayers who are not residents of the country. This implies that non-residents will continue to be taxed based on the source of their income.

The difference between the methods used to determine the taxable income of residents and non-residents makes it vital to determine the residence of a person, when the income tax system shifts from being source-based to being residence-based. Clauses 7 to 11 of the Income Tax Bill (2012) set out the rules that will be used to determine the residence of a taxpayer. Certain phrases in the definitions of the various types of resident taxpayers are open to different interpretations and need further clarification. For this reason, relevant case law and principles from South Africa will be used to elaborate on the meaning of these phrases.

The exclusion of capital receipts and accruals from the gross income definition in section 8(1) of the current Income Tax Act (Chapter 23:06) makes it essential to distinguish between receipts that are of a capital nature and those that are of a revenue nature. The distinction is currently not provided for in the Income Tax Act and would be decided on a case-by-case basis in terms of common law. The Income Tax Bill (2012) addresses this problem by providing a clearer distinction between the different types of income. The Explanatory Memorandum for the Income Tax Bill (2012) explains that the proposed new method of calculating taxable income will separate the income earned by a taxpayer into employment

income, business income or property income and the deductions allowed will depend on whether the income is employment income, business income, property income, net gains on the disposal of investment property or other specified income. An amount will fall into one of the categories and the need to determine whether an amount is of a capital nature or revenue nature falls away. Furthermore, Capital Gains Tax will no longer be applicable due to the various classes of amounts including capital receipts in the “gross income” of a taxpayer. Clauses 23 to 26 of the Income Tax Bill (2012) set out the components of each type of income. Clauses 30 to 44 of the Income Tax Bill (2012) contain the provisions that relate to deductions allowed from employment income, business or property income and amounts that may not be deductible.

According to the Explanatory Memorandum for the Income Tax Bill (2012), the taxable income of a resident taxpayer will be determined by reducing the income earned by the taxpayer from all geographical sources with the deductions allowed by the Income Tax Bill. It is evident that an analysis of the changes relating to deductions allowed and their tax effect is required in order to understand the full extent of the tax consequences that will arise for the taxpayer as a result of implementing the Income Tax Bill (2012) in Zimbabwe. The major changes to principles as described in the Explanatory Memorandum for the Income Tax Bill (2012) include providing a clearer distinction between deductions allowable from income that are of a technical nature closely related to the production of income and deductions that promote public policy objectives.

Section 15(2)(a) of the existing Income Tax Act (Chapter 23:06) grants the deduction of expenditure incurred for the purposes of trade or in the production of income. However, clause 31 of the Income Tax Bill (2012) restricts the deduction of expenditures and losses to those incurred in the production of income, unless the expense incurred is allowed for desirable public policy reasons. This implies that expenditure and losses incurred for trading purposes but not incurred in the production of income will no longer be eligible for deduction. The expenses that will be allowed for desirable public policy reasons are specified in the Tenth Schedule of the Income Tax Bill.

Olhoft (2003, in Bonu & Pedro: 2009) concluded that spending a large proportion of tax revenue on tax breaks and incentives is likely to be a misguided strategy when the country has a budget deficit, which Zimbabwe has. This justifies the restriction of allowable

deductions to expenditure incurred in the production of income, other than expenses incurred for desirable public policy reasons.

The restriction of allowable deductions makes it vital to understand the meaning of the term “in the production of income”. The proposed new Income Tax Act (Chapter 23:13) does not provide an explanation of what the term means. Furthermore, Zimbabwe does not have any case law relating to expenditures and losses actually incurred in the production of income, as the concept is not yet applicable. The lack of case law to be used as precedent when determining whether an expense is incurred in the production of income does not assist in understanding which expenses will be allowed as deductions when the Income Tax Bill is implemented. The Explanatory Memorandum for the Income Tax Bill (2012) acknowledges that the principle of only allowing the deduction of expenditures and losses actually incurred in the production of income is a concept applied by other countries in the region. South Africa is one of the countries in the region that restricts allowable deductions in this way and, consequently, South African case law relating to expenditures or losses incurred in the production of income can be used to determine the meaning of the term “in the production of income”.

It is evident that the amendments contained in the Income Tax Bill will have an effect on the taxability of amounts earned by the taxpayers and the deductions allowed. It is therefore important to critically analyse the major income tax consequences for the taxpayer as a result of implementing the Income Tax Bill (2012).

### **1.3 GOALS OF THE RESEARCH**

The implementation of the Income Tax Bill (2012) will have an effect on the method used to determine the taxability in Zimbabwe of income earned by taxpayers. The goal of this research is to elaborate on and explain the income tax consequences that will arise.

The research addresses the following sub-goals:

- to analyse the changes that will be made to existing income tax legislation as a result of the proposed new Income Tax Act being applied in Zimbabwe; and
- to explain the tax consequences for the taxpayer when the proposed new Income Tax Act is applied in Zimbabwe.

## 1.4 METHODS, PROCEDURES AND TECHNIQUES

An interpretative approach was adopted for purposes of this research as it seeks to understand and describe the tax consequences for taxpayers when the Income Tax Bill (2012) is implemented in Zimbabwe. McKerchar (2008) describes doctrinal research as a research methodology that provides a methodical explanation for the rules that govern a specific legal category (in this case the legal rules relating to the possible changes in the Zimbabwean income tax system as a result of the current Income Tax Act being repealed and replaced by the proposed new Income Tax Act), analyses the relationships between rules, explains areas of difficulty, may predict future developments and is entirely based on documentary data. It is evident from this description that the research methodology applied in this research can be described as *doctrinal* research.

The research was purely based on a qualitative method that involved the analysis and interpretation of extracts from the following documents:

- Legislation: The Explanatory Memorandum for the Income Tax Bill, the Income Tax Bill which will be known as The Income Tax Act (Chapter 23:13) when implemented, the Capital Gains Tax Act (Chapter 23:01), the Companies Act (Chapter 24:03), and the Act which is currently in use, namely, the Income Tax Act (Chapter 23:06);
- Relevant case law; and
- Articles written on the planned changes relating to the income tax system in Zimbabwe as a result of implementing the Income Tax Bill.

Examples will be also used to illustrate the impact of the proposed changes to the Income Tax Act.

The research was conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and all conclusions were ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;

- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

No ethical considerations applied to the research as all the data used is available in the public domain. Interviews were not conducted; opinions were considered in their written form.

The Explanatory Memorandum for the Income Tax Bill (2012) states that the changes embodied in the Income Tax Bill also include the abolishment of the Special Court for Income Tax Appeals whilst retaining the Fiscal Appeal Court and updating outdated terms so as to take into account the developments that have occurred in the field of income tax. These changes were not discussed in this research as they were beyond its scope.

## **1.5 OVERVIEW OF CHAPTERS TO FOLLOW**

The goals of the research are to provide an analysis of the changes that will occur when the proposed new Income Tax Act is implemented and to explain the tax consequences it will create for the taxpayer. The proposed Act will change the income tax system applied in Zimbabwe from a source-based system to a residence-based system. Consequently, the second chapter will address the goals set in this research by carrying out a comparison between the two income tax systems, discussing the rules which will determine the residency of a taxpayer and providing examples that illustrate how the taxability of amounts earned by a taxpayer will be determined when the income tax system applied in Zimbabwe is changed.

Chapter three will discuss the various classes of income in the Income Tax Bill. This chapter will achieve the goal of analysing the changes that will be made to existing legislation as a result of implementing the proposed new Income Tax Act in Zimbabwe by providing a description of the various classes of income. The chapter will also provide worked examples that explain the effects of classifying income into various classes, so as to achieve the goal of explaining the tax consequences that will arise as a result of changing the income tax legislation applied in the country.

The fourth chapter will focus on the changes relating to permissible deductions. An analysis of the changes that will be made to existing income tax legislation as a result of the proposed

Income Tax Act will be carried out in the fourth chapter by providing a comparison between the current and proposed permissible deductions.

The fifth chapter of the research will conclude the research by summarizing the main findings and identifying opportunities for future research.

## **CHAPTER TWO:**

# **The source-based income tax system and the residence-based income tax system**

### **2.1 INTRODUCTION**

The first goal of this research is to analyse the changes that will be made to the existing income tax legislation as a result of implementing the proposed new Income Tax Act in Zimbabwe. The Explanatory Memorandum for the Income Tax Act (2012) explains that one of the major changes contained in the Income Tax Bill is a shift from using a source-based tax system to the application of a residence-based income tax system. This chapter will contribute to achieving the first goal of the research by providing an analysis of the changes that will occur as a result of changing the income tax system applied in the country. The second goal of this research is to provide an explanation of the tax consequences that will arise for the taxpayer by providing examples where applicable. The last section of this chapter provides worked examples to explain the tax consequences that will arise for the taxpayer when the income tax system in Zimbabwe is changed.

### **2.2 A COMPARISON BETWEEN THE SOURCE-BASED TAX SYSTEM AND THE RESIDENCE-BASED TAX SYSTEM**

Brincker, Honiball and Olivier (2004) explain that the right of a country to tax an amount can either be connected to the person receiving the income or the activities that gave rise to the income. The authors also explain that the residence-based tax system is a system where a person is connected to the country for tax purposes, whereas a source-based tax system is a system where the activities that give rise to the income are related to the country.

The “gross income” definition set out in section 8(1) of the current Income Tax Act includes amounts earned by a taxpayer from a source within or deemed to be within Zimbabwe. This implies that amounts received from sources not within the boundaries of Zimbabwe are not subject to income tax, unless the amount is from a deemed source as specified in section 12 of the current Income Tax Act. Clearly, it is important to determine the source of income

when determining the taxability of an amount. The need to determine the source of income flows from the fact that the activities that give rise to the income earned by a taxpayer should be connected to Zimbabwe for an amount to be taxable in the country. The source of income being the driving factor behind the taxability of an amount indicates that the residency of a taxpayer does not play a role in determining the amounts to be included in the “gross income” of a taxpayer. Therefore, the method used to determine the “gross income” of a resident and a non-resident is the same.

The Southern African Development Community (2014) recognises that the tests used to determine the source of income are the originating cause or the geographic cause of the amount earned by the taxpayer. The website also explains that the originating cause of an amount can either be the business of the taxpayer or the employment of resources, whereas the geographic cause of an amount is where the income generating activities are performed or where the capital is used. This means that under the current tax system used in Zimbabwe, an amount is subject to income tax if the originating cause of the income earned or the asset causing the income to be generated is situated in Zimbabwe.

The Explanatory Memorandum for the Income Tax Bill (2012) states that the Income Tax Bill proposes a shift from applying a source-based income tax system to a residence-based income tax system, where the taxable income of a taxpayer resident is the income from all geographical sources within or outside Zimbabwe. The change is effected by section 2 of the proposed new Income Tax Act, which states that “gross income” means income earned from all sources, and section 15 of the proposed new Income Tax Act, which explains that the taxable income of a resident taxpayer will be calculated by reducing the income earned by a taxpayer from sources within and outside Zimbabwe with the deductions allowed by the proposed new Income Tax Act. It is evident that taxpayers who satisfy the requirements of being resident individuals and resident companies will be taxed on their world-wide income when the residence-based tax system is applied. This will make the source of income irrelevant when determining the taxability of amounts earned by resident taxpayers. This means that amounts that are currently not subject to income tax will become taxable under the residence-based income tax system.

Section 15 of the proposed new Income Tax Act will not be applicable to an insurance company, a holder of a special mining lease and petroleum operators, as their taxable income will continue to be subject to the provisions of the First, Second and Third Schedules,

respectively (Explanatory Memorandum for the Income Tax Bill: 2012). This means that resident insurance companies, holders of special mining leases and petroleum operators will not be affected by the implementation of the Income Tax Bill (2012). Consequently, these entities will not be liable for tax on their world-wide income, even if they are residents of Zimbabwe.

Non-residents will not be affected by the residence-based income tax system as they will continue to be taxed on amounts earned from a source within Zimbabwe. Therefore, determining the source of income for non-residents will be important when the Income Tax Bill (2012) is implemented. According to section 17 of the proposed new Income Tax Act, the taxable income of non-residents will be determined by applying the provisions of Chapter VIII of the Act. According to section 88(1) of the proposed new Income Tax Act, amounts that are from a source within Zimbabwe include amounts that are earned from activities carried out in Zimbabwe, employment in Zimbabwe, immovable property located in Zimbabwe, moveable property used in Zimbabwe and intellectual property used in Zimbabwe. Section 88(2) states that income not earned from a source within Zimbabwe will be regarded as income obtained from a foreign source.

Section 90(1) of the proposed new Income Tax Act states that in cases where a Double Tax Agreement exists between Zimbabwe and the country in which the non-resident taxpayer resides, the tax payable on any income under foreign law will be allowed as a tax credit against the tax charged on that income in Zimbabwe. This means that the tax payable by a non-resident taxpayer in Zimbabwe will be reduced by a tax credit, which is equal to the tax paid in the other country for income subject to tax in Zimbabwe. It is evident that the section 90(1) provision prevents the same amount from being taxed in Zimbabwe and the country with which it has a Double Tax Agreement.

Section 90(3) of the proposed new Income Tax Act will limit the tax credit a non-resident taxpayer can receive to the tax levied in Zimbabwe. This means that a tax refund will not be created by tax credits given to the taxpayer. Therefore a non-resident will not be liable for tax in Zimbabwe for a year of assessment in which tax credits are equal to or exceed the tax charged in Zimbabwe.

Section 91 of the proposed new Income Tax Act provides relief from double taxation for a non-resident taxpayer in the absence of a Double Tax Agreement between Zimbabwe and the taxpayer's country of residence. In terms of this section, a taxpayer will have to prove to the

Commissioner that he or she has either paid tax or is liable for tax in another country in respect of income earned from a source within or deemed to be within Zimbabwe. Unlike section 90 of the proposed new Income Tax Act, section 91 places the onus of proof on the non-resident taxpayer. Therefore, the non-resident taxpayer will not be able to receive tax relief if he or she fails to prove that he or she has paid or is liable for tax in his or her place of residence in respect of an amount earned from a source within or deemed to be within Zimbabwe. It is evident that in cases where a Double Tax Agreement does not exist between Zimbabwe and the country of residence, a taxpayer will risk paying tax on the same amount twice.

The taxability of an amount will depend on whether the person receiving the income is a resident taxpayer in Zimbabwe or not when the income tax system changes. Therefore, it will be crucial to determine the residence of a person when the Income Tax Bill (2012) is implemented in Zimbabwe. In addition, the Explanatory Memorandum for the Income Tax Bill (2012) explains that clauses 15 to 21 of the Income Tax Bill will rearrange the income tax base according to the taxable income of a resident taxpayer, a temporarily resident taxpayer, a non-resident taxpayer and trusts or deceased estates. The rearrangement of the income tax base also makes it important to determine the residency of a taxpayer when calculating the tax liability of a person. The rules used to determine the residency of a person are set out in clauses 7 to 11 of the Income Tax Bill (Explanatory Memorandum for the Income Tax Bill: 2012).

### **2.3 THE RULES FOR DETERMINING THE RESIDENCY OF A PERSON**

It was explained above that the Explanatory Memorandum for the Income Tax Bill (2012) states that the rules that will be used to determine the residence of a taxpayer are contained in clauses 7 to 11 of the Income Tax Bill. This implies that taxpayers who fail to meet the requirements stipulated by these clauses will be non-resident taxpayers in Zimbabwe. This section will analyse the rules that will be used to determine the residency of a person and how they will be taxed.

### **2.3.1 Resident Individual**

An individual will be a resident of Zimbabwe if he or she meets one of the criteria contained in section 7(1)(a), (b) or (c) of the proposed new Income Tax Act.

An individual will be a resident of Zimbabwe if the taxpayer “has a normal place of abode in Zimbabwe and is present in Zimbabwe at any time during the year of assessment” (section 7(1)(a) of the proposed new Income Tax Act: 2012). This means that a person whose normal place of abode is in Zimbabwe and who is physically present in the country will be considered a resident of the country, even if the person is present in the country for a short period of time during the year under assessment. Many Zimbabweans have residences in the country to which they emigrated, due to the prospect of improved living standards or better opportunities found in other countries. Most of these Zimbabweans retained their residence and visit the country from time to time.

Section 7(1)(a) of the proposed new Income Tax Act appears to imply that Zimbabweans based outside the country will be considered to be residents of Zimbabwe for tax purposes if they are present in the country at any time during the year of assessment. However, this may not be the case as it is necessary to ascertain the meaning of the term “normal place of abode”. The proposed new Income Tax Act does not explain the meaning of the term “normal place of abode”. Consequently, the main principles drawn from decisions made by courts in other countries in relation to “ordinary residents” will be used as a guideline to explain the meaning of the term “normal place of abode”.

Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks and De Swardt (2013) explain that *Reid v IRC*, 1926 SLT 365 confirms that a person can have several places of residence for the purpose of income tax. Evidently, the assumption used in this case was that the terms “resident” and “ordinarily resident” had the same meaning. If this approach is adopted, a person with a residence in Zimbabwe and another place outside the country will be considered to be a resident taxpayer of Zimbabwe. However, it is unrealistic to consider Zimbabweans based outside the country as Zimbabwe resident taxpayers when they visit their home country for short periods of time. Therefore, the principles drawn from *Reid v IRC* should be used in conjunction with other factors, such as the reason for visit, frequency of visits, duration of stay in the country and the country where occupation or trade is carried out by the taxpayer, when determining whether or not the individual has a normal place of abode in Zimbabwe.

Williams (1995) quotes the judge in *CIR v Kuttel*, 1992 (3) SA 242 (A), 54 SATC 298, stating that the terms “resident” and “ordinarily resident” have different meanings and that the issue that he had to address was the meaning of the term “ordinarily resident” as it was clear that a person was allowed to have several places of residence. The judge decided that a person is “ordinarily resident” in the country where he normally resides (Williams: 1995). The author also acknowledges that the outcome of the Kuttel case is similar to *Cohen v CIR*, 1946 AD 174, 13 SATC 362, where the court held that it was not possible to be a resident of two or more countries at the same time because a person is a resident of the country to which he or she returns after his or her wanderings. This means that an individual will have his or her normal place of abode if he or she normally resides in the country. Consequently, Zimbabweans who emigrate but retain their homes in the country will not have their normal place of abode in Zimbabwe, even if they effect improvements to their properties or the property is readily available for use when they visit their home country because, apart from occasional absences, their normal place of residence will be in other countries.

Stiglingh *et al* (2013) note that in *Levene v IRC*, 1928 AC 217, the court held that a person is a resident of the place where he or she has some degree of continuity, excluding temporary or accidental absences. Generally, a person will have a degree of continuity in the country where he or she establishes his or her life, has an element of permanence and to which he or she intends to return after visiting other countries. Based on the outcome of the *Levene* and *Cohen* cases, Zimbabweans who have relocated to other countries do not have a normal place of abode in Zimbabwe as they intend to return to the countries in which they have established their lives, after visiting Zimbabwe. Consequently, Zimbabweans who have established a degree of continuity in other countries will not be seen as resident taxpayers of the country in terms of section 7(1)(a) of the proposed new Income Tax Act.

In *Cohen v CIR*, *Levene v IRC* and *CIR v Kuttel*, the judges all agree that a person is an ordinary resident of the country he or she returns to after temporary absences. It is evident from the case law that a taxpayer will have a normal place of abode in Zimbabwe if the taxpayer returns to Zimbabwe after his or her wanderings. In addition, the Kuttel case shows that the actions carried out by the taxpayer can also be used to determine his or her normal place of abode. Therefore, Zimbabweans who have relocated to other countries but have retained their homes in the country and visit from time to time will not be resident taxpayers of the country, provided they do not meet the conditions stated in section 7(1)(b) or (c) of the proposed new Income Tax Act.

According to section 7(1)(b) of the proposed new Income Tax Act, an individual who is physically present in the country for 183 days or more, in aggregate, during the year of assessment will be a resident taxpayer. The fact that the 183 days are aggregated implies that the days do not have to be continuous for section 7(1)(b) of the proposed new Income Tax Act to be applicable. This means that visitors who stay in the country for at least 183 days in aggregate during the year will be seen as resident taxpayers when the Income Tax Bill (2012) is implemented. Therefore, individuals who do not have a normal place of abode in Zimbabwe should avoid staying in Zimbabwe for a total of 183 days during the twelve month period under assessment if they do not wish to be classified as residents of Zimbabwe for tax purposes.

In terms of section 7(1)(c) of the proposed new Income Tax Act, a public officer carrying out his or her duties outside the country during the year of assessment will be a resident individual. This means that public officers will be regarded as resident individuals, regardless of whether or not they are physically present in the Republic during the year of assessment. Consequently, it is not necessary to determine if the normal place of abode is in Zimbabwe for public officers or to establish whether a public officer has been in the Republic for a period of 183 days or more in aggregate during the year of assessment. Based on section 7(1)(c) of the proposed new Income Tax Act, a public officer will be regarded as a resident individual of Zimbabwe for tax purposes by virtue of the nature of his or her occupation. Section 2(b) of the proposed new Income Tax Act defines a public officer as a person who is paid to hold an office in the government services sector. Clearly, for the purpose of section 7(1)(c) of the proposed new Income Tax Act, a public officer includes a civil servant who is paid to represent Zimbabwe in another country.

Section 7(2) of the proposed new Income Tax Act stipulates that a person who was not a resident of Zimbabwe in the previous year of assessment will not be a resident of Zimbabwe during the period prior to entering the country for the first time. This means that a person who qualifies as a resident individual of the country during the year of assessment will be treated as such from the day of initial entry onwards. Consequently, amounts earned by the taxpayer from sources outside Zimbabwe before entering the country for the first time will not be subject to income tax in Zimbabwe.

According to section 7(3) of the proposed new Income Tax Act, an individual will cease to be a resident taxpayer of Zimbabwe from the period following the last day he or she was present

in the country, provided that the individual has a closer connection with the foreign country he or she has relocated to than with Zimbabwe. This implies that an individual will cease to be a resident of the country from the day after leaving the country, if the relationship between the individual and the foreign country is stronger than the relationship between Zimbabwe and the individual. However, the proposed new Income Tax Act does not explain the method that will be used to determine the closeness of the relationship between the individual, Zimbabwe and the foreign country the individual relocates to for the purpose of section 7(3). This makes section 7(3) of the proposed new Income Tax Act ambiguous as individuals regard their relationships differently. From a subjective perspective, one individual may identify the closeness of the relationship in terms of his or her place of normal residence rather than the country of his or her origin, whilst another may have a different opinion. Clearly, it can be argued that the term “closer connection” to a foreign country than Zimbabwe is open ended and susceptible to different interpretations. If the matter were to be subject to a court decision, the court may have regard to certain objective factors in deciding on the closeness of the relationship. Therefore, clarification in respect of how the relationship will be determined is required.

It is clear from the provisions of section 7(1) that a person cannot be regarded as a resident individual of Zimbabwe if he or she has a normal place of abode outside Zimbabwe and has never been physically present in the country at any point in time during the year of assessment, unless the person is a public officer carrying out his or her duties outside the country. In terms of section 7(4) of the proposed new Income Tax Act, an individual is deemed not to be present in Zimbabwe on any day if he or she enters the country for any of the reasons stated in paragraphs (a) to (d) of the section. Evidently, a person who satisfies any of the provisions set out in section 7(4) of the proposed new Income Tax Act will not be regarded as a resident taxpayer in Zimbabwe.

According to section 7(4) of the proposed new Income Tax Act, an individual is deemed not to be present in Zimbabwe if he or she enters the country for any one of the following reasons:

- the performance of services as an employee in Zimbabwe; or
- the person is in transit between destinations outside Zimbabwe; or
- for medical treatment or as a full time student; or
- the person is a diplomat of a foreign country or a dependent of a diplomat.

Section 7(4)(a) of the proposed new Income Tax Act explains that a person who enters the country for purposes of rendering a service as an employee is viewed as being absent from the country for the purposes of section 7. The section 7(4)(a) provision appears to be intended for employees and will not be applicable to individuals who enter Zimbabwe to start a business.

Section 7(4)(b) of the proposed new Income Tax Act states that a person in transit between destinations outside Zimbabwe is deemed to be absent from the country for section 7 purposes. This is because in-transit visitors have no intention to visit the country and are in the country to make connections to their final destinations. Therefore, section 7(4)(b) of the proposed new Income Tax Act will not be applicable to a person whose passport is stamped as a visitor staying in the country at the port of entry.

Section 7(4)(c) of the proposed new Income Tax Act provides that an individual who enters the country with the intention of studying on a full time basis will be deemed not to be present in Zimbabwe for the purpose of section 7 of the proposed new Income Tax Act. However, an individual may cease studying on a full time basis for various reasons after entering Zimbabwe. When this happens, the individual will be no longer be deemed to be an individual not present in the country for tax purposes. The provisions of section 7(4)(d) will not be applied to diplomats or their dependents when their term of office expires.

### **2.3.2 Temporarily Resident Individuals**

In terms of section 16 of the proposed new Income Tax Act, the taxable income of a temporarily resident individual will be the total of the income earned by the taxpayer from a source within Zimbabwe and the income earned by the taxpayer from outside sources, which should be remitted to Zimbabwe in terms of any enactment that relates to exchange control, less the deductions allowed by the proposed Income Tax Act. Section 16 of the proposed new Income Tax Act is intended to ensure that income earned by temporarily resident individuals from a source outside Zimbabwe will not be subject to income tax if it is not compulsory to remit it to Zimbabwe in terms of exchange control enactments. For this reason, it is important to make a distinction between resident individuals and temporarily resident individuals.

Section 8 of the proposed new Income Tax Act states that an individual referred to in section 7(1) of the proposed new Income Tax Act will be temporarily resident in Zimbabwe for a

year of assessment if the individual satisfies all the three requirements stipulated in section 8(a) to (c) of the proposed new Income Tax Act. In terms of section 8(a) of the proposed new Income Tax Act, the first requirement for a temporarily resident individual in Zimbabwe is that the individual is not a citizen of Zimbabwe, does not have domicile in the country, or does not hold a permit that allows him or her to reside in the country indefinitely in terms of the Immigration Act (Chapter 4:02). This implies that Zimbabweans who have emigrated from the country or individuals who are domiciled in Zimbabwe are not considered to be temporarily resident taxpayers. Sun Life Financial (2009) states that an individual's place of domicile is the place where he or she returns to after fulfilling the purpose for being absent and that an individual can domicile in a country he or she has not lived in for a long period of time. There is thus a difference between "normal place of abode" and "place of domicile". The difference is that a person cannot have a normal place of abode in a country he or she has not lived in for many years, whilst a person can be domiciled in a country he or she has not lived in for several years.

The second requirement for an individual to be regarded as a temporarily resident taxpayer in Zimbabwe is set out in section 8(b) of the proposed new Income Tax Act. According to this section, an individual should not have the intention of residing in the country for more than four years. An individual can argue that he or she does not intend to stay in the country for more than four years so as to avoid being subject to income tax on all income earned from sources outside Zimbabwe. It is difficult to know the intentions of an individual. However, the actions of an individual can be used to indicate these intentions. Therefore, it can be submitted that an individual will not be regarded as a temporarily resident individual for tax purposes if his or her actions indicate the intention to stay in the country for a long period. In addition, it can also be submitted that, inherently, the intention of an individual is subject to change at any point in time during the year of assessment. Consequently, the intention of a temporarily resident taxpayer should be reviewed in each year of assessment.

In terms of section 8(c) of the proposed new Income Tax Act, the last requirement needed for an individual to qualify as a temporarily resident individual is that the individual should not be present in Zimbabwe for more than four years at the end of the period under assessment. This implies that an individual who has been present in Zimbabwe for more than four years will not be a temporarily resident taxpayer in Zimbabwe, even if during the previous year of assessment the individual did not intend to stay in the country for a period of more than four years.

### 2.3.3 Resident Company

Section 9 of the proposed new Income Tax Act provides the rules that will be used to determine the residency of companies. In terms of section 9, a company will be a resident company in Zimbabwe if it fulfils at least one of the requirements contained in paragraphs (a) to (c) of this section.

Section 9(1)(a) of the proposed new Income Tax Act states that a resident company in Zimbabwe will be a company incorporated or registered in Zimbabwe or required to do so by the Companies Act (Chapter 24:03). A company formed in Zimbabwe will be regarded as a resident taxpayer in Zimbabwe even if the company is not managed in Zimbabwe or performs its daily operations in another country. Therefore, it can be submitted that it will be possible for a company not yet officially incorporated or established to be a resident taxpayer in Zimbabwe when the proposed new Income Tax Act is implemented.

In terms of section 9(1)(b) of the proposed new Income Tax Act, a company that has its effective management and exercises control in Zimbabwe will be regarded as a resident taxpayer in the country. However, the proposed new Income Tax Act does not provide for any procedures to be followed when determining the place where the effective management is carried out or where control is exercised. Stiglingh *et al* (2013) explain, in relation to the South African situation, that the place of effective management is the place where the activities of a company are performed. Consequently, a company that performs its daily activities in Zimbabwe at any point in time during the year of assessment is likely to be regarded as a resident taxpayer. It is clear from section 9(1)(b) that a company will also be a resident taxpayer in Zimbabwe if control is exercised in the country, regardless of whether the business activities are performed within or outside the borders of Zimbabwe. Farlex (2014) defines control as exercising authoritative influence over something. Based on this definition, it appears that the control of a company will be exercised in the country where decisions that influence the company are carried out. This implies that the control of a company will be exercised in Zimbabwe if the decisions that directly affect the company are made in Zimbabwe.

Section 9(1)(c) of the proposed new Income Tax Act states that a company that carries out most of its operations in Zimbabwe will be a resident company in the country. This means that a company will be a resident taxpayer in Zimbabwe if the majority of activities that generate income for the business are performed in Zimbabwe, irrespective of whether or not

the company is established or controlled in Zimbabwe. However, the proposed new Income Tax Act does not specify what will be considered as the majority of operations for purposes of section 9(1)(c). In general, the majority is considered to be more than 50 per cent, but clarity is required in relation to what will be considered as the majority of the operations for the purpose of section 9(1)(c).

According to section 9(2) of the proposed new Income Tax Act, a branch company of a non-resident operating in Zimbabwe shall be treated as a separate person and will be a resident in Zimbabwe if it qualifies under the provisions of either section 9(1)(a) or (b) or (c) of the Act. As a branch company operating in Zimbabwe is treated as an independent company for the purposes of section 9, it is unnecessary to determine the place where the company of which it is a branch company is situated. Section 31 of the current Income Tax Act states that non-residents' tax on remittances should be levied at a fixed rate for the benefit of the Consolidated Revenue Fund in accordance with the provisions of the Eighteenth Schedule. Paragraph 2 of the Eighteenth Schedule requires non-residents to pay non-residents' tax in respect of remittances effected in relation to expenditures allocated to the non-resident within fifteen days from the date of remittance or within an extended time frame granted by the Commissioner for a good cause. In accordance with this provision, the Southern African Development Community (2014) recognises that a branch of a foreign company is required to pay tax at a rate of 20 per cent on remittances made to their headquarters in respect of foreign expenses allocated to the operations of that branch. The website also indicates that companies in Zimbabwe are currently taxed at a rate of 25 per cent. In terms of section 9(2) of the proposed new Income Tax Act, a branch of a foreign company operating in Zimbabwe will be regarded as a resident taxpayer in Zimbabwe if it qualifies under the provisions of section 9(1). In other words, the branch operating in Zimbabwe will be treated in the same manner as any other company operating in the country. Consequently, a branch of a foreign-based company operating in Zimbabwe will not be subject to the current tight deadline of settling its tax obligations within 15 days from the date of remittance and the tax paid in respect of remittances made to their headquarters will be replaced by income tax, when the proposed new Income Tax Act is implemented. This will provide the branch of a foreign based company operating in Zimbabwe with more time to settle its tax obligations in the country. The removal of the tight deadline of settling a tax obligation is favourable as inflation reduces the value of money. However, the favourable timing factor will come with a higher tax rate of 25 per cent, which can result in the branch of a foreign company paying more tax.

#### **2.3.4 Resident Trusts**

According to section 10 of the proposed new Income Tax Act a trust will be a resident in Zimbabwe if it meets one of the three requirements set out in paragraphs (a), (b) or (c) of this section.

Section 10(1)(a) of the proposed new Income Tax Act states that a trust established in Zimbabwe will be taxed as resident in the country. This implies that a trust will be a resident taxpayer if it is formed or registered in Zimbabwe.

Section 10(1)(b) of the proposed new Income Tax Act stipulates that a trust will be a resident in Zimbabwe if the trustee of the trust is a resident person. Section 2 of the proposed Income Tax Act indicates that the trustee is the person responsible for the control or management of the property owned by a trust. Evidently, a trust will be a resident in Zimbabwe if the person responsible for managing the resources owned by the trust is a resident taxpayer in terms of section 7 of the proposed new Income Tax Act.

Section 10(1)(c) of the proposed new Income Tax Act explains that a trust will be a resident taxpayer in Zimbabwe if the management and control is carried out in Zimbabwe at any time during the year of assessment. This implies that a trust will be a resident taxpayer if the resources owned by the trust are effectively managed in Zimbabwe and the decisions that directly affect the trust are made in the country. It is clear from section 10(1)(c) that both control and management should be exercised in Zimbabwe at any time during the year of assessment in order for income earned by a trust from all geographical sources to be taxable in Zimbabwe.

Based on the provisions in section 10 of the proposed new Income Tax Act, it can be concluded that a trust will be regarded as a resident taxpayer if it is established in Zimbabwe, if a trustee of the trust is a resident taxpayer in Zimbabwe at any time during the year of assessment or if the trust is effectively managed and controlled in Zimbabwe at any time.

