Dear Sir

RE: CALL FOR COMMENT ON DRAFT TAXATION LAWS AMENDMENT BILL 2011, DRAFT TAXATION LAWS SECOND AMENDMENT BILL 2011 (“DTLAB 2011”) AND DRAFT EXPLANATORY MEMORANDUM

We refer to the call for comment on the above-mentioned documents. Set out below please find the SAICA National Tax Committee’s Second Submission regarding policy comments. As requested the comments follow the sequence of the Draft Explanatory Memorandum (“EM”) (the numbering in this document refers directly to the numbering as contained in the EM).

DRAFT TAXATION LAWS AMENDMENT BILLS 2011 AND DRAFT EXPLANATORY MEMORANDUM

MAIN AMENDMENTS

1. INCOME TAX: RATES AND THRESHOLDS

No comments.

2. INCOME TAX: EMPLOYMENT, INDIVIDUALS AND SAVINGS

2.3 Long Term Insurance: Contribution as a Fringe Benefit

Clause 113 / Effective date of new para 12C of the Seventh Schedule to the Income Tax Act, No. 58 of 1962 (“the Act”)

Problem statement
This fringe benefit is proposed to come into operation on 1 January 2011. While retrospective legislation is never welcomed, making a benefit retrospective into the last tax year (i.e. for the last two months of 2010-11) will introduce practical difficulties. EMP501s for that year have been submitted and IRP5s have been issued. If this proposal is confirmed, many employers have under-paid PAYE and must thus re-perform their recons and IRP5s.

**Proposed solution**
We suggest that clause 110(1)(c) and clause 113 only be effective to companies for years of assessment commencing on or after 1 January 2011 and applicable in respect of premiums incurred on or after that date similar to the 2010 amendment in respect of section 11(w) to ensure companies do not have to readjust their payroll in respect of a previous year of assessment for which IRP5 reconciliations have already been completed and submitted to SARS. If the effective date must be retrospective, 1 March 2011 would be more appropriate. Alternatively 1 March 2012.

**Clause 110 / par 2(k) of the Seventh Schedule**  
**Problem statement**
We are of the view that clause 110(1)(c) in terms of which para 2(k) of the Seventh Schedule is amended, is too wide. It will potentially also catch approved insurance policies where the pension fund is the owner, especially where the employer makes the payments on behalf of the pension fund.

**Proposed solution**
Para 2(k) should accordingly be reworded to only include employer contributions to insurers (where the employer is the owner of the policy) that are made directly or indirectly for the benefit of the employer’s employees. Alternatively contributions to approved policies that are part of the pension fund should be excluded from para 2(k) read with para 12C of the Seventh Schedule similar to the proposed exclusions for para (m) of the gross income definition contained in clause 7(x) of the proposed amendments.

**Clause 51 / Section 23(m)(iii)**  
**Problem statement**
In terms of clause 51(1)(a) section 23(m)(iii) is amended to include any contribution or payment made by the employer in terms of an insurance policy.

**Proposed solution**
Par 2(4)(c) of the Fourth Schedule to the Act must also be amended to include any contribution or payment made by the employer to ensure that employees receive a monthly benefit in the payroll for employer contributions that are made to insurance policies, i.e. this is to ensure that employees are not negatively affected when a disability employer contribution as opposed to the employee contribution is made.

2.4 **Long-term Insurance: Key Person Plan Elections**
Clause 33 / Section 11(w)(ii)
Problem statement (i)
Paragraph 12C of the Seventh Schedule to the Act is to provide that premiums paid by an employer to disability income protection plans for the benefit of an employee, will constitute a taxable benefit in the employee’s hand. The EM states that employees seemed to have lost the option of deducting premiums for disability income protection plans, which have been paid on their behalf and that this option will be restored. However, this is not provided for in the proposed legislation.

Proposed solution
Paragraph 12C of the Seventh Schedule to the Act could be amended to state that such premiums paid by an employer for the benefit of an employee must, to the extent that the amount has been included in the income of that employee as a taxable benefit, be deemed to have been paid by that employee.

Problem statement (ii)
The EM provides that the proposed amendment will be applicable for premiums incurred on or after 1 January 2011.

Proposed solution
We recommend that the proposed amendment should only be effective for years of assessment commencing on or after 1 January 2011 and applicable in respect of premiums incurred on or after that date similar to the 2010 amendment in respect of section 11(w), to ensure that companies do not have to, *inter alia*, retrospectively correct their payrolls to qualify for a section 11(w) deduction (see comments on clause 110 and 113 above).

2.5 Long-term Insurance: Taxation of Proceeds

Clause 7 / Section 1 para (m) of the “gross income” definition
Problem statement
Page 22 of the EM, paragraph beginning: “*As a side matter...*”, states that the proceeds of a policy stemming from a group life plan associated with pension or provident fund membership will be excluded from the new regime, since they will be taxed in terms of the retirement regime (i.e. the Second Schedule).

There is no guidance as to what policies “stem” from a group life plan “associated with” pension and provident fund membership. The legislation does not delve into this. In practice it can be very difficult to distinguish between stand-alone policies and those linked to pension/provident plans. An employer may make one payment to the insurance company each month, but in the background may be a number of different policies. Are they “associated”?

Proposed solution
Now that the taxation of long-term insurance premiums and proceeds has been made clearer, it will be critical to determine what is defined as ‘group life’. National Treasury is requested to release further guidance in this regard.

2.6 Medical Scheme Credits

Clause 10 / Section 6A
Problem statement
The previous amendments to paragraph 12A(1) of the Seventh Schedule to include equivalent foreign medical aid schemes left several questions unanswered, and these questions remain in the proposed section 6A(2)(iii), which refers to a “fund”.

In practice, most foreign medical benefits are insurance policies, not “funds” or “schemes” as described in South Africa and regulated in terms of our Medical Schemes Act. Further, if foreign medical insurance policies are regulated in their own countries, it may often be in terms of insurance law, not necessarily any equivalent to our Medical Schemes Act.

Proposed solution
We request that National Treasury clarify if it is the intention not to include such foreign insurance policies in the ambit of “medical aid” benefits/deductions/credits?

2.7 Dividends from Employee Share Based Schemes

Clause 30 / section 10(1)(k)(i)(dd)(C)
Problem statement (i)
Treasury’s attention to the problems created by the original dividend exemption rules, as they applied to employee share trusts, is welcomed. Making a dividend exemption subject to Ministerial regulation is however, not the appropriate response.

Proposed solution
With respect, whether a dividend is taxable or not should be a matter of legislation, passed by the elected Parliament and subject to public scrutiny, as would be expected in a constitutional democracy. If the legislation was meant only to deny a dividend exemption to certain arrangements then these arrangements should be defined in the legislation.

Problem statement (ii)
It is proposed that dividends in respect of a restricted equity instrument that constitutes an interest in a trust be excluded from the anti-avoidance rule, if that interest meets the requirements prescribed by the Minister by regulation.

Conflicting commencement dates have been provided. The EM advises that the proposed amendment will be effective as of 1 January 2011 in respect of dividends received on or after that date, whereas the draft legislation indicates that it will come into operation on a date to be determined by the Minister of Finance.
Proposed solution
Clarity should be given on the implementation date for this proposal.

2.8 Road Accident Fund Payouts

Clause 30 / Section 10(1)(gB)
Problem statement
The RAF sometimes pays out lump sums to victims, but intends to move to annuities, as these provide more security of support for recipients. The problem is that these are gross income in terms of paragraph (a) of the definition of “gross income” in section 1 of the Act. The decision of the Appellate Division in SBI v Hogan 55 SATC 329 1993 AD, where the court arrived at just this result, to the detriment of the unfortunate taxpayer is relevant. To avoid this unwanted result, a new section 10(1)(gB) has been introduced to exempt any amount of compensation from the RAF. The exemption is set to apply from 1 March 2012.

Proposed solution
The proposal should be applied from 1 March 2011.

2.9 Employee Compensation Fund Entities

Clause 30 / Section 10(1)(t)(vi) and section 9(d) of the VAT Act
Problem statement
The Government compensation fund, which is funded by contributions from employers, is exempt from tax. In addition, the payments received in the hands of recipients from this fund are also exempt from taxation. However, this exemption does not apply to private sector entities licensed to operate in this area. A new section 10(1)(t)(vi) provides for such exemption. In addition, these private entities are now themselves exempt from tax under section 9(d), and their activities are excluded from the definition of “enterprise” in the VAT Act. There are safeguards to ensure that their activities do not stray into normal commercial activities. The exemption is to be effective for years of assessment commencing on or after 1 January 2011 and the VAT amendment from the date of promulgation.