#### **2.3.5 Resident Partnerships**

Section 11 of the proposed new Income Tax Act stipulates that partnerships will be resident taxpayers if a partner was a resident partner at any time during the year of assessment. This

implies that the residence of a partnership will be dependent on the residence of the partners who formed it.

## **2.4 ILLUSTRATIVE EXAMPLES**

This section will provide examples that explain the tax consequences for the taxpayer as a result of changing the income tax system applied in Zimbabwe.

### **2.4.1 Examples for Individual Taxpayers**

In terms of the proposed tax regime, the taxability of amounts earned by individuals will depend on whether or not the individual is a resident taxpayer in Zimbabwe. To this effect, two examples will be provided to illustrate the tax consequences for individuals when the proposed new Income Tax Act is implemented.

Harvey Spector is a Zimbabwean who is married with two sons. Three years ago, Harvey got the opportunity to head the South African branch of the company he worked for in Zimbabwe. Consequently, he emigrated from Zimbabwe to South Africa with his family. Harvey continues to own the house he resided in in Zimbabwe before locating to South Africa and also owns a flat in Zimbabwe as an investment.

In the current year of assessment, Harvey and his family were present in Harare for the following periods:

1 January to 8 January (8 days)

8 April to 18 April (10 days)

15 December to 30 December (15 days)

During the current year of assessment, Harvey received the following amounts (in Rands):

Rental income from the flat situated in Harare	5 000
Share of profit from a partnership in Zimbabwe	10 000
Salary	500 000

This example will discuss the taxability of amounts earned by Harvey in terms of the provisions of the proposed new Income Tax Act.

The Explanatory Memorandum for the Income Tax Bill (2012) explains that under the proposed Income Tax Act, the taxable income of a resident taxpayer will be the income earned from all sources. However, non-resident taxpayers will continue to be taxed on income earned from sources within or deemed to be from within Zimbabwe. Therefore, it will be important to determine the residency of a taxpayer when the residence-based income tax system is applied in Zimbabwe. The rules that will be used to determine whether Harvey is a resident individual in Zimbabwe for the purpose of income tax are set out in section 7 of the proposed new Income Tax Act.

Section 7(1)(a) of the proposed Income Tax Act states that an individual shall be a resident taxpayer in Zimbabwe if he or she has a normal place of abode in the country and is physically present at any time during the year of assessment.

The provisions of section 7(1)(a) and (b) of the proposed new Income Tax Act make it clear that they are only applicable when an individual is present in Zimbabwe. This implies that section 7(1) of the proposed new Income Tax Act requires the individual to be physically present in the country, unless the individual is a public officer, to be regarded as a resident taxpayer. However, section 7(4) of the proposed new Income Tax Act sets out instances where the taxpayer is deemed to be absent from Zimbabwe for the purpose of section 7(1) of the Act. This implies that Harvey will not be regarded as a resident taxpayer in Zimbabwe if he satisfies any of the provisions set out in section 7(4) of the Act.

Section 7(4)(a) of the proposed new Income Tax Act states that a person who enters Zimbabwe for the performance of services as an employee will not be present in Zimbabwe for the purposes of section 7 of the Act. The provisions of section 7(4)(a) cannot be applied in this scenario.

Section 7(4)(b) of the proposed new Income Tax Act deems a person who is in transit between two destinations outside Zimbabwe as a person not present in Zimbabwe. This provision cannot be applied to Harvey because Zimbabwe is his final destination when he visits the country. In terms of section 7(4)(c) of the proposed new Income Tax Act, an individual will not be present in Zimbabwe if he or she enters the country for medical treatment or as a full-time student. Harvey is not visiting Zimbabwe for any of the reasons stated in section 7(4)(c). Consequently, he cannot be deemed to be absent in Zimbabwe in terms of section 7(4)(c). Section 7(4)(d) of the proposed new Income Tax Act indicates that individuals who enter Zimbabwe as foreign diplomats and their dependents will not be

present in Zimbabwe for the purposes of the proposed new Income Tax Act. Harvey and his family are ordinary individuals who visit their home country from time to time. Consequently, they cannot be deemed to not be present in the country when they visit in terms of section 7(4)(d) of the proposed Act.

Harvey failed to satisfy any of the requirements set out in section 7(4) of the proposed new Income Tax Act. Therefore, it can be submitted that Harvey is physically present in Zimbabwe when he visits the country and will be a resident taxpayer in Zimbabwe in terms of section 7(1)(a) of the proposed Act if he has a “normal place of abode” in Zimbabwe. Williams (1995) indicates that the judge in *CIR v Kuttel* made a distinction between the terms “resident” and “ordinarily resident” and decided that a person is an ordinary resident of the place where he or she normally resides. Williams (1995) also acknowledges that this decision is in agreement with the outcome of *Cohen v CIR*, where it was decided that a person is “ordinarily resident” where he or she returns to after his or her wanderings. In addition, Stiglingh *et al* (2013) note that in *Levene v IRC* the court held that a person is an ordinary resident of the country where he or she has some degree of continuity, apart from temporary absences. Based on these cases, Harvey will have a normal place of abode in Zimbabwe if he normally resides in Zimbabwe, has some degree of permanence in the country and returns to Zimbabwe after his wanderings.

The fact that Harvey works in South Africa, returns to South Africa after he visits other countries with his family shows that, apart from temporary absences, Harvey normally resides in South Africa and has established some degree of permanence there. Therefore, it can be submitted that although Harvey retained his residential property in Zimbabwe, he does not have a normal place of abode in Zimbabwe. Consequently, he will not be a resident taxpayer in Zimbabwe, unless he fulfils the requirements of section 7(1)(b) or (c) of the proposed Income Tax Act.

Section 7(1)(b) of the proposed new Income Tax Act requires an individual to be present in Zimbabwe for at least 183 days, in aggregate during the year of assessment. The fact that the 183 days must be aggregated means that the days do not need to be continuous. Harvey has been present in the country for 35 days. Evidently, Harvey has not fulfilled the section 7(1)(b) requirement, hence, he will not be considered as resident taxpayer in Zimbabwe if he does not meet the requirement of section 7(1)(c) of the proposed new Income Tax Act.

According to section 7(1)(c) of the proposed new Income Tax Act, a public officer carrying out his duties outside Zimbabwe during the year of assessment is a resident individual of Zimbabwe for tax purposes. Section 2(b) of the proposed new Income Tax Act states that a public officer is an individual who is paid to hold an office in the services of the government. Even though Harvey works for the same company he worked for in Zimbabwe, he is not holding an office in the services of the government. This means that Harvey is not a public officer carrying out his duties outside Zimbabwe. Consequently, Harvey will not be a resident taxpayer in Zimbabwe during the year of assessment. The conclusion that Harvey is a non-resident taxpayer in Zimbabwe will result in Harvey being subject to Zimbabwean tax on amounts that he earned from a source within Zimbabwe.

Section 88(1)(a) of the proposed new Income Tax Act states that an amount will be obtained from a source within Zimbabwe if the activities that give rise to it are carried out in Zimbabwe. The share of profit from a partnership is an amount that has been earned by Harvey as a result of a business activity carried out in Zimbabwe. This implies that the share of profit from a partnership of R10 000 is an amount earned from a source within Zimbabwe. Consequently, the share of profit earned by Harvey from a partnership will be included in his gross income for the purposes of income tax in Zimbabwe.

Section 88(1)(c) of the proposed new Income Tax Act states that amounts that accrue to the taxpayer as a result of immovable property situated in Zimbabwe will be regarded as income obtained from a source within Zimbabwe. The flat situated in Zimbabwe is the immovable property that gave rise to the rental income earned by Harvey. This indicates that the rental income earned by Harvey is obtained from a source within Zimbabwe. Consequently, the rental income of R5 000 will be subject to income tax in Zimbabwe.

According to section 88(2) of the proposed new Income Tax Act, foreign-sourced income is an amount not obtained from a source within Zimbabwe under the provisions of section 88(1). Section 88(1)(b) of the proposed new Income Tax Act explains that income that accrues from employment in Zimbabwe shall be regarded as income from a source within Zimbabwe. Harvey does not obtain his salary from employment in Zimbabwe because he works in South Africa. This means that the salary of R500 000 earned by Harvey will not be income earned from a source within Zimbabwe. Consequently, Harvey's salary will not be subject to tax in Zimbabwe.

Section 90(1) of the proposed new Income Tax Act allows a tax credit to be claimed against tax payable in Zimbabwe when a Double Tax Agreement exists between Zimbabwe and the country where the taxpayer resides. However, section 90(3) of the proposed new Income Tax Act prohibits the tax credit claimable from exceeding the total tax levied in Zimbabwe. A Double Tax Agreement exists between South Africa and Zimbabwe. Consequently, Harvey can claim a tax credit against the tax payable in Zimbabwe. However, a refund cannot be created by the tax credit exceeding his tax liability in Zimbabwe. Therefore, Harvey will not be liable for tax in Zimbabwe during the year of assessment if his tax credit exceeds the tax charged in Zimbabwe.

The second illustrative example relating to individuals will discuss the taxability of amounts earned by a resident taxpayer in terms of the current and proposed Income Tax Acts.

Harvey is a 26 year old male who has lived in Zimbabwe for his entire life. During the year of assessment, Harvey earned the following amounts (in Rands):

Rental income from the flat situated in South Africa	5 000
Share of profit from a partnership in Zimbabwe	10 000
Salary	500 000

Under the current Income Tax Act, both residents and non-residents are taxed on income earned from a source within or deemed to be within Zimbabwe. Therefore, the source of income is the factor that determines the taxability of an amount. The Southern African Development Community (2014) acknowledges that the current Income Tax Act does not provide a meaning for the term “source”. The website document also explains that the tests used to determine the source of income are the originating cause and the geographic cause of the income earned by the taxpayer.

The Southern African Development Community (2014) indicates that the source of income is the place where the asset is used to generate income. The rental income earned by Harvey is a result of letting the flat he owns in South Africa. Thus, the rental income of R5 000 is income earned from a source within South Africa. In terms of section 8(1) of the current Income Tax Act, the rental income obtained from a source within South Africa will only be included in Harvey’s gross income if it is obtained from a source deemed to be within Zimbabwe. In terms of section 12 of the current Income Tax Act, rental income obtained from a foreign source is not deemed to be obtained from a source in Zimbabwe. This will result in the rental

income of R5 000 not being subject to income tax in Zimbabwe even under the current Income Tax Act.

The Southern African Development Community (2014) explains that an amount originates from the place where the business activity is performed. The share of profit from the partnership results from an activity carried out in Zimbabwe. This means that the share of profit received by Harvey is obtained from a source within Zimbabwe. Consequently, the amount will be included in Harvey's gross income.

The Southern African Development Community (2014) explains that the use of assets can also be the originating cause of an amount. The skills applied by an employee to render a service are the asset which he or she uses to produce income. Therefore, the employment of an employee is the originating cause of his or her salary. This implies that the source of income of a salary is the country where he or she works. The fact that Harvey works in Zimbabwe means that the salary he earned is an amount obtained from a source within Zimbabwe. Consequently, the salary of R500 000 is subject to income tax in Zimbabwe.

The Explanatory Memorandum for the Income Tax Bill (2012) recognises that under the proposed new Income Tax Act, the amounts earned by a resident taxpayer from all sources will be subject to income tax. Clearly, determining the source of income earned by a resident taxpayer will be immaterial when the residence-based tax system is applied. Therefore, in order to determine the taxability of the amounts earned by Harvey, it is important to determine his residency.

Section 7(1)(a) of the proposed new Income Tax Act states that an individual will be a resident taxpayer in Zimbabwe if he or she has a normal place of abode in Zimbabwe and he or she is physically present in the country during the period under assessment.

It was discussed in the part (a) solution that a person will have a normal place of abode in Zimbabwe if he or she usually resides in the country. The fact that Harvey works in Zimbabwe and did not emigrate from the country indicates that he normally resides in Zimbabwe. This implies that Harvey has a normal place of abode in Zimbabwe. Consequently, he will be a resident taxpayer in Zimbabwe under the provisions of section 7(1)(a). Harvey being regarded as a resident taxpayer in Zimbabwe in terms of section 7(1) of the proposed new Income Tax Act will result in all the amounts he earned being subject to income tax, regardless of the source.

The example illustrates that the effect of applying a residence-based tax system in Zimbabwe will be that the rental income of R5 000 earned by Harvey from a source outside Zimbabwe will become taxable, which increases his taxable income. However, changing the income tax system applied in Zimbabwe will not affect the amounts earned by Harvey from a source within Zimbabwe. This is shown in the example by the share of profit and the salary earned from sources within Zimbabwe being taxable under the current and the proposed new Act.

#### 2.4.2 Example for temporarily resident individuals

Scottie McKay is an economist who has been invited by Zimbabwe's Ministry of Finance to act as an independent consultant for the next three years on economic issues faced in the country. Scottie accepts the appointment and is given a Temporary Resident's Permit that expires in three years. A few months before the tenure, expired, the Ministry of Finance offered to extend her contract by a further three years. Scottie accepted the offer and renewed her Temporary Resident's Permit.

During the six years she stayed in Zimbabwe, Scottie received the following amounts (in United States Dollars):

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Consulting fee	120 000	120 000	120 000	125 000	125 000	125 000
Foreign income which must be remitted to Zimbabwe	7 000	5 000	6 000	5 500	6 400	5 300
Foreign income which need not be remitted to Zimbabwe	4 000	2 000	2 500	3 000	1 000	3 500

This example will discuss how the income earned by Scottie will be taxed in Zimbabwe when the income tax legislation applied in Zimbabwe is changed as a result of implementing the proposed new Income Tax Act.

Section 16 of the proposed new Income Tax Act states that in relation to temporarily resident individuals in Zimbabwe, the income earned from a source within the country and foreign-sourced income, which should be remitted to Zimbabwe, will be subject to income tax in

Zimbabwe. There is still a need for clarification with regard to instances when foreign income should be remitted to Zimbabwe in terms of the performance of any enactment which relates to exchange control, when the proposed tax law is implemented. In order to illustrate the tax effects of foreign income earned by a temporarily resident taxpayer, the foreign income earned by Scottie was split into that which should be remitted to Zimbabwe and that which should not.

In terms of section 8 of the proposed Income Tax Act, a resident individual will be regarded as a temporarily resident individual in Zimbabwe if he or she satisfies all the requirements set out in section 8(a), (b) and (c). It is clear from the provisions of section 8 of the proposed new Income Tax Act that temporarily resident individuals must first qualify as a resident taxpayer in Zimbabwe under the provisions of section 7 before they are considered to be temporarily resident individuals.

Section 7(1)(a) of the proposed new Income Tax Act states that a person will be a resident taxpayer in Zimbabwe if he or she has a normal place of abode and is physically present in the country. The fact that Scottie works in Zimbabwe and has a Temporary Resident's Permit indicates that Scottie's usual place of residence during the six years she acts as a consultant is Zimbabwe. Therefore Scottie has a normal place of abode in Zimbabwe for the period she is working in the country.

The provisions of section 7(4)(a) of the proposed new Income Tax Act should be considered when determining if Scottie was physically present in Zimbabwe. In terms of section 7(4)(a), an individual will be deemed to be absent if he or she enters Zimbabwe to perform services as an employee in the country. Scottie is entering the country to perform a service as an independent consultant for a specified period of time. The fact that she is an independent consultant disqualifies her from being deemed to be absent in terms of section 7(4)(a). This implies that Scottie is physically present in Zimbabwe for the purpose of section 7(1).

It can be concluded that Scottie is a resident individual in Zimbabwe because she has a normal place of abode in Zimbabwe and is physically present in the country. Section 8(a) of the proposed Income Tax Act requires a resident:

- not to be a citizen of Zimbabwe; or
- not to have domicile in Zimbabwe; or
- not to hold a permit that allows the individual to stay in the country indefinitely.

Sun Life Financial (2009) states that the citizenship status is given to certain individuals and is not changed by emigrating to another country. This implies that holding a Temporary Resident's Permit does not make an individual a citizen of that country. The residency only provides her with the right to legally work as a consultant in Zimbabwe for the time-frame stipulated on her Permit whilst using a foreign-passport. To this effect, Scottie will only become a citizen if she applies for the citizenship status and it is approved. It is evident that Scottie being a resident of Zimbabwe for income tax purposes does not mean that she has renounced her home country citizenship. Therefore, Scottie relocating to Zimbabwe for a specified period of time and being classified as a resident taxpayer in the country will not make her a Zimbabwean citizen during her stay in the country.

Sun Life Financial (2009) recognises that the place of an individual's domicile is the place to which he or she returns after fulfilling the purpose for his or her absence in that country. Scottie has not acted in a manner that indicates that she intends to stay in Zimbabwe after her contract expires. This implies that Zimbabwe is not the place of her domicile. Scottie does not hold a Permanent Resident's Permit that allows her to stay in Zimbabwe indefinitely. She will only be allowed to stay in the country for the time stipulated in her Temporary Resident's Permit. It is clear from the facts that Scottie satisfies the requirements of section 8(a) of the proposed new Income Tax Act before and after the extension of her contract.

According to section 8(b) of the proposed new Income Tax Act, an individual should not have the intention of residing in Zimbabwe for more than four years. During the first two years, there are no actions that indicate Scottie's intention to stay in the country for more than four years. However, the renewal of the contract and the Temporary Resident's Permit for an additional three years during the third year of her stay in the country indicates that Scottie intends to reside in Zimbabwe for more than four years. During the subsequent years of assessment, the renewed Temporary Resident's Permit will indicate that Scottie intends to stay in the country for more than four years. It is clear that Scottie satisfies the second requirement of temporarily resident taxpayers in Zimbabwe for the first two years she is present in the country.

In terms of section 8(c) of the proposed new Income Tax Act, an individual should not be present in Zimbabwe for more than four years. Scottie will be present in Zimbabwe for more than four years during the second year following the renewal of her permit. This implies that

she satisfies the section 8(c) requirement during her entire first term in Zimbabwe and for the first year after renewal.

The provisions of section 8 of the proposed new Income Tax Act will not be applicable to Scottie during the years she fails to satisfy one of the three requirements for an individual to be regarded as a temporarily resident individual in Zimbabwe. Scottie satisfies all the requirements of section 8 in the first two years of her contract. Consequently, she will be regarded as a temporarily resident individual in Zimbabwe during the first two years of her stay in Zimbabwe. Thereafter, she will be regarded as a resident taxpayer under the provisions of section 7(1) as a result of the renewal of her contract (section 8(b)).

Section 15 and 16 of the proposed new Income Tax Act indicate that income earned from sources within Zimbabwe by resident taxpayers and temporarily resident individuals will be subject to income tax in the country. The Southern African Development Community (2014) explains that the source of income is the place from which the amount originates. The originating cause of the consulting fee will be the use of Scottie's consulting skills, which will be applied in Zimbabwe. Consequently, Scottie's consulting fee will be an amount received from a source within Zimbabwe. In accordance with the provisions of section 15 and 16 of the proposed Income Tax Act, Scottie's fee for all the six years will be subject to tax in Zimbabwe.

Section 16 of the proposed new Income Tax Act indicates that income earned by a temporarily resident taxpayer from foreign sources will only be subject to tax in Zimbabwe if it is compulsory to remit the amount to Zimbabwe in terms of any enactment which relates to exchange control. Consequently, the foreign source income earned by Scottie during the first two years will be subject to tax if it should be remitted to Zimbabwe. However, the foreign income which need not be remitted to Zimbabwe will not be taxable in Zimbabwe for the first two years.

Section 15 of the proposed new Income Tax Act requires all the foreign income earned by a resident taxpayer to be subject to income tax in Zimbabwe. This implies that all the foreign income earned by Scottie from the third year onwards will be subject to income tax in Zimbabwe, regardless of whether or not it should be remitted to Zimbabwe. The difference between the taxability of amounts earned by resident individuals and temporarily resident individuals is that income earned by a temporarily resident individual from a foreign source

will only be subject to Zimbabwean tax if it has to be remitted to Zimbabwe, whereas all foreign income earned by a resident individual will be subject to tax in Zimbabwe.

The table below summarizes how the amounts earned by Scottie will be taxed during her stay in Zimbabwe.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Consulting fee	120 000	120 000	120 000	125 000	125 000	125 000
Foreign income which must be remitted to Zimbabwe	7 000	5 000	6 000	5 500	6 400	5 300
Foreign income which need not be remitted to Zimbabwe	-	-	2 500	3 000	1 000	3 500

It is clear from the table above that the change from being classified as a temporarily resident taxpayer to a resident individual will only affect the taxability of amounts earned by Scottie from a source outside Zimbabwe because all foreign-sourced income earned from the third year onwards will be subject to tax in Zimbabwe, regardless of whether or not the foreign income should be remitted to the country for any enactment related to exchange control.

### **2.4.3 Example for companies**

Rory Limited is a multinational company whose headquarters is situated in the United States of America. The company has a branch that operates in Zimbabwe.

During the year of assessment, the branch in Zimbabwe made a profit of USD1 000 000.

The headquarter company has allocated expenses amounting to USD 30 000 to the operations of the branch in Zimbabwe. Rory Limited requires all branches not operating in the United States of America to pay the headquarter company an amount equal to the expenditure allocated to it.

This example aims to illustrate the tax consequences that will arise for a branch of a foreign-based company operating in Zimbabwe when the residence-based income tax system is applied in the country.

Under the current tax legislation, paragraph 2 of the Eighteenth Schedule requires a non-resident to pay tax on remittances it effects in respect of expenses allocated to it within 15 days or an extension of that period granted by the Commissioner for a good cause. This means that the branch company of Rory Limited operating in Zimbabwe has to pay tax on the USD30 000 it remits to the headquarters for expenses allocated to it. The Southern African Development Community (2014) indicates that the rate currently applied to amounts remitted to the headquarters for expenses allocated to a branch operating in Zimbabwe is 20 per cent. Consequently, the Rory Limited branch operating in Zimbabwe has to pay tax of USD6 000 on the amount it remits to the headquarters.

Section 9(2) of the proposed new Income Tax Act requires the branch of a foreign company operating in Zimbabwe to be treated as a separate resident taxpayer in Zimbabwe if it qualifies as a resident in terms of section 9(1)(a), (b) or (c). Section 9(1)(a) of the proposed Income Tax Act states that a company will be regarded as a resident taxpayer in Zimbabwe if it is incorporated or registered in terms of the Companies Act in Zimbabwe or if it is required to do so. Rory Limited is a company formed in the United States of America. The fact that Rory Limited has a branch operating in Zimbabwe does not mean that the company is incorporated in Zimbabwe. Consequently, the branch of Rory Limited operating in Zimbabwe will not be regarded as a resident taxpayer in Zimbabwe in terms of section 9(1)(a). However, this can change if the branch operating in Zimbabwe satisfies the requirements of section 9(1)(b) or (c).

A company will be a resident taxpayer in Zimbabwe in terms of section 9(1)(b) of the proposed Income Tax Act if the place of management and control is in Zimbabwe. However, the proposed Income Tax Act does not provide an explanation of how the place of effective management or control will be determined when the residence-based tax system is implemented. In South Africa, in terms of one of the tests used to determine the place of effective management, a company is effectively managed in the country where it performs its income generating activities. The branch of Rory Limited operating in Zimbabwe is producing income by providing financial services to customers in Zimbabwe. In other words, the branch carries on its business activities in the country. Therefore, if the South African

principles are applied to determine the place of effective management, the place of effective management for the branch operating in Zimbabwe will be in Zimbabwe. Consequently, the branch operating in the country will be regarded as a resident taxpayer in Zimbabwe, regardless of where control is exercised.

In terms of section 9(1)(c) of the proposed new Income Tax Act, a branch of a foreign based company operating in Zimbabwe will be regarded as a resident taxpayer in the country if it performs the majority of its operations in Zimbabwe. The branch of Rory Limited operating in Zimbabwe generates all its income from activities carried out in Zimbabwe. This indicates that the branch company of Rory Limited operating in Zimbabwe carries out all of its operations in Zimbabwe. Thus, in accordance with section 9(1)(c) of the proposed Act, the branch company of Rory Limited operating in Zimbabwe will be regarded as a resident taxpayer in Zimbabwe.

The provisions of section 9(1)(b) and (c) of the proposed new Income Tax Act indicate that a branch of a foreign company operating in Zimbabwe may be regarded as a separate person when determining its place of residence for income tax purposes in Zimbabwe.

The example illustrates that the even though the branch of Rory Limited operating in Zimbabwe is not incorporated or registered in the country and is not required to do so by the law, the branch will be regarded as a resident taxpayer in the country because it performs all of its operations in Zimbabwe and is effectively managed in the country.

The Explanatory Memorandum for the Income Tax Bill (2012) states that resident taxpayers will be taxed on income from all sources when the residence-based tax system is applied in Zimbabwe. Therefore, it is clear that treating the branch in Zimbabwe as an entity separate from its headquarters will result in the income earned by the branch from all sources being subject to tax in Zimbabwe.

Section 31(1)(a) of the proposed Act reduces the tax liability of a person by providing for the deduction of expenditure incurred in the production of income. The expenditure allocated to the operations of the branch operating in Zimbabwe will be deductible in terms of section 31(1)(a) because it enables the branch to earn income.

The table below shows the effect of treating Rory Limited (Zimbabwe) as a separate person:

	<u>Current</u>	<u>Proposed</u>	<u>Effect</u>
Tax Payable	6 000 <sup>1</sup>	242 500 <sup>2</sup>	236 500

1.  $20\% \times 30\,000$
2.  $25\% \times (1\,000\,000 - 30\,000)$

The fact that the Rory Limited branch operating in Zimbabwe will be classified as a resident taxpayer in Zimbabwe in terms of the proposed new Income Tax Act means that the branch will no longer be liable for tax withheld at a rate of 20 per cent on the expenses allocated to it by the headquarter company, but for income tax at a rate of 25 per cent on the difference between income earned and deductible expenditure. The classification will also result in the branch of Rory Limited operating in Zimbabwe being liable to tax on an annual basis instead of within fifteen days of remitting the USD30 000 to the United States of America.

## **2.5 CONCLUSION**

This research aimed to analyse the changes that will be made to the existing tax legislation as a result of implementing the proposed new Income Tax Act. This chapter achieved this goal by analysing the changes that will occur as a result of changing the income tax system from a source-based tax system to a residence-based tax system and presented examples to illustrate the effect of the changes.

The “gross income” definition set out in section 8(1) of the current Income Tax Act only includes amounts earned by the taxpayer from a source within or deemed to be within Zimbabwe. This means that under the existing tax legislation, income earned by a taxpayer from a source not within the borders of Zimbabwe is not subject to income tax in the country, unless the source is deemed to be from within Zimbabwe for tax purposes. Consequently, the taxability of an amount depends on the source of the income. The originating cause of an amount is one factor that determines the taxability of an amount and the same method is used to determine the taxability of an amount earned by both resident and non-resident taxpayers under the existing legislation. The residence of a taxpayer does not play a role when

determining the “gross income” of a taxpayer. However, this will not be the case when the proposed new Income Tax Act is implemented in the country.

The Explanatory Memorandum for the Income Tax Bill (2012) indicates that the Income Tax Bill will change the income tax system from a source-based tax system to a residence-based tax system. Section 2 of the proposed new Income Tax Act states that the income earned by a resident taxpayer from all sources will be included in the “gross income” of a taxpayer, separated into the various classes of income. The use of the term “all” in the proposed “gross income” definition indicates that the source of income will not affect the method used to determine the “gross income” of a resident taxpayer. According to section 15 of the proposed new Income Tax Act, the taxable income of a resident taxpayer will be the income earned from all sources minus the deductions allowed by the proposed Income Tax Act, unless the taxpayer is an insurance company, holder of a special mining lease or petroleum operator.

The residence of an individual will be determined by applying the provisions set out in section 7 of the proposed new Income Tax Act and the rules that will determine the residence of a company are set out in section 9 of the proposed new Income Tax Act. Section 16 of the proposed new Income Tax Act provides that the taxable income of a taxpayer who is a temporary resident will be the sum of income earned from a source within Zimbabwe and income which is earned from a source outside Zimbabwe and which must be remitted to Zimbabwe in respect of any enactment that relates to exchange control, less any deductions allowed by the proposed new Income Tax Act. This indicates that not all income earned from a source outside Zimbabwe will be included in the “gross income” of an individual temporarily resident in Zimbabwe. An individual will be regarded as a temporary resident taxpayer if he or she meets all the requirements listed in section 8 of the proposed new Income Tax Act.

A taxpayer who fails to meet the requirements of sections 7 to 11 of the proposed new Income Tax Act will be a non-resident taxpayer in Zimbabwe. In terms of section 17 of the proposed new Income Tax Act, the taxable income of a non-resident will be determined by applying the provisions contained in Part III of Chapter VII. These provisions indicate that non-residents will not be affected by the change in the basis of taxation as they will continue to be taxed on income earned from a source within or deemed to be within Zimbabwe. According to section 90 of the proposed new Income Tax Act, a non-resident taxpayer will be entitled to a tax credit for an amount subject to tax in another country in situations where a

Double Tax Agreement exists between Zimbabwe and the other country. Section 91 of the proposed new Income Tax Act provides relief for non-residents in cases where a Double Tax Agreement does not exist between Zimbabwe and the other country, provided the taxpayer proves to the Commissioner that tax is due or was paid in another country for an amount subject to Zimbabwean Tax.

The first part of the first example in the chapter illustrated that the fact that the taxpayer owns a residential property in Zimbabwe does not imply that the taxpayer has a normal place of abode in the country. The first section of the first example concluded that the taxpayer was not a resident taxpayer of Zimbabwe because he failed to satisfy one of the requirements set out in section 7(1) of the proposed Act. Consequently, the amounts he earned were subject to tax in terms of section 17 of the proposed Act. Only the rental income and the share of profits were subject to tax in Zimbabwe because these amounts were earned from a source within Zimbabwe. The salary was not taxable in Zimbabwe because it was earned in terms of his employment in South Africa. The second part of the example indicated that a resident taxpayer will be taxed on all amounts earned, regardless of the source. Changing from a source-based to a residence-based tax system will not affect the taxability of amounts earned by the taxpayer from a source within Zimbabwe.

In the second example the individual was taxed as a temporarily resident taxpayer during the years she satisfied all the requirements of section 8 of the proposed Act. She was not treated as a taxpayer who is temporarily resident in Zimbabwe during the years she failed to comply with one of the requirements in section 8 of the proposed Act and during these years she was treated as a resident taxpayer in Zimbabwe as she satisfied the requirements of section 7(1) of the Act. The change in classification resulted in the foreign income which did not need to be remitted to Zimbabwe in terms of the Exchange Control Act becoming taxable.

The third example illustrated that a branch of a foreign based company operating in Zimbabwe will be regarded as a resident taxpayer if it fulfils the requirements of section 9 when the tax legislation applied in Zimbabwe is changed and will be taxed on amounts earned from all sources, instead of the current practice of being liable for tax at a rate of 20 per cent on amounts remitted to its headquarter company in respect of expenditure allocated to it.

The difference in methods used to determine the taxability of amounts earned by resident taxpayers, temporarily resident taxpayers and non-resident taxpayers indicates that, in terms

of the proposed tax law, the taxability of an amount will depend on the residence of the taxpayer instead of the source of income.

According to section 8(1) of the current Zimbabwean Income Tax Act, amounts earned by a taxpayer from foreign sources and income that is of a capital nature are excluded from the “gross income” of a taxpayer, unless the capital amount is specifically included in the “gross income” definition. Section 2 of the proposed new Income Tax Act will change the “gross income” definition by including the income earned by resident taxpayers from all sources, separating it into employment income, business income, property income or other specified income. The proposed “gross income” definition establishes two main principles. The first principle includes all amounts earned in the “gross income” of a taxpayer, which was discussed in this chapter. The second principle established by the revised “gross income” definition is that income earned by a taxpayer will be classified into employment income, business income, property income or other specified income, as opposed to excluding capital amounts earned by the taxpayer from his or her gross income. This change will be analysed in the next chapter.

## **CHAPTER THREE:**

### **The various classes of income in the Income Tax Bill**

#### **3.1 INTRODUCTION**

The first goal of this research is to analyse the changes that will occur to the tax legislation currently applied in Zimbabwe as a result of implementing the Income Tax Bill (2012). The “gross income” definition set out in Clause 2 of the Income Tax Bill (2012) provides that the income earned by a taxpayer will be separated into employment income, business income, property income and other specified income. This chapter will provide a description of what constitutes an amount to be included in each class of income, thus satisfying part of the first goal of the research.

The second goal of this research is to explain the tax consequences that will arise for the taxpayer as a result of changing the tax legislation applied in Zimbabwe. This chapter will provide examples that will illustrate the effect of the proposed new Income Tax Act, providing a clearer distinction between the various classes of income a taxpayer can earn.

#### **3.2 DESCRIPTION OF THE VARIOUS CLASSES OF INCOME**

The Explanatory Memorandum for the Income Tax Bill (2012) states that the proposed new Income Tax Act will provide a clearer distinction between the various classes of income, these being employment income, business income, property income and other specified income. In general, the classification of income into different categories will not affect the taxability of amounts that are of a revenue nature, but will have a significant impact on the taxability of amounts that are of a capital nature.

The “gross income” definition set out in section 8(1) of the current Income Tax Act excludes amounts that are of a capital nature, unless the amount is specifically included in terms of the sub-paragraphs of section 8(1). The exclusion of capital amounts from the “gross income” definition does not mean that these amounts are entirely “tax free” as they may be subject to Capital Gains Tax. Consequently, it is important to determine whether a receipt is of a capital nature or a revenue nature. The current Income Tax Act does not distinguish between receipts

that are of a capital nature and those that are of a revenue nature and both classes of income are included in gross income.