Proposed solution
If this applies for the current year, why delay the exemption under section (10)(1)(gB)?

2.10 Judicial Long Distance Commuting

Clause 111 / Paragraph 7(8) of the Seventh Schedule
Problem statement
It is proposed that paragraph 7(8) of the Seventh Schedule be amended to allow judges to treat their daily commute between home and work as business travel. This proposal, to allow a certain group of employees to claim their daily commute as business travel, is discriminatory, since it treats a certain group of employees differently from other employees, who may have similar travel requirements in order to perform their employment duties.
This provision is very narrow as it applies only to judges and then only to their travelling between home and court. The changes to the company car fringe benefit provisions in operation from 1 March 2011 (logbooks etc) have placed a particular burden on judges because distance travelled between home and work does not count, and never has counted, as business travel. Judges by the nature of their work often have to travel long distances to get to the courts where they might be presiding for a period – e.g. to regional courts or even Bloemfontein where a judge sits on the SCA but doesn’t live there. Accordingly a new paragraph 7(8A) of the 7th Schedule provides that travel between home and court where the judge presides is deemed to be business travel. The judge must still keep a log book and comply with the other requirements of paragraphs 7(7) and 7(8).

People in the private sector who, by the nature of their work, are required to travel between their homes and work in special circumstances? Experience shows that special concessions create tax avoidance schemes, and even though this concession is very narrow, such concessions in tax legislation are problematic.

**Proposed solution**
The method for determining the value of the taxable benefit arising from the private use of employer-provided vehicles should be applied to all employees equally. Therefore, the above proposal should either be extended to all employees in similar circumstances or not be implemented at all.

### 3. INCOME TAX BUSINESS

#### 3.5 Assumption of Contingent Liabilities: Taxable Company Acquisitions

**Clause 7 / Section 1 definition of “gross income”; section 11F**

**Problem statement**
The proposed amendment to the gross income definition is to be effective from 1 January 2012, whereas section 11F is to be introduced with effect from 1 April 2012. Section 11F should be effective from 1 January 2012 and not 1 April 2012 as provided for in the EM and to ensure that it agrees with the effective dates when the proposed amendments to section 22(3)(a)(iv) and section 24CA are applicable.

**Proposed solution**
The effective date of these proposals should be aligned.

**Clause 36 and 53 / Section 11F and 24CA**

**Problem statement**
Amendments to clarify this complex issue are to be welcomed. However, it is not clear that the proposed amendments are necessary as the application of the general legal principles set out below are of application and would seem to give rise to the same intended result for the parties. In essence the end result should not be any different for the parties whether a seller
disposes of assets for R100 000 cash, or for cash of R95 000 and the delegation of contingent liabilities with an agreed value of R5 000.

To the extent that a purchaser assumes contingent liabilities owed by the seller as consideration for the acquisition of any assets/business from the seller, the agreed value of the contingent liabilities (R5 000 in the example) merely constitutes part of the consideration payable by the purchaser for such assets/business (R100 000 in the example) and the treatment thereof in the hands of the seller should not differ from any other form of consideration derived by the seller (R100 000 cash in the example). That is, it will either constitute gross income (if, for example it relates to the disposal of trading stock), a recoupment of previously claimed capital allowances (if it relates to the disposal of so-called allowance assets) or proceeds derived in respect of the disposal of capital assets (such as goodwill). As regards the purchaser, he or she has incurred expenditure equal to the agreed value of the assumed contingent liabilities (R5 000 in the example) and such expenditure (together with the agreed cash component of the consideration - R95 000 in the example) should be allocated to the relevant assets that have been acquired by the purchaser, whether trading stock, allowance assets or capital assets. This outcome is based on the application of general tax principles.