In terms of section 2 of the proposed new Income Tax Act, income earned by a taxpayer has to be separated into employment income, business income, property income and other specified income, thus satisfying the requirements of a specific income classification. The proposed Income Tax Act appears to follow a more objective approach. This obviates the problem of determining whether an amount earned by the taxpayer is of a revenue nature or a capital nature.

The Capital Gains Tax Act (Chapter 23:01), applies to the disposal or deemed disposal of immovable property or marketable securities within Zimbabwe, unless exempted by the Capital Gains Tax Act. This implies that certain capital amounts that are not included in the “gross income” of a taxpayer in terms of the provisions of section 8(1) of the current Income Tax Act may be subject to Capital Gains Tax. The various classes of income provided for in the proposed new Income Tax Act will include income that is of a capital nature in the “gross income” of a taxpayer and subject it to income tax when the tax legislation is changed. The provisions contained in the Capital Gains Tax Act will become obsolete. The inclusion of amounts that are of a capital nature in the “gross income” of a taxpayer will result in individuals who earn taxable income in excess of the tax-free threshold and companies paying more tax in respect of capital amounts.

The provisions which relate to the classification of income are set out in clauses 22 to 26 of the Income Tax Bill (2012). The Explanatory Memorandum for the Income Tax Bill (2012) explains that clauses 22 to 26 will have a significant impact on the method used to determine the taxable income of a person. This is because certain amounts that are currently not subject to income tax will be included in the “gross income” of a taxpayer by the provisions stipulated in clauses 22 to 26 of the Income Tax Bill (2012).

### **3.2.1 Employment income**

Section 23(1) of the proposed new Income Tax Act states that employment income consists of all the income earned by an individual from past, present or future employment as an employee, regardless of whether the amount is of a revenue or a capital nature. However, section 27 of the proposed new Income Tax Act states that income specified in the Seventh

Schedule will be exempt from income tax. Paragraph 7 of the Seventh Schedule lists the exemptions which are related to employment income. This means that all amounts received by an employee from his or her employer will be taxed as employment income, provided that the amount is not exempt from income tax in terms of paragraph 7 of the Seventh Schedule.

According to paragraph 7 of the Seventh Schedule, the following amounts provided to an employee by his or her employer will be exempt from tax:

- A loan or credit paid for the education or technical training of an employee, his or her spouse and children;
- medical treatment or the cost of travelling to obtain the medical treatment;
- medical aid contributions;
- entertainment or hospitality allowance not spent for private purposes;
- the value of accommodation if the employee is required to move to a specific location and he or she maintains his or her previous place of residence;
- the difference between the old rental value and the new rental value if the employee is required to change his or her normal place of abode but does not maintain his or her previous place of residence;
- reimbursements for expenditure incurred by the employee on behalf of his or her employer;
- contributions paid to an approved retirement fund, to the extent it does not exceed 30 per cent of the employee's employment income for the year of assessment;
- one-third of severance pay, a gratuity or a similar benefit paid when the employee is retrenched, provided the amount is not a pension payment or cash paid in lieu of leave;
- petty fringe benefits;
- a bonus or performance-related award, to the extent it does not exceed USD400; and
- the value of accommodation and transport provided to employees of hospitals and rural clinics owned, operated or sponsored by a religious body or rural district council.

Section 8(1)(f)(ii) of the current Income Tax Act indicates that the benefit that arises from an employee making use of a motor vehicle provided to him or her by his or her employer for private use should be included in his or her "gross income" at a value which depends on the engine capacity of the vehicle, unless the taxpayer proves that the motor vehicle is not used

for private purposes or the Commissioner considers the cost of the benefit to be greater. This implies that the value related to a motor vehicle provided to an employee by his or her employer will not be included in his or her “gross income” if the motor vehicle is exclusively used for business purposes.

In terms of section 23(1) of the proposed new Income Tax Act, the free use of a motor vehicle will be classified as employment income. Section 23(1)(j)(ii) of the proposed new Income Tax Act provides that the taxable value of a motor vehicle of the employer that is used wholly or partly by an employee for private purposes will be determined by applying the provisions of paragraph 2 of the Fourth Schedule. Paragraph 2 of the Fourth Schedule states that the taxable value of the free use of a motor vehicle granted to an employee by his or her employer will be determined by applying the formula  $(C+R) \times P$ , where “C” is 20 per cent of the cost to the employer, “R” is the running costs of the vehicle during the year and “P” is the percentage used by the employee for private purposes.

In terms of paragraph 2 of the Fourth Schedule, it is assumed that a motor vehicle used by an employee is exclusively used for private purposes, unless the employee satisfies the Commissioner that more than 75 per cent of the total use is for business purposes. This paragraph also states that business use does not include the travel between the employee’s place of residence and work. This means that “P” will be deemed to be 100 per cent if the employee fails to prove to the Commissioner that less than 25 per cent of the use of the vehicle was for private purposes. It is evident that paragraph 2 of the Fourth Schedule places the onus of proving that the motor vehicle is mainly used for business purposes on the taxpayer. This makes it crucial for the taxpayer to keep accurate records that indicate how the vehicle was used during the period under assessment. Failure to maintain records will result in the taxpayer paying more tax for the free use of a motor vehicle provided by the employer as there will be no evidence that more than 75 per cent of the total use of the motor vehicle was for business purposes. The effect of the formula on the taxable value of the motor vehicle used by an employee on his or her tax position will therefore depend on the percentage used for private purposes.

### **3.2.2 Business income**

In terms of section 24 of the proposed new Income Tax Act, business income is an amount of a revenue nature or a capital nature, which accrues to a person from business profits or gains. Section 76(1) of the proposed new Income Tax Act indicates that the partners of a partnership will be taxed in their own right on their respective share of the partnership income. A partner's share of profits from a partnership is a gain resulting from a business relationship. Consequently, the share of profit earned by a partner will be included in his or her "gross income" as business income.

Section 22 of the proposed new Income Tax Act indicates that the net gains on the disposal of business property will be included in the taxpayer's income as business income. Section 67 of the proposed new Income Tax Act explains that the gain that will arise from the disposal of business or investment property will be the difference between the proceeds received and the cost base of the asset disposed of. The gain on the disposal of these properties, which is currently not taxable, will become subject to income tax when the proposed new Income Tax Act is implemented.

The Explanatory Memorandum for the Income Tax Bill (2012) explains that under the current tax legislation, only immovable property and marketable securities are subject to Capital Gains Tax and that any gain obtained from the disposal of business property that exceeds the recoupment of allowances previously deducted is not subject to income tax. The future inclusion of net gains obtained from the disposal of business property in the business income of a taxpayer will increase the taxable income of a taxpayer when the Income Tax Bill (2012) is implemented.

### **3.2.3 Property income**

According to section 25 of the proposed new Income Tax Act, the property income of a person consists of income earned from investment property, the use of property and amounts deemed to be property income by the Fifth Schedule, unless the amount is also classified as employment income or business income under the proposed new Income Tax Act. In certain instances, an amount earned by a taxpayer can be classified as property income, employment income or business income. Section 24(d) of the proposed new Income Tax Act states that the business income of a taxpayer includes rent received from the letting of property and section

25 provides that rental income is categorised as property income. Section 25 of the proposed new Income Tax Act makes it clear that the classification as business income or employment income takes precedence over property income when an overlap exists. It can be argued that all rental income received from the letting of property is regarded as property income, but not all rental income received by a taxpayer can be classified as business income. This is because income received from the letting of property held for investment purposes but not in the course of carrying out a business will not be classified as business income.

The similarities which exist between certain provisions of sections 24 and 25 of the proposed new Income Tax Act may provide some difficulties when determining whether to classify income earned as property income or business income. Therefore, in certain instances, it could be helpful to use the dictionary definitions of a “business” and an “investment” as a guideline to distinguish between income earned from business activities and the income earned from investments. According to the Merriam-Webster dictionary (2014), a business is an entity formed with the aim of making a profit by selling goods and services, whereas investments are funds injected into an entity with the expectation of favourable returns over a period of time. Thus business income is earned actively whilst investment income is earned passively.

The “gross income” definition in section 8(1) of the current Income Tax Act includes amounts earned from a source deemed to be from within Zimbabwe. Section 12(2) of the current Income Tax Act provides that the interest and dividends earned by a resident taxpayer in Zimbabwe from a source outside Zimbabwe are deemed to be obtained from a source within Zimbabwe. The Southern African Development Community (2014) explains that these amounts are generally taxed at a flat rate of 20 per cent. However, under section 25 of the proposed new Income Tax Act, income earned from investments will be classified under property income. This means that foreign dividends and interest earned by resident taxpayers will be subject to income tax. Interest and dividends will continue to be taxable, but not at a flat rate of 20 per cent. The effect of this change in the tax position of the taxpayer will depend on whether the taxpayer is a company or an individual and the income tax bracket the individual falls within. The Southern African Development Community (2014) explains that companies are taxed at a rate of 25 per cent in Zimbabwe. The tax liability of companies and individuals who earn an amount above the tax threshold will be greater on investment income earned from a foreign source. The tax position of individuals who fall within the 20 per cent

tax bracket will not be affected by the change making income earned from investments subject to income tax.

### **3.2.4 Other specified income or gains**

In terms of section 26 of the proposed new Income Tax Act, the category of other income or gains will include amounts or gains received by a taxpayer as a result of improvements effected to land and buildings by the lessee, treasure troves, awards, prizes, other similar amounts and proceeds received from criminal or unlawful activities. The Explanatory Memorandum for the Income Tax Bill (2012) notes that the most important change that will arise from clause 26 of the Income Tax Bill (2012) is the clause specifically stating that proceeds received by a taxpayer from crime or other illegal activities will be subject to income tax. Amounts that are obtained from fraudulent activities, theft, prostitution, drug trafficking and other unlawful activities will now be taxable.

The current Income Tax Act does not address the issue of how proceeds obtained illegally should be taxed. Consequently, case law is used as a guideline on how amounts earned from crime or other unlawful activities should be treated for the purpose of income tax. When the proposed new Income Tax Act is implemented in Zimbabwe, there will be no need to determine the legality of proceeds obtained by the taxpayer.

## **3.3 ILLUSTRATIVE EXAMPLES**

The second goal of this research is to explain the tax consequences that will arise as a result of implementing the proposed new Income Tax Act. This section will address this goal by providing examples that explain the effects of classifying income into different categories when the proposed new Income Tax Act becomes the law.

### **3.3.1 Example for individuals**

Jewel and Geoff Kay are a married couple who reside in Zimbabwe.

During the year of assessment, Jewel received the following amounts in United States Dollars (USD):

Salary	24 000
Independent consultancy services rendered	10 000
Cash award as employee of the month	6 000

Jewel had the use of a motor vehicle belonging to her employer. The motor vehicle had an engine capacity of 2800 cubic centimetres and 20 per cent of the total use of the car was for private purposes. Jewel keeps accurate records that show how the motor vehicle was used during the year. The motor vehicle cost the employer USD25 000 and the costs of running the motor vehicle during the year amounted to USD5 000. The costs of running the motor vehicle were incurred by her employer.

During the year of assessment, Geoff received the following amounts in USD:

Salary	25 000
Cash prize won from a Spar competition	5 000
Rental income	13 200

Geoff has the right to use a motor vehicle provided by his employer. The motor vehicle has an engine capacity of 3800 cubic centimetres and 20 per cent of the total use of the motor vehicle was used for private purposes. However, Geoff did not keep an accurate record that indicates how he used the motor vehicle during the year of assessment. The motor vehicle cost his employer USD45 000 and the annual running costs paid by the employer in respect of the motor vehicle amounted to USD6 000.

The example will discuss the taxability of the amounts received by Jewel and Geoff Kay under the current and proposed tax legislation and will discuss the tax consequences of Geoff not maintaining accurate records that indicate how he used the motor vehicle provided by his employer.

Section 8(1)(b) of the current Income Tax Act includes any amount earned by the taxpayer as a result of services rendered in gross income, regardless of whether or not the services are rendered under a contract of employment or service. The salary of USD24 000, the amount of USD10 000 from independent consulting services and the cash award of USD6 000 are amounts earned by Jewel from rendering services. Consequently, these amounts will be

subject to income tax under the provisions of section 8(1)(b) of the current Income Tax Act. The salary of USD25 000 earned by Geoff will be treated in the same manner as that earned by Jewel. Hence, Geoff's salary will also be subject to income tax under the provisions of section 8(1)(b).

Section 23(1) of the proposed new Income Tax Act stipulates that an amount earned from past, present or future employment will be classified as employment income when the proposed new Income Tax Act is implemented and will be subject to income tax. Section 23(1)(a) of the proposed new Income Tax Act specifically includes a salary in the employment income of a taxpayer. Consequently, the salaries of USD24 000 and USD25 000 earned by Jewel and Geoff respectively, will be regarded as employment income.

In terms of section 23(1)(b) of the proposed new Income Tax Act, any gift received by an employee in the course of present employment will be regarded as employment income. The cash award of USD6 000 is received by Jewel in the course of present employment and will be classified as employment income.

The amount of USD10 000 earned by Jewel from carrying out independent consultancy work will not be regarded as employment income as it is not received by her in terms of employment. Section 24(1) of the proposed new Income Tax Act states that profits or gains which result from a business shall be regarded as business income. Section 2 of the proposed new Income Tax Act indicates that a business includes a trade, profession or occupation, provided it is not employment. The independent consultancy services provided by Jewel will be regarded as a business the USD10 000 she earned will be subject to income tax. The proposed classification of amounts into various classes in terms of the proposed Income Tax Act will not affect how amounts received by Jewel and Geoff in respect of services rendered are taxed.

In terms of section 8(1) of the current Income Tax Act, amounts that are of a capital nature are not included in the "gross income" of a taxpayer. Stiglingh *et al* (2013) explain that isolated lottery wins are amounts of a capital nature (in terms of South African case law). The cash prize won by Geoff is an isolated gain and it appears that it would be an amount of a capital nature. Consequently, the cash prize is an amount not subject to income tax under the present Income Tax Act.

Section 26(c) of the proposed new Income Tax Act includes awards, prizes and other similar amounts in the income of a taxpayer. Under the proposed tax law, the cash prize of USD5 000 won by Geoff will be subject to income tax and will no longer be tax-free when the proposed new Income Tax Act is implemented in Zimbabwe.

Section 8(1) of the current Income Tax Act only includes amounts that are of an income nature in the “gross income” of a taxpayer. The rental income earned by a taxpayer is an amount received as a result of letting another person use his or her asset and not from the disposal of the asset. This implies that the rental income of USD13 200 received by Geoff will be included in his “gross income” under the provisions of the current Income Tax Act.

Section 25(a) of the proposed new Income Tax Act provides that income earned by a taxpayer from investment property such as rent will be regarded as property income. The rental income earned by Geoff will be subject to income tax as property income. Therefore, the classification of income will not affect the taxability of the rental income earned by Geoff.

Section 8(1)(f) of the current Income Tax Act indicates that an amount equal to the value of a benefit obtained by an employee in respect of employment is included in the “gross income” of a taxpayer. The use of the motor vehicles granted to Jewel and Geoff are as a result of their employment. Consequently, the value of the motor vehicle benefit will be included in their “gross income”. According to section 8(1)(f) of the current Income Tax Act, the taxable value of a motor vehicle provided to an employee by his or her employer will be the deemed benefit, which depends on the engine capacity of the motor vehicle.

The engine capacity for the motor vehicle received by Jewel is 2800 cubic centimetres. BDO Zimbabwe (2013) indicates that the deemed motor vehicle benefit for a motor vehicle with an engine capacity that falls between 2001 cubic centimetres and 3000 cubic centimetres is USD300 per month. Under the existing tax legislation, the taxable value of the motor vehicle benefit received by Jewel from her employer will be USD3 600.

According to BDO Zimbabwe (2013), the deemed motor vehicle benefit for motor vehicles with an engine capacity that exceeds 3000 cubic centimetres is USD400 per month. The engine capacity of the motor vehicle given to Geoff by his employer is 3800 cubic centimetres and therefore, in terms of the current tax legislation, the taxable value of the benefit received by Geoff is USD4 800.

Section 23 of the proposed new Income Tax Act states that amounts earned by a taxpayer as an employee from past, present or future employment will be regarded as employment income. The motor vehicle benefits received by Jewel and Geoff from their respective employers are amounts earned as a result of present employment. Consequently, the motor vehicle benefit received by Jewel and Geoff will be regarded as employment income.

Section 23(1)(j)(ii) of the proposed new Income Tax Act indicates that the tax value of a motor vehicle used by an employee for private purposes will be determined by applying the provisions of paragraph 2 of the Fourth Schedule, which states that the formula that will be used to calculate the taxable value of the motor vehicle benefit received by an employee from his or her employer will be  $(C+R) \times P$ .

“C” represents 20 per cent of the consideration paid by the employer to acquire the motor vehicle. Therefore, “C” for Jewel will be USD5 000 and USD9 000 for Geoff. “R” in the formula represents the annual cost incurred by the employer for running the motor vehicle. Consequently, “R” for Jewel and Geoff will be USD5 000 and USD6 000 respectively. “P” is the percentage use by the employee for private purposes. Paragraph 2 of the Fourth Schedule also explains that the formula is based on the assumption that the motor vehicle used by an employee is used exclusively for private purposes, unless the taxpayer proves to the Commissioner that more than 75 per cent of the total use is for business purposes. The fact that Jewel maintains records which indicate how she used the motor vehicle provided to her by her employer means that she has evidence to substantiate the claim that more than 75 per cent of that total use of the motor vehicle was for business purposes. Consequently, “P” will be applied at a rate of 20 per cent for Jewel.

Geoff, by not keeping an accurate record, will not have the evidence to support the fact that 20 per cent was used for private purposes. Therefore, in accordance with the provisions of paragraph 2 of the Fourth Schedule, the fact that Geoff mainly used the vehicle for business purposes will not be taken into consideration when calculating the taxable value of the motor vehicle benefit and Geoff will be deemed to have exclusively used the motor vehicle for private purposes. Consequently, “P” will be deemed to be 100 per cent. As a result of the onus of proof being placed on the taxpayer, Geoff will pay more tax in relation to the motor vehicle benefit he received from his employer.

The tax effects of changing the method used to determine the taxable benefit received by a taxpayer from his or her employer is shown below:

	<u>Current</u>	<u>Proposed</u>	<u>Effect</u>
Motor vehicle benefit received by Jewel	3 600	2 000 <sup>1</sup>	(1 600)
Motor vehicle benefit received by Geoff	4 800	15 000 <sup>2</sup>	10 200

1.  $(5000+5000) \times 20\%$

2.  $(9000+6000) \times 100\%$

The proposed Income Tax Act can result in a taxpayer paying less tax in relation to a motor vehicle benefit if he or she is able to prove that the motor vehicle was mainly used for business purposes. However, failure to provide evidence that proves that the motor vehicle was mainly used for business purposes will significantly increase the taxable value of a motor vehicle benefit received by a taxpayer from his or her employer.

The tax effect of Geoff not maintaining accurate records in relation to the use of the motor vehicle provided to him by his employer is shown below:

	<u>Keeps records</u>	<u>No records kept</u>	<u>Effect</u>
Tax value of motor vehicle benefit	3 000 <sup>3</sup>	15 000	(12 000)

3.  $20\% \times 15\ 000$

It is therefore imperative for the taxpayer to maintain accurate records that indicate how the motor vehicle was used during the year of assessment when the proposed new Income Tax Act is implemented in Zimbabwe.

### **3.3.2 Example illustrating proceeds obtained from illegal activities**

Delilah is an accountant at SAMSO Limited. During the year, she misappropriated company funds and stole an amount of USD 45 000 for her personal use and tried to leave the country. However, she was caught by the police at the Beit Bridge Border.

The current Income Tax Act does not specifically state how proceeds earned by a taxpayer from crime or other unlawful activities should be taxed. The present position taken in Zimbabwe in relation to the taxability of amounts stolen and therefore earned by a taxpayer

from criminal or unlawful activities is based on the decision in *COT v G*, 1981 (4) SA 167 (ZA), 43 SATC 159, where an amount earned by the taxpayer from theft was not included in his “gross income”. However, the position relating to proceeds obtained from illegal activities other than the theft of money is uncertain under the present legislation. Gono (2013) indicates that, in general, proceeds received from criminal or other unlawful activities are not subject to tax. This implies that in most instances, amounts that are obtained from illegal or unlawful activities are entirely tax free. Consequently, the USD 45 000 stolen by Delilah will probably not be included in her “gross income”.

According to section 26(d) of the proposed new Income Tax Act, proceeds obtained from crime or other unlawful activities will be subject to income tax. This implies that the legality of the method used by the taxpayer to obtain an amount will be immaterial when the proposed new Income Tax Act is implemented. Consequently, the USD45 000 stolen by Delilah will be subject to income tax when the proposed new Income Tax Act becomes the law.

### **3.3.3 Example illustrating capital gains obtained from the sale of a business**

Rhett is a sole trader who runs a business of delivering water to his customers. During the year, Rhett decided to sell a water truck for USD150 000. The water truck was purchased at a cost of USD125 000 and had an income tax value of USD100 000. Rhett also sold his office building for USD100 000. The office building was acquired at a cost of USD60 000.

Section 67 of the proposed Act states that the gain obtained from the disposal of business assets is the difference between the proceeds obtained by the taxpayer and the cost of acquiring the asset. Therefore, the gain obtained by Rhett from the disposal of the water truck and the office building is USD25 000 and USD40 000, respectively.

In terms of section 8(1) of the current Income Tax Act, amounts that are of a capital nature are not included in the “gross income” of a taxpayer. However, not all capital amounts are entirely free from tax because gains obtained from the disposal of immovable property or marketable securities are subject to Capital Gains Tax Act. This implies that gains obtained by the taxpayer from the disposal of moveable property are not subject to Capital Gains Tax. The capital gain made by Rhett from the sale of the water truck is not subject to income tax. The capital gain obtained by Rhett from the sale of the office building will be subject to

Capital Gains Tax as it is immovable property. The Southern African Development Community (2014) indicates that the rate to be applied for the purpose of Capital Gains Tax is 20 per cent. Consequently, USD8 000 (20% of 40 000) of the capital gain obtained from the sale of offices will be subject to tax under the current tax legislation.

Section 24(1) of the proposed Act indicates that amounts, of a revenue or capital nature, obtained by the taxpayer from gains that result from business activity will be regarded as business income. The capital gain obtained by Rhett from the disposal of the water truck and the offices are gains which resulted from the sale of property used in the business of delivering water. Consequently, both the capital gains of USD25 000 and USD40 000 will be taxed as Rhett's business income.

It is clear from the example that, as opposed to the current practice of not taxing all capital gains obtained by the taxpayer from the sale of business property, the proposed Income Tax Act will result in these capital gains being fully taxable. Also, these gains will be taxed at a higher rate of tax under the proposed new Income Tax Act.

### **3.4 CONCLUSION**

The "gross income" definition in section 8(1) of the current Income Tax Act excludes amounts that are of a capital nature, unless the amount is specifically included in the "gross income" of a taxpayer in terms of the Act. This implies that only amounts of a revenue nature are subject to income tax, with a few exceptions. Therefore; it is important to distinguish between amounts that are of a capital nature and amounts that are of a revenue nature. The current Income Tax Act does not provide a means of distinguishing between amounts that are of a revenue nature and those that are of a capital nature. Consequently, case law is used to determine the nature of an amount. Determining whether an amount is of a capital nature or a revenue nature is subjective and can be ambiguous.

The Explanatory Memorandum for the Income Tax Bill (2012) notes that the Income Tax Bill provides a clearer distinction between the different types of income, namely, employment income, business income and property income. This is reflected by the "gross income" definition provided in section 2 of the proposed new Income Tax Act, which states that income should be separated into employment income, business income, property income and other specified income. The amounts to be included in each class of income are set out in

sections 23 to 26 of the proposed new Income Tax Act. The classification of income will result in an amount being subject to income tax under a specific class, regardless of its income or capital nature. This indicates that the proposed tax legislation follows a more objective approach which obviates the need to determine whether an amount received by the taxpayer is of a capital nature or a revenue nature. Consequently, the provisions of the Capital Gains Tax Act will no longer be applicable when the tax legislation applied in Zimbabwe changes.

Gono (2013) explains that Capital Gains Tax is currently only applicable to the disposal of immovable property or marketable securities in Zimbabwe. Capital amounts that are not specifically included in the “gross income” definition set out in section 8(1) of the current Income Tax Act or not related to the disposal of immovable property or marketable securities within Zimbabwe are not subject to any tax.

The application of the provisions of section 24 of the proposed new Income Tax Act results in the net gain obtained from the disposal of all business property being regarded as business income. Consequently, capital amounts that are presently tax-free will become taxable when the proposed new Income Tax Act becomes law in Zimbabwe. The method that will be used to calculate the taxable gains obtained from the disposal of business property is provided for by sections 67 to 73 of the proposed new Income Tax Act. The last example in this chapter indicated that this will increase the taxpayer’s taxable income as the capital gains obtained by Rhett from the disposal of business property became subject to income tax, as opposed to the current tax legislation wholly or partially exempting these amounts from tax.

Paragraph 2 of the Fourth Schedule will change the method used to determine the taxable value of the use of a motor vehicle provided to an employee by his or her employer for private use. The method will change from the application of a deemed amount based on the engine capacity of the motor vehicle to the application of a formula. According to paragraph 2 of the Fourth Schedule, the formula to be used when determining the taxable value of the free use of a motor vehicle will be  $(C+R) \times P$ , where “C” is 20 per cent of the cost of the motor vehicle to the employer, “R” is the annual running costs incurred by the employer in respect of the motor vehicle used by the employee and “P” is the percentage used for private purposes. Paragraph 2 of the Fourth Schedule also provides that the employee will have the onus of proving to the Commissioner that more than 75 per cent of the total use is for business purposes. This means that “P” will be applied at the full rate of 100 per cent if the

employee fails to prove to the Commissioner that over 75 per cent of the use is business related. Therefore, the taxpayer will pay less tax for the use of a motor vehicle provided by the employer if he or she keeps a record that indicates how he or she used the motor vehicle during the year of assessment and the private use is less than 25 per cent. The importance of the taxpayer maintaining records that indicate how the taxpayer used the motor vehicle provided to him or her in terms of employment was shown in the example where Geoff was unnecessarily liable for more tax because he did not have evidence to support the fact that 20 per cent of the total use was for private purposes.

The second example dealt with the taxability of an amount obtained by that taxpayer from misappropriation of company funds. The Explanatory Memorandum for the Income Tax Bill (2012) emphasizes the importance of clause 26 of the Income Tax Bill specifically including the proceeds received from criminal activities or other unlawful activities within the scope of income tax for the first time. This means that income obtained from a unilateral taking such as theft, or fraud or any other illegal activity will become taxable when the Income Tax Bill (2012) is implemented. This will bring certainty to an area of law that is presently uncertain. The Explanatory Memorandum for the Income Tax Bill (2012) states that the Income Tax Bill seeks to provide for a residence-based tax system where the taxable income of a resident taxpayer is determined by reducing the income earned by a taxpayer from all sources with the deductions allowed by the Income Tax Bill (2012). The previous chapter and this chapter focused on the changes related to the income component. In order to understand the full extent of the tax consequences created by the Income Tax Bill (2012), the permissible deductions under the proposed new Income Tax Act should be taken into account. Consequently, the next chapter will analyse the changes relating to permissible deductions.

## **CHAPTER FOUR:**

### **Deductions allowed by the Income Tax Bill**

#### **4.1 INTRODUCTION**

This chapter will further analyse the changes to the existing tax legislation as a result of implementing the proposed new Income Tax Act by providing a discussion of the changes relating to permissible deductions. The chapter will compare the deductions in terms of the current tax legislation and the proposed tax legislation. The proposed tax legislation will restrict permitted deductions to expenditure incurred in the production of income. However, a definition that explains the meaning of the term “in the production of income” is not provided for by either the current or proposed Income Tax Acts. South Africa is one of the countries that restrict deductible expenditure to expenses incurred in the production of income. Consequently, South African tax law will be used as a guideline to determine the meaning of the term “in the production of income”. An example which illustrates the tax effects of the changes relating to permissible deductions will also be included in this chapter to address the second goal of explaining the tax consequences for the taxpayer when the new proposed Income Tax Act is applied in Zimbabwe.

#### **4.2 COMPARISON BETWEEN DEDUCTIONS ALLOWED BY THE CURRENT INCOME TAX ACT AND THE PROPOSED NEW INCOME TAX ACT**

Section 15(1) of the current Income Tax Act states that the taxable income of a person is determined by deducting amounts allowed by the provisions of section 15 from the income of a taxpayer. According to section 15(2)(a) of the current Income Tax Act, an amount will be allowed as a deduction if it is an expenditure or loss incurred by the taxpayer for the purpose of trade or in the production of income, except for expenditures or losses of a capital nature. Section 2 of the current Income Tax Act defines “trade” as any profession, trade, business, activity, calling or occupation that is carried out by the taxpayer to produce the income. Therefore, the deductibility of expenses or losses incurred by the taxpayer will depend on whether or not the expense or loss is related to an amount constituting income of a taxpayer.

The current Income Tax Act does not provide an explanation of what constitutes expenses or losses incurred in the production of income and there is no case law in Zimbabwe that can be used as guidance when determining the meaning of this term. The “trade” definition in section 2 of the current Income Tax Act indicates that a trade is carried out with the objective of producing income. Therefore, all expenses incurred in the production of income can be classified as expenditure incurred for the purposes of trade. Consequently, the fact that expenses incurred for the purposes of trade are deductible makes it unnecessary to understand the meaning of the term “in the production of income”.

Rehman (2014) defines “capital expenditure” as an amount spent to acquire fixed assets, improve fixed assets or increase the earning capacity of the business. The author also explains that capital expenditure represents an asset or a liability in the balance sheet. It is evident that a capital expenditure increases the income-earning structure used by the taxpayer to produce income. The proposed new Income Tax Act will not change the method used to determine the capital allowances that can be claimed by a taxpayer in respect of expenditure which is of a capital nature. Certain provisions embodied in the other paragraphs of section 15(2) provide for allowances that can be claimed by the taxpayer in respect of capital expenditures.

Section 15(2)(c) of the current Income Tax Act permits an allowance to be claimed in respect of commercial buildings, farm improvements, fencing, industrial buildings, railway lines, staff housing, tobacco barns, articles, implements, machinery and utensils owned and used by the taxpayer for trade purposes. Section 15(2)(c)(iii) provides for an allowance for buildings and equipment used for training purposes. It is clear that the intention of section 15(2)(c) is to grant an allowance for assets owned by the taxpayer to generate income.

Section 15(2)(d) of the current Income Tax Act permits an allowance to be claimed in respect of amounts paid by the taxpayer for the *right to use* the following assets for the purposes of trade or in the production of income:

- land or buildings;
- plant or machinery;
- patent, design, trade mark, copyright, model, plan, secret formula and other similar intangible assets; or
- films, sound recordings or advertisements relating to the film or sound recording.

Section 15(2)(d) of the current Income Tax Act therefore provides for an allowance to be claimed by the taxpayer in respect of assets leased by the taxpayer to produce income.

Section 15(2)(e) of the current Income Tax Act provides that an allowance in respect of an amount spent by the taxpayer on effecting improvements on land or buildings used for trade purposes or in the production of income, under an agreement where the right to occupy or use the land or buildings is granted by another person, shall be deducted in arriving at the taxpayer's income. This implies that the lessee can claim an allowance in respect of expenditure incurred to effect improvements on land or buildings if he or she is obligated to do so. Clearly, a taxpayer will not be eligible to claim an allowance in terms of section 15(2)(e) if it is not compulsory to effect the improvements or if the taxpayer owns the land and buildings improved.

Section 31(1)(a) of the proposed new Income Tax Act states that all expenditure and losses incurred in the production of income shall be allowed as a deduction from business income, unless the deduction is disallowed by the proposed Act. The proposed new Income Tax Act will not change the provisions relating to amounts that are not deductible in terms of section 16 of the current Income Tax Act.

Section 45 of the proposed new Income Tax Act prohibits the deduction of personal, domestic or living expenses. This implies that costs incurred by the taxpayer for personal reasons such as the maintenance of himself or herself and his or her family members, travel between his or her place of residence and work will not be eligible for a deduction when the Income Tax Bill is implemented.

In certain instances, an amount may qualify as a deduction under more than one provision of the Act. This presents a risk of double deduction. Section 15(4) of the current Act prohibits the deduction of an amount more than once and provides the taxpayer with an option to elect the provision to apply when claiming a deduction which relates to an expense deductible under several provisions. This is consistent with section 50 of the proposed Act indicating that the amount deductible when an expense qualifies as a deduction under two or more provisions of the Act will be the deduction elected by the taxpayer. In the event that the taxpayer does not elect a provision for deduction purposes, section 50 of the proposed Act will give the Commissioner the right to select the most appropriate deduction based on the nature of the expense.

It is evident that both Acts prohibit the deduction of expenditure more than once. The proposed Act takes it a step further by allowing the Commissioner to exercise his judgement when the taxpayer does not elect the provision to apply when an amount qualifies as a deduction under several provisions of the Act.

Section 46 of the proposed Act disallows the deduction of amounts paid as a bribe, kick-back, or other similar unlawful expenses, fines or penalties imposed on the taxpayer for breaching the law. Section 26(d) of the proposed new Act includes amounts earned by the taxpayer from unlawful activities in the income of a taxpayer and this indicates that amounts derived from an activity that is against public policy will be taxable when the Income Tax Bill is implemented. This change will not result in the deductibility of amounts spent on activities that are against public policy. In other words, expenditure incurred by the taxpayer for unlawful activities or fines and penalties imposed on the taxpayer for not complying with the law will not be deductible when the tax legislation applied in Zimbabwe is changed.