It is apparent that the proposed amendments to the definitions of "gross income" (clause 7(1)(n) of the TLAB) and "proceeds" (clause 118 of the TLAB) are intended to give effect to the income accrual aspect dealt with above. While the proposed amendment to paragraph 20(1)(a) of the Eighth Schedule confirms the expenditure in the nature of the assumed liabilities by the purchaser constitutes base cost of the assets acquired for CGT purposes, no provision has been made for the recognition of such expenditure in regard to the cost of the assets for income tax purposes - albeit this is arguably dealt with by applying general tax principles.

The real issue is the treatment of the assumed contingent liabilities in the hands of the seller and purchaser once the purchaser has agreed to assume the contingent liabilities as part of the consideration payable by the purchaser for the assets/business acquired from the seller. In a sense the contingent liabilities have now crystallised in the hands of the seller and have been incurred by the seller as it has in essence now borne the economic cost by agreeing to receive what is in effect a reduced cash payment (R95 000 in the example). The transaction could be structured on the basis that the seller receives/is entitled to R100 000 cash for the assets but agrees to pay the purchaser R5 000 to assume the contingent liabilities. The seller would therefore have received gross income/recoupment/proceeds of R100 000 and incurred expenditure of R5 000 in respect of the contingent liabilities. Whether the seller is entitled to any tax relief in respect of this expenditure (R5 000 in the example) depends on the nature of the expenditure. If it relates to, for example, staff (contingent bonuses, leave pay), then the expenditure should be allowable, but if it relates to a capital expense, for example, a warranty in respect of a capital asset, it would not be deductible but could trigger a capital loss. The purchaser in turn has received R5 000 against which it should be entitled to claim a deduction when and if the relevant assumed contingent liability is in fact actually unconditionally
incurred by it. Such liabilities are deductible in the hands of the purchaser on the basis that the purchaser has actually incurred the liabilities in the production of the R5 000 received from the seller for having assumed the contingent liabilities.

It is apparent that the proposed new sections 11F (clause 36 of the TLAB) and 24CA (clause 53 of the TLAB) are intended to address these issues. However, it is not clear why the relief provided for in the proposed sections should only be of application where the transaction involves the disposal of a going concern, and not in relation to assets in general, whether disposed of as part of the disposal of a going concern or otherwise. The correct tax outcome should be achieved even in respect of assets that are disposed of other than as part of the disposal of a going concern.

**Proposed solution**
It is recommended that the requirement that the transaction must relate to a "going concern" should be deleted.

**Clause 53 / Section 24CA**

**Problem statement**
There is also uncertainty at the moment whether purchasers may deduct actual expenses incurred against contingency liabilities that are taken over by the purchaser.

**Proposed solution**
We accordingly suggest that it be specifically included in section 24CA that the purchaser will be allowed a deduction when expenditure is actually incurred against the contingency liability and that such actual expenditure will reduce the expenditure that is likely to be incurred as provided in terms of the proposed section 24CA(2).

### 3.8 Incentive: Research and Development (“R&D”) revisions

**Clause 35 / Section 11D(8)**

**Problem statement (i)**
It is proposed that section 11D(8) be introduced into the Act, which provides that the Minister of Science and Technology must approve any R&D, in order for the expenditure relating to the R&D to qualify for the allowances provided in section 11D. In the EM to the Draft 2006 Revenue Laws Amendment Act, in terms of which section 11D in its current form was introduced into the Act, it was stated that “the Governments sometimes provide extra support for local R&D via direct subsidies as well as through tax incentives (i.e. which operate as indirect subsidies)”. While South Africa offers a variety of direct subsidies for R&D, the South African tax regime for R&D does not provide substantial incentives. South Africa accordingly needs an improved set of R&D tax incentives to ensure that local R&D is not at a global competitive disadvantage. When implementing the pre-approval process, care must be taken that the R&D tax incentive will not be subject to lengthy and uneconomic administrative procedures, similar to those which so often render government grants ineffective. Should this be the case, businesses involved in R&D may very well decide not to
use South Africa as a destination for conducting R&D, or even to move existing R&D activities to other, more supportive jurisdictions.

**Proposed solution**

It should be ensured that an effective approval procedure is in place before the proposed amendments come into effect. In addition, a maximum turnaround time (preferably 6 months or less) should be prescribed by law, for the DST to process applications for pre-approval. Furthermore, draft regulations as prescribed in terms of proposed subsection 9 should be released for discussion as soon as possible and ought to be finalised well before the amendments take effect.