It is evident from section 31(1)(a) that, unlike the current Income Tax Act, the proposed Act does not provide for expenditure or losses incurred for the purpose of trade. This means that expenses incurred for trade purposes, but not incurred in the production of income will no longer be eligible for a deduction. This is explained in the Explanatory Memorandum for the Income Tax Bill (2012) that the Income Tax Bill will restrict allowable deductions to expenditure incurred “in the production of income” unless the deduction promotes public policy objectives. Thus it will be essential to understand the meaning of the term “in the production of income”. The proposed new Income Tax Act does not provide a set of rules to be followed when determining whether or not an expense was incurred in the production of income.

The Explanatory Memorandum for the Income Tax Bill (2012) indicates that the practice of restricting deductible amounts to expenditure incurred in the production of income is applied by other countries in the region. South African case law has established principles used to determine the meaning of the term “in the production of income” and the relevant cases are used to determine the meaning of “in the production of income”.

Williams (1995) indicates that *Port Elizabeth Electric Tramway Limited v CIR*, 1936 CPD 241, 8 SATC 13, where the taxpayer carried on business as a tramway transporter company, is the authoritative case which defines the meaning of the term “in the production of income”. In the *Port Elizabeth Electric Tramway Company Limited v CIR* case, a driver who was

employed by the taxpayer claimed for compensation in terms of the Workmens' Compensation Act because he had suffered from life threatening injuries as a result of an accident which occurred while he was on the job. The taxpayer decided to resist the claim and incurred legal expenses during the process. However, the taxpayer lost the case and was forced to settle the claim. Williams (1995) explains that the issue addressed by the courts in Port Elizabeth Electric Tramway v CIR was whether or not the compensation paid and the legal expenses incurred by the company could be regarded as expenditures incurred in the production of income. Watermeyer AJP, the judge in the Port Elizabeth Electric Tramway v CIR case, posed the questions whether the act that gave rise to the expenditure was performed in the production of income and whether the expense is closely related to the production of income, as a guideline to solve the issue at hand. Stiglingh *et al* (2013) simplify the questions asked by Watermeyer AJP when they explain that an expense is incurred in the production of income when the action that gave rise to it is closely related to the income generating activity. This means that an expense will be incurred in the production of income if it is inherent to the nature of activity carried out by the taxpayer to produce income.

The compensation paid by the taxpayer in Port Elizabeth Electric Tramway v CIR was an amount paid as a result of an accident that occurred whilst the driver was carrying out his employment duties. The activity that generated income for the taxpayer was carrying out its business as a tramway company and in this business the drivers play a crucial role in the production of income. Accidents are an inherent risk that comes with the nature of the occupation carried out by drivers. Consequently, the action that gave rise to the compensation paid to the driver's spouse was closely connected to the income generating activity of the taxpayer.

The legal costs incurred by the tramway company were as a result of resisting a compensation claimed by an employee who was injured in the course of employment. Resisting the claims is an action that was not incurred by the taxpayer to produce income. Consequently, the legal costs incurred were not closely related to the income generating activity carried out by the taxpayer.

In Port Elizabeth Electric Tramway v CIR, Watermeyer AJP decided that the compensation paid by the taxpayer was an expense incurred in the production of income whilst the legal fees incurred to resist the claim were not expenditure incurred in the production of income.

An expense will be incurred in the production of income if it is closely related to the taxpayer's income-earning activity.

Williams (1995) indicates that *Sub-Nigel v CIR*, 1948 (4) SA 580 (A), 15 SATC 381 illustrates that there is no need to prove that the expenditure incurred by a taxpayer relates to income produced during the year of assessment for it to be allowed as a deduction. This is explained by Stiglingh *et al* (2013) when they state that expenditure will be deductible during the year it is incurred in the production of income, even if the income is earned in the future. The fact that expenditure is incurred "in the production of income" is sufficient for it to qualify as a deduction during the year of assessment. Therefore, it is not necessary to determine the income to which an expense relates.

Williams (1995) indicates that in *Provider v COT*, 1950 SR 161, 17 SATC 40, the court held that payments made by a taxpayer to induce employees to enter and remain in service are an expense incurred in the production of income. Williams (1995) also explains that the outcome of *W F Johnstone & Co Ltd v CIR*, 1951 (2) SA 283 (A), 17 SATC 235 was that an amount paid to a former employee on retirement for prior services rendered will not qualify as an expense incurred in the production of income. *Provider v COT* and *W F Johnstone v CIR* have different outcomes, even though both cases relate to amounts paid by the taxpayers as a result of employing individuals in the course of carrying out a business. The deduction of the amount spent in *Provider v COT* was allowed because employees play an active role in the production of income and in their absence, no income will be generated by the business. However, the amount spent on the employee in *W F Johnstone v CIR* was not deductible because former employees do not play a role in the process of producing income for the taxpayer. The main difference between *Provider v COT* and *W F Johnstone v CIR* is that *Provider v COT* dealt with amounts paid to current employees whilst the latter dealt with amounts paid to a former employee. Clearly, these cases indicate that the issue of establishing whether or not an amount spent by a taxpayer on his or her employees is an expense incurred in the production of income will depend on whether the employee is involved in the production of current or future income.

### 4.3 ILLUSTRATIVE EXAMPLE

Bambie Limited is a company that has a factory that manufactures furniture. The company also has two retail outlets that are responsible for selling the furniture produced at the factory.

- The manager paid a fee of USD1 000 to an officer of the Zimbabwe Revenue Authority so as to under-declare the value of raw materials imported from South Africa.
- The company purchased new machinery to be used at the factory for USD50 000.
- The Sales Manager retired due to old-age and was given USD7 000 as a token of appreciation for the twenty years he had worked for the company.

Bambie Limited also incurred the following expenses in United States Dollars (USD):

Audit fee	15 000
Tax consultancy fee to identify areas of tax exposure	10 000
Insurance costs to mitigate losses related to the machinery used	8 000
Bank charges	150
Marketing research	4 500
Employee training costs	6 500

Section 15(2) of the current Income Tax Act provides for the deduction of expenditure incurred for the purposes of trade or in the production of income. This implies that all expenditures incurred in the course of a business are deductible, unless the deduction is prohibited by the Income Tax Act. However, section 31(1)(a) of the proposed new Income Tax Act will restrict the permissible deductions to expenditure incurred in the production of income. It is evident that, contrary to the current Income Tax Act, the proposed new Income Tax Act will not permit the deduction of expenditure incurred for the purpose of trade but not in the production of income. This will affect the deductibility of certain expenses incurred by Bambie Limited. Therefore, it is important to understand the amounts that constitute expenditure incurred for purposes of trade but not in the production of income and those that are incurred in the production of income.

The proposed new Income Tax Act does not provide an explanation of which amounts constitute expenditure incurred in the production of income. In terms of the outcome of Port

Elizabeth Electric Tramway Limited v CIR, an amount spent by Bambie Limited will be incurred in the production of income if it is expended for the purpose of earning income.

The current Income Tax Act does not address the issue of whether or not expenditures that are against public policy are deductible. These expenditures include bribes, interest or fines paid for non-compliance with the law and any other amounts spent on unlawful activities. The position currently taken in respect of amounts spent on unlawful activities is not clear. The manager under-declaring the value of raw materials imported is an unlawful activity. The fee of USD1 000 paid to the Zimbabwe Revenue Authority Officer appears to be a bribe. Consequently, the USD 1 000 paid to the Zimbabwe Revenue Authority Official is unlikely to be eligible for a deduction in terms of the current Act.

Bambie Limited under-declaring the value of imports will result in the company paying less Excise and Customs Duty, which will in-turn increase the profit earned by the company. Therefore, the bribe of USD1 000 paid to the Zimbabwe Revenue Authority Officer is an expense incurred with the intention of earning income. However, section 46 of the proposed new Income Tax Act prohibits the deduction of expenditure that is against public policy. Paragraph (a) of the section includes a bribe as an expense against public policy. Consequently, the fee paid to the Zimbabwe Revenue Authority Official will not be deductible when the tax legislation changes. Section 46 of the proposed new Income Tax Act prohibits the deduction of expenditure which is against public policy. This indicates that the proposed Act takes a clearer position regarding the deductibility of expenditures incurred for unlawful activities. This will eliminate the “grey area” which currently exists in respect of the deductibility of these expenditures.

The USD50 000 spent on acquiring the machinery to be used at the factory is not deductible in terms of section 15(2)(a) of the current Income Tax Act because the expenditure is of a capital nature. However, section 15(2)(c) of the current Income Tax Act provides that the Fourth Schedule allowances can be claimed in respect of amounts spent on the acquisition of machinery. The provisions of paragraph 7 of the Fourth Schedule allow Bambie Limited to claim a special initial allowance, which is spread over a number of years, in respect of the USD50 000 spent on the acquisition of machinery.

Section 34(1)(a)(ii) of the proposed new Income Tax Act states that the capital allowance for machinery owned and used by the taxpayer for business purposes will be granted in terms of the Eighth Schedule. Paragraph 2(c) of the Eighth Schedule allows the taxpayer to claim a

special initial allowance in respect of capital expenditure incurred by the taxpayer on the acquisition of machinery, provided it is used for the first time during the year of assessment and it is exclusively purchased for business purposes. The purpose of purchasing the new machinery is to use it in the factory to produce furniture, which indicates that it will be used for the first time by Bambie Limited during the year for business purposes. Therefore, the company will be able to claim a special initial allowance in terms of paragraph 2(c) of the Eighth Schedule for the USD50 000 it spent on purchasing the new machinery.

Paragraph 6(1)(b) of the Eighth Schedule indicates that allowances claimed in terms of paragraph 2 will be claimed at a rate of 25 per cent from the year of assessment following the year in which the machinery is used for the first time. Consequently, the capital allowance will be claimed by Bambie Limited as follows:

Current year of assessment (Year 1)	-
Year 2 to 5 (25%*50 000)	12 500
Total Claimed at the end of year 5 [0+ (12 500*4)]	50 000

Paragraph 6 of the Eighth Schedule will allow Bambie Limited to claim a special initial allowance spread over a period of five years in respect of the USD50 000 expended for the purpose of acquiring the machinery. The proposed new Income Tax Act will not change the method used to calculate capital allowances that can be claimed by the taxpayer as it applies the same principles used by the current Income Tax Act. Therefore, the special initial allowance claimable in respect of the USD50 000 spent by Bambie Limited will be spread over five years and at the same amounts under both Acts.

The USD7 000 given to the former Sales Manager as a token of appreciation for services rendered is deductible in terms of section 15(2)(a) of the current Income Tax Act because it is an amount spent for the purposes of trade. *Provider v COT* illustrates that amounts spent by the employer to encourage employees to enter or remain in service constitutes expenditure incurred by the taxpayer in the production of income. The USD7 000 given to the Sales Manager on retirement is a gift that shows the employer's gratitude for services rendered by the manager in the past. The amount is not an incentive provided to encourage the Sales Manager to enter or remain in service. Consequently, the outcome of the *Provider v COT* case cannot be applied in this case.

W.F Johnstone v CIR addresses the issue of gratuitous amounts given to employees on retirement. In terms of this case, an amount paid to an employee on retirement for services rendered does not constitute expenditure incurred in the production of income. This is because the expense relates to income generated in the past. Therefore, the USD7 000 given to the former sales manager will not be classified as an expense incurred in the production of income. The restriction on deductions allowed will result in the USD7 000 given to the former manager no longer being eligible for a deduction when the proposed new Income Tax Act is implemented.

The audit fee, tax consultancy fee, insurance fee relating to the plant and machinery used, bank charges, marketing research and the costs of training employees are expenses incurred by Bambie Limited for the purpose of trade and are of a revenue nature. Consequently, these amounts are deductible in terms of section 15(2)(a) of the current Income Tax Act. In terms of section 31 of the proposed new Income Tax Act, the deduction of the audit fee, tax consultancy fee, insurance fee relating to the plant and machinery used, bank charges, marketing research and the costs of training employees amounts will depend on whether or not the expense is incurred in the production of income.

According to section 146 of the Companies Act (Chapter 24:03), the accounts of a company and the auditor's report should be annexed to a signed balance sheet. Section 146(2) of the Act indicates that a company and its officers will be found guilty of an offence and liable to a fine if it issues, circulates or publishes a balance sheet without an auditor's report. It is evident that an auditor's report is a legislative requirement which carries adverse consequences if not produced with the financial statements of a company. Therefore, it was compulsory for Bambie Limited to incur the audit costs of USD15 000. The audit fee is an expense incurred in terms of a legislative requirement. In South Africa, the deductibility of this legislative requirement was recently addressed in the CSARS v Mobile Telephone Networks Holdings (Pty) Ltd, 2014 (5) SA 366, where the income-earning operations of the taxpayer comprised of exempt income in the form of dividends from shares and taxable income derived from interest charged on loans provided to customers.

In CSARS v Mobile Telephone Network Holdings (Pty) Ltd, the Supreme Court of Appeal assessed the closeness of the connection between the audit fee and the income-earning operations of the taxpayer to determine the deductibility of the audit fee. The court concluded that the audit fee was an expense incurred necessarily for the performance of the taxpayer's

income earning operations and that when an expense is incurred for a dual purpose, the expense must be apportioned on a fair and reasonable basis. In his verdict, the judge allowed the taxpayer to claim 10 per cent of the audit fee because most of the audit time was spent on issues which related to exempt income.

Based on the outcome of CSARS v Mobile Telephone Networks Holdings, the deductibility of the audit fee incurred by Bambie Limited will depend on the closeness of the connection between the expense and its income-earning operations. Therefore, the audit fee will be deductible if it relates to taxable income and will not be deductible if it relates to exempt income. In the event where the audit fee is incurred for a dual purpose, the expense will have to be apportioned on an equitable basis.

The tax consultancy fee of USD 10 000 is an expense incurred to identify areas of tax exposure so as to reduce the tax payable and not incurred in the production of “income” for tax purposes. Thus, the tax consultancy fee of USD10 000 will not be deductible in terms of section 31 of the proposed new Income Tax Act.

The insurance costs of USD8 000 paid by the company relate to the machinery used by the company. The insurance cost of R8 000 will not produce any income for Bambie Limited because the insurance is limited to mitigating losses that relate to the actual machinery and does not extend to the income produced by the machinery. Consequently, should an unforeseen loss such as damage, theft or any other loss that prevents the machinery from generating income occur, the insurer will compensate the company for the machinery lost by Bambie Limited and will not compensate the company for the income not generated as a result of the loss. Therefore, the insurance cost of USD8 000 is not incurred in the production of income. To this effect, the insurance cost paid by Bambie Limited will not be eligible for a deduction when the proposed new Income Tax Act is implemented.

The deductibility of insurance costs under the proposed law would have been different if the insurance covered a risk relating to the loss of income because the expenditure would result in the company earning income in the event of an unforeseen loss. It is clear that under the proposed tax law, the deductibility of insurance costs will depend on the risk it covers. Consequently, the deductibility of insurance costs should be considered on the facts.

The bank charges of USD150 are incurred to maintain the company’s bank account and not closely related to the income generating activity of the taxpayer. Consequently, the bank

charges of USD150 are not an expense incurred in the production of income and will not be deductible in terms of section 31(1)(a) of the proposed new Income Tax Act.

The purpose of conducting a market research is to investigate how the business can increase its sales so as to increase future income. The fact that the marketing research costs of USD4 500 are incurred by the taxpayer to earn more income indicates that the expense is incurred in the production of income. The marketing research costs of USD4 500 are incurred for the purpose of earning future income. The timing issue is addressed in the Sub-Nigel v CIR case, which indicates that expenditure does not have to be matched with the income it will produce for it to be deductible. Therefore, the fact that the marketing research costs were incurred to produce future income will not affect the timing when the expense is deductible. Consequently, the marketing research costs of USD4 500 incurred by Bambie Limited will be deductible in the current year of assessment.

Training costs of USD6 500 are incurred by Bambie Limited to equip employees with the skills they need to produce income more efficiently and effectively. The training costs of USD6 500 are therefore incurred by Bambie Limited for the purpose of earning income in the future. Sub-Nigel v CIR indicates that expenditure incurred will be deductible, even if it relates to income that will be earned in the future (Stiglingh *et al*: 2013). The training costs of USD6 500 will be classified as an expense incurred in the production of income and will be deductible in terms of section 31 of the proposed new Income Tax Act.

The deductibility of expenditure incurred in training employees will not be affected when the proposed new Income Tax Act is implemented.

#### **4.4 CONCLUSION**

Section 15(2)(a) of the current Income Tax Act provides for the deduction of expenses incurred for the purpose of trade or in the production of income, provided the expense is of a revenue nature. Consequently, expenses incurred in the course of carrying out a trade are deductible, unless the deduction of the amount is prohibited by the Act. This was illustrated by the example that concluded that the cost of acquiring a motor vehicle to be used for private purposes by an employee, audit fee, tax consultancy fee, insurance cost relating to risk involved with the loss of machinery, bank charges, marketing research and the employee training costs incurred by Bambie Limited were deductible in terms of section 15(2)(a) of the

current Income Tax because they constituted expenditure of a revenue nature incurred for trade purposes.