Also refer clause 35(6)(i), we suggest that overhead costs are defined to ensure that it is clear to taxpayers which expenses would be excluded from the provisions of section 11D.

**Problem statement (ii)**

Whilst clause 35(2) of the Bill states that the amendments to section 11D are to come into effect on 1 January 2012, the EM, on page 46, states that it will come into effect on 1 April 2012.

**Proposed solution**

For the purposes of consistency and clarity the EM and the draft legislation should be brought into agreement.

**3.9 Incentive: Film Production Revisions**

**Clause 43 / Section 12O**

**Problem statement / proposed solution**

The reference to "citizen" in section 12O(2)(a) is incorrect and should refer to "resident" as citizens implies that the co-production agreement can only be entered into by natural persons. This does not follow from the requirement of a "special purpose corporate vehicle" which is responsible for the production of a film as required by the DTI in terms of the Programme Guidelines for the South African Film and Television Production and Co-production Incentive.

The person entitled to the receipts and accruals of income derived from the exploitation rights of a film must be the same person that is entitled to these receipts and accruals at the time of the production of the film. This removes the possibility for a film production to introduce a new funder at a later stage.

The income must be received or accrued in respect of films for which principal photography commences after 1 January 2012 but which "completion date", i.e. date which the film is in a form which can be circulated to the public, by 1 January 2017. This provides a period of 5 years from which principal photography should begin and the film should be ready for circulation, which may not be a long enough period for many independent film producers,
especially for film producers who may conceptualise the film towards the end of the 5 year period or due to delays caused by funding, take longer than 5 years to complete a film.

3.10 Small Business: Micro-Business Turnover Tax Relief

Clause 106 / Sixth Schedule
Problem statement
Although the proposed amendments to the Sixth Schedule to the Act are welcomed, it is unfortunate that the definition as to what constitutes a “professional service” has not been narrowed.

As was noted in the EM to the Taxation Laws Amendment Bill 2010, taxpayers providing professional services are generally rendered by more sophisticated, high-income earning taxpayers (with profit margins that are significantly higher than those assumed in the design of turnover tax) and should, therefore, generally be excluded from registering for turnover tax. This EM continues to provide examples of such professional services, but does not include, inter alia, the service in the field of “education” (which is still contained in the definition of “professional service” in paragraph 1 of the Sixth Schedule to the Act).

It is submitted that various small businesses may still find themselves barred from registering for turnover tax purely because they provide a service in the field of (particularly) education. For example, a taxpayer who provides or facilitates tutoring services on a part-time basis to children would currently not be able to register for turnover tax, as the service is “in the field of” education. However, such service could not be regarded as being of a sophisticated or high income earning nature. It is therefore submitted that the current legislation does not give expression to the intention of the legislature (i.e. to only exclude sophisticated services by high income earning taxpayers from participating in the turnover tax regime).

Proposed solution
It is proposed that the definition of “professional service” be narrowed so as to exclude a service being provided in the field of “education”. It is submitted that the same argument may also be raised for services being provided in the field of draftmanship, translation and valuation.

3.11 Debt Cancellation: Character Issues

Clause 7 / Section 1 definition of “gross income”
Problem statement
It is proposed that the face value of debt reduction or discharge be treated as a receipt or accrual to be included in the gross income or proceeds of the person being granted the debt reduction or discharge.

In order to avoid double taxation, the EM continues to state that the above will no longer be viewed as a recoupment (despite the fact that the debt reduction or discharge is associated
with a prior allowance or deduction). However, it appears that no amendments were proposed to adjust section 8(4)(m) and paragraph 12(5) of the Eighth Schedule accordingly with the above intention.

**Proposed solution**
In order to avoid confusion and potential double taxation, it is proposed that section 8(4)(m) and paragraph 12(5) of the Eighth Schedule be amended to give effect to the intention of the legislature as expressed in the EM.

### 3.16 Dividends Tax: Removal of the Value-Extraction Tax (VET)

**Clause 91 / section 64E**

**Problem statement**
The EM states that VET will be repealed in favour of a facts and circumstances test. More specifically, the EM states that “Whether a value extraction from a company qualifies as a dividend, salary, payment for the purchase or use of an asset, amongst others, must be determined through reliance on the same legal connection (e.g. “in respect of” or “as consideration for”).