The example also illustrated that the provisions of section 15(2)(a) could not be applied to capital amounts by indicating that the USD50 000 spent on the acquisition of machinery was not eligible for a deduction in terms of section 15(2)(a) because it constitutes capital expenditure. However, this does not mean that the amount spent by Bambie Limited on the acquisition of machinery was not deductible at all in terms of the current Income Tax Act. Section 15(c) of the current Income Tax Act permitted the deduction of the USD50 000 incurred by Bambie Limited to acquire the machinery to be spread over five years.

Section 31(1)(a) of the proposed new Income Tax Act allows the deduction of expenditure incurred in the production of income. The section has removed the statement “incurred for the purposes of trade” And therefore restricts deductible expenditure to expenses incurred in the production of income. Consequently, expenditure incurred in the course of carrying on a trade, but not in the production of income will not be deductible when the proposed new Income Tax Act is implemented.

The restriction makes it crucial to understand what constitutes expenditure incurred in the production of income when the tax legislation in Zimbabwe is changed. South African case law will be used to explain the meaning of the term “in the production of income” because the proposed new Income Tax Act does not provide an explanation for the term.

The outcome of Port Elizabeth Tramway Company Ltd v CIR case is the authoritative case which establishes the meaning of the term “in the production of income”. The judge in Port Elizabeth Electric Tramway Company v CIR held that an expense is incurred in the production of income if the action which gives rise to it is closely connected to the income-generating activity. Therefore, the proposed new Income Tax Act results in expenses incurred for trade purposes but not closely related to the income generating activity of the taxpayer no longer being deductible.

Sub-Nigel v CIR indicates that there is no need to prove that the expenditure incurred by a taxpayer relates to income produced during the year of assessment for it to be deductible. Consequently, an expenditure incurred in the production of income will be deductible in the year it is incurred, even if the income it relates to is earned in the future.

In *Provider v COT*, the amounts spent by the employer to encourage an employee to enter or remain in service were regarded as income earned in the production of income. This is because employees that are in service are actively involved in the process of earning income. In *W F Johnstone v CIR*, a gratuitous amount paid by the taxpayer to an employee on retirement was not classified as income earned in the production of income. *Provider v COT* and *W F Johnstone v CIR* are both cases that deal with amounts spent by employers on their employees. The decision made by the judge in *W F Johnstone* is different from that made in *Provider v COT* because retired employees do not produce any current or future income for the taxpayer. Therefore, *Provider v COT* and *W F Johnstone* indicate that the deductibility of amounts relating to payments made to the employee will depend on whether or not the employee is involved in the production of current or future income.

The example illustrated that the marketing research costs and employee training costs will be classified as expenditure incurred in the production of income because they are incurred so as to earn income. Consequently, these amounts are deductible in terms of the current and proposed Acts.

The proposed new Income Tax Act does not affect the deductibility of expenses incurred by *Bambie Limited* in respect of the cost of machinery, market research and employee training costs.

The illustrative example also indicated that the amount paid to the retired Sales Manager as a token of appreciation, the tax consultancy fee, insurance cost which mitigates losses which relate to the loss of machinery and bank charges were expenditure incurred by *Bambie Limited* in the course of its trade, but are not closely related to the income earning operations of *Bambie Limited*. Consequently, these amounts will not be regarded as expenses incurred in the production of income and will not be deductible in terms of the proposed new Income Tax Act. Clearly, section 31(1)(a) will affect the deductibility of expenditure incurred for trade purposes but not in the production of income.

Based on *CSARS v Mobile Telephone Networks Holdings*, the audit fee will be deductible to the extent it relates to the income earning activity of the taxpayer. The portion which relates to the income earning operations of the taxpayer will be determined by applying a fair and reasonable basis to apportion the cost.

The Explanatory Memorandum for the Income Tax Bill (2012) states that the taxable income of a taxpayer will be the difference between the income subject to tax and the deductions allowed by the Income Tax Bill. Certain provisions used to determine the taxable income of a taxpayer under the Income Tax Bill (2012) are not the same as those applied by the current Income Tax Act. The previous chapters focused on the changes that relate to the income component and this chapter addressed the changes that relate to permissible deductions. The next chapter will conclude the research by providing a summary of the main findings.

# **CHAPTER FIVE: Conclusion**

## **5.1 GOALS OF THE RESEARCH**

The Zimbabwe Situation (2014) reported that the Income Tax Bill (2012), which was not approved by the President of Zimbabwe, was listed for consideration in Parliament. This means that the Income Tax Bill (2012) may be implemented in Zimbabwe sometime in the future. The changes embodied in the Income Tax Bill (2012) will affect the method used to determine the taxable income of a taxpayer. Therefore it is important to understand the changes the Income Tax Bill contains and the tax consequences it will create for the taxpayer. This research aimed to analyse the changes that will be made to the existing income tax legislation as a result of implementing the proposed new Income Tax Act and to explain the tax consequences for the taxpayer.

The previous chapters provided an analysis of the changes that will be made to existing legislation as a result of implementing the proposed new Income Tax Act in Zimbabwe. In addition, the chapters also provided illustrative examples to explain the tax consequences for the taxpayer when the proposed new Income Tax Act is applied in Zimbabwe. This chapter will summarize the main findings of the research and identify opportunities for future research.

## **5.2 MAIN FINDINGS**

The Explanatory Memorandum for the Income Tax Bill (2012) states that the Income Tax Bill will change the income tax system applied in Zimbabwe from a source-based tax system to a residence-based tax system. This change was analysed in the second chapter, thus contributing to addressing the goal of providing an analysis of the proposed changes embodied in the Income Tax Bill. Under the current income tax system, tax is levied on income that is earned from a source within or deemed to be from within Zimbabwe. However, the proposed new Income Tax Act will levy tax on income earned from all sources (The Explanatory Memorandum for the Income Tax Bill: 2012). It is evident that under the current tax system, the source from which income is obtained is the driving factor when

determining the taxability of an amount. Therefore, resident taxpayers and non-resident taxpayers in Zimbabwe are presently taxed in the same manner.

Under the proposed new Income Tax Act, non-residents will continue to be taxed on a source basis, whilst resident taxpayers will be taxed on income earned from all sources, regardless of whether or not the amount is earned from a source within the borders of Zimbabwe. Section 16 of the proposed new Income Tax Act explains that the income earned by taxpayers who are temporarily resident in Zimbabwe will be subject to tax if the income is obtained from a source within Zimbabwe or if the amount is foreign sourced income that must be remitted to Zimbabwe in terms of a performance related to exchange control. The different tax methods used to determine the taxability of an amount earned by resident taxpayers, temporarily resident taxpayers and non-resident taxpayers indicates that the taxability of an amount earned by the taxpayer will depend on the taxpayer's residency. Sections 7 to 11 of the proposed new Income Tax Act will be used to determine whether a taxpayer is a resident taxpayer, temporarily resident taxpayer or a non-resident taxpayer.

The second chapter of the research elaborated on the changes that will result from applying the residence-based system in Zimbabwe, so as to contribute to achieving the goal of explaining the tax consequences that will arise as a result of implementing the proposed tax legislation. The first example illustrated that an individual will be regarded as a resident taxpayer if he or she satisfies one of the requirements set out in section 7(1) of the proposed Act. Therefore, individuals who fail to satisfy the requirements set out in section 7 will be regarded as non-resident taxpayers. The example also illustrated that the residence-based tax system will only affect the taxability of foreign sourced income earned by resident taxpayers. The taxability of amounts earned by non-resident taxpayers will not be affected by the change.

In the second example the taxpayer was regarded as a temporarily resident taxpayer during the years she satisfied all the section 8 requirements and became a resident taxpayer when she failed to meet the requirements of section 8. The example indicated that the change in classification only affected the taxability of the foreign income which need not be remitted to Zimbabwe.

In the last example, the branch of an American company operating in Zimbabwe was treated as an independent entity and regarded as a resident taxpayer in Zimbabwe because it satisfied the requirements of section 9 of the proposed Act.

The “gross income” definition in section 2 of the proposed new Income Tax Act requires amounts which are subject to income tax to be separated into employment income, business income, property income and other specified income. This change was analysed in the third chapter, contributing to the first goal of analysing the changes that will result from the proposed tax legislation. Sections 23 to 26 of the proposed new Income Tax Act stipulate the type of income to be included in each class of income. In terms of the proposed new Income Tax Act, amounts that are of a capital nature are included in the income of a taxpayer. This deviates from the existing practice of excluding amounts that are of a capital nature from the “gross income” of a taxpayer. The inclusion of amounts that are of a capital nature in the income of a taxpayer will make it unnecessary to distinguish between capital and revenue amounts. The inclusion of capital amounts in the income of a taxpayer will also result in the Capital Gains Tax Act becoming redundant.

Section 23 of the proposed new Income Tax Act stipulates the amounts which will constitute employment income. Section 23(j) of the proposed new Income Tax Act will change the method used to determine the taxable value of the free use of a motor vehicle provided to an employee by his or her employer. Presently, in terms of section 8(1)(f), the taxable value of a motor vehicle benefit that arises from the employee making use of a motor vehicle provided to him or her for private use is a deemed value which depends on the engine capacity of the vehicle. However, in terms of section 23(1)(j)(ii) of the proposed new Income Tax Act, the tax value of the free use of a motor vehicle will be determined by the application of a formula set out in paragraph 2 of the Fourth Schedule. The formula used to calculate the taxable value of the motor vehicle benefit will be  $(C+R) \times P$ , where “C” will represent 20 per cent of the cost paid by the employer to acquire the vehicle, “R” will be the annual running costs of the motor vehicle borne by the employer and “P” the proportion used for private purposes.

Paragraph 2 of the Fourth Schedule assumes that the use of a motor vehicle granted to an employee by his or her employer is exclusively used for private purposes, unless the employee proves to the Commissioner that more than 75 per cent of the total use is for business purposes. This implies that “P” will be deemed to be 100 per cent if the taxpayer fails to prove that the motor vehicle is used mainly for business purposes. Thus the taxpayer will pay more tax in respect of the free use of a motor vehicle if he or she fails to prove that the motor vehicle is used mainly for business purposes. The effect of the proposed change in the method used to determine the taxable portion of the free use of a motor vehicle granted to an employee by his or her employer will depend on the proportion used for private purposes.

The Southern African Development Community (2014) indicates that in Zimbabwe, the Capital Gains Tax Act is only applied on capital gains or losses obtained from the disposal of immovable property and marketable securities. This implies that other capital amounts that are not included in the “gross income” of a taxpayer by the provisions of section 8(1) of the current Income Tax Act are entirely free from tax in Zimbabwe. The Explanatory Memorandum for the Income Tax Bill (2012) indicates that clauses 67 to 73 of the Income Tax Bill (2012) explain how net gains obtained from the disposal of business or investment property should be taxed. This implies that the net gain from the disposal of business and investment property will become subject to income tax when the tax legislation is changed. In terms of section 24 of the proposed new Income Tax Act, the net gains from the disposal of business property will be classified as business income.

At present, the position taken in relation to the taxability of amounts earned from criminal or unlawful activities is uncertain because the current income Tax Act does not provide for the taxability of these amounts. Gono (2013) indicates that, in general, income earned from crime or any other unlawful activities is currently not taxable. This implies that amounts not earned within the boundaries of the law are unlikely to be subject to any tax in Zimbabwe. Section 26(d) of the proposed new Income Tax Act includes the proceeds obtained from crime or any other unlawful activity in the income of a taxpayer. This indicates that the proposed new Income Tax Act takes a clear position in respect of the taxability of proceeds obtained from illegal activities such as theft or fraud.

The third chapter also addressed the goal of explaining the tax consequences that will arise from implementing the proposed Act by providing examples that illustrate the effects of classifying income into various categories and the effect of the inclusion of amounts of a capital nature in the income of a taxpayer.

The examples illustrated that the proposed Act will have no effect on the taxability of a salary, remuneration from independent consulting services, a cash award received as an employee of the month and rental income because these amounts are subject to income tax in terms of section 8(1) of the current Income Tax Act.

The proposed new Income Tax Act resulted in a tax reduction for the employee in the example in respect of the valuation of the free use of a motor vehicle granted to an employee by his or her employer because 20 per cent of the total use was for private use, whilst the tax value of the motor vehicle for the other employee increased because the vehicle was deemed

to be exclusively used for private purposes. Therefore, the effect of the proposed Act applying a formula instead of a deemed value which depends on the engine capacity will be determined by the proportion used by the taxpayer for private purposes. Even though both taxpayers mainly used the motor vehicles provided by their employers for business purposes, the one was taxed at the full rate because he was not in a position to prove that the motor vehicle was mainly used for business purposes. This emphasises the importance of maintaining records that indicate how a motor vehicle provided to an employee by his or her employer is used during the year of assessment.

The fourth chapter provided an analysis of the changes that will be made to the current legislation by comparing permissible deductions under the current and proposed Acts, in order to address the goals of the research. An example that illustrated the changes related to permissible deductions was also provided to explain the tax consequences for the taxpayer as a result of implementing the proposed new Income Tax Act.

Section 15(2)(a) of the current Income Tax Act provides for the deduction of expenses incurred for the purposes of trade or in the production of income. Section 31(1)(a) of the proposed new Income Tax Act will restrict deductions allowed to expenditure incurred in the production of income. The section omits a deduction in respect of expenditure incurred for the purposes of trade and this results in expenses not incurred for the purpose of generating income no longer being deductible. To this effect, the decision in *Port Elizabeth Electric Tramway Company v CIR* and the example illustrated that expenses such as insurance which relates to the loss of assets, gratuitous amounts paid to employees on retirement for services rendered in the past, the tax consultancy fees and legal fees will no longer be deductible when the current Income Tax Act is replaced by the Income Tax Bill (2012).

The restriction on deductible expenditure will not affect expenditure incurred for the purpose of earning income. The marketing research costs, employee training costs and compensation paid to employees in the course of employment were deductible under both the current and the proposed Act.

Section 15(2)(c),(d) and (e) of the current Act provide for an allowance granted in respect of capital expenditure. The allowance granted depends on the expense incurred. The proposed Act does not contain any amendments in respect of the allowances granted in respect of capital expenditure.

The example illustrated that the deductibility of capital expenditure incurred by the taxpayer will not be affected by implementing the proposed Income Tax Act as the cost of acquiring new machinery for business purposes will be deductible over five years, at a rate of zero per cent in the first year of purchase and twenty-five per cent for the subsequent four years, in terms of both Acts.

The example also indicated that the proposed Act takes a clear position in terms of the deductibility of amounts incurred that are against public policy. An amount spent by the taxpayer was considered to be a bribe and was unlikely to be deductible in terms of the current Income Tax Act, but was expressly prohibited as a deduction in terms of section 46(a) of the proposed Act.

The analysis of the tax consequences that will result from the implementation of the proposed new Income Tax Act indicates that proposed Act will increase the taxpayer's taxable income as it makes amounts that are currently not subject to tax taxable whilst restricting the deductible amounts.

### **5.3 SOME OBSERVATIONS**

Gono (2013) explains that the United States of America, South Africa, Mozambique, Tanzania and Australia currently make use of the residence-based tax system, which is being proposed in Zimbabwe. The Explanatory Memorandum for the Income Tax Bill (2012) states that the practice of restricting deductions to expenditure incurred in the production of income is applied by other countries in the region. However, these countries are at different levels of development compared to Zimbabwe and it is not guaranteed that changing the tax legislation applied in Zimbabwe will yield the optimum results for the Zimbabwean economy. Consequently, it is important to weigh the advantages and disadvantages of applying each income tax system and limiting permissible deductions to those incurred in the production of income. In order to determine whether or not Zimbabwe should proceed with the plans of changing the tax legislation applied in the country, it is important to determine the feasibility of implementing the proposed Income Tax Act in the country.

Gono (2013) acknowledges that the country is currently operating on a constrained fiscal budget. Therefore, the country should use every opportunity to improve its cash flows and cannot afford to continuously miss set revenue collection targets. Based on the latest statistics

published by the Zimbabwe Revenue Authority in Zimbabwe, Chawafambira (2014) indicates that the government failed to meet its revenue target by 9 per cent during the third quarter and also missed the target set in 2013 by 6 per cent. Clearly, the gap between the budgeted revenue collection amount and the actual performance is widening, which creates an adverse variance for the country. This indicates that the Zimbabwe Revenue Authority in Zimbabwe is currently struggling to effectively collect tax on amounts earned by the taxpayer from within the country's borders. Therefore, an investigation on how the Revenue Authority in Zimbabwe can improve on its revenue collection methods is required to ensure that the change from applying a source-based income tax system to a residence-based tax system yields the best possible results.

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