However, it is proposed that section 64E(4) be introduced to deem a company to have paid a dividend, where any amount has been loaned or advanced to a shareholder by virtue of shares held by that person. The quantum of such a dividend (on which dividends tax is to be paid) will be equal to the shortfall between the actual interest charged on the loan and the “market-related interest”, as defined in that section.

It is unclear as to whether such deemed dividends would enjoy the same exemptions from tax, as “real dividends” enjoy in terms of section 64F. Should this not be the case, the proposed treatment of “deemed dividends” will be more punitive than the repealed VET system.

**Proposed solution**
In order to provide clarity on the matter, it is proposed that the legislation expressly states that the exemptions provided for in section 64F also applies in respect of amounts deemed to be a dividend in terms of section 64(E)(4).

### 3.20 Dividends Tax: New Dispensation for Foreign Dividends

**Clause 32 / Section 10B(7)(b)**

**Problem statement / Proposed solution**
The purpose this provision is seemingly unclear, perhaps an example could be provided to assist in understanding its intended purpose.

**Clause 32 / Section 10B**

**Problem statement / Proposed solution**
Section 10B needs to be extended to include distributions from foreign co-operatives as per section 10(1)(k)(ii)(dd) especially now that the reference to 'similar interest' is removed from the definition of 'equity share' in section 1.

323  Anti-avoidance: Dividend Cessions

Clause 13 / Section 6sex, proviso (ee) to section 10(1)(k)(i)
Problem statement
The example on page 78 of the EM on shares held via trusts, requires the company beneficiary to have a vested interest in the shares held by the trust before the dividends it receives from the trust is exempt income. This removes the possibility of companies being beneficiaries of discretionary trusts.

The requirement to hold shares from the date a dividend is declared to the date the dividend is paid out is impractical and ignores the necessity to react quickly due to market volatility. This requirement also indirectly hinders market liquidity.

Proposed solution
The proposal must be reconsidered by National Treasury.

324  Anti-avoidance: Debt without set Maturity Dates

Clause 23 / Section 24J
Problem statement (i)
It is proposed that the following definition of “demand instrument”, be introduced into section 24J:

“demand instrument means any instrument where the holder of that instrument has, at any time during a year of assessment, a right to require the redemption of that instrument at any time before the date specified in terms of that instrument as the date of redemption of that instrument” (our emphasis)

This definition implies that only instruments with specified dates of redemption will constitute demand instruments, as defined. This may have the unintended consequence that all instruments without specified dates of redemption, will not qualify as demand instruments and, consequently, instruments such as revolving credit arrangements and overdraft facilities may by default be deemed to be “perpetual instruments”, as defined in section 8G.

Consequently, interest paid in respect of these instruments would not be allowed as a deduction and would be deemed, both in relation to the issuer and the holder of that instrument, to be a dividend. It seems absurd that interest on, for example, a standard overdraft facility be treated in this manner.
Further, what are the consequences if the issuer can demand redemption before that date?

**Proposed solution**
It is suggested that the definition of demand instrument be amended so as to accommodate instruments, such as revolving credit arrangements and overdraft facilities, which do not have specified dates of redemption.

**Problem statement (ii)**
The proposed definition of “date of redemption”, which is to be introduced into section 24J, states that where *the terms of an instrument do not specify a date on which all liability to pay all amounts in terms of that instrument will be discharged*, the date of redemption will be the date on which, on a balance of probabilities, all liability to pay all amounts in terms of that instrument is likely to be discharged.

However, section 8G defines a “perpetual instrument” to mean:

“*any instrument as defined in section 24J the terms of which do not specify any date on which all liability to pay all amounts in terms of that instrument will be discharged*” (our emphasis)

The interaction between section 24J and section 8G is unclear. Surely the above definitions do not imply that it is possible to construct a date of redemption in respect of all instruments and thus prevent an instrument from constituting a perpetual instrument, in order to avoid the concomitant unfavourable tax treatment?

**Proposed solution (ii)**
The interaction between section 24J and section 8G should be clarified.

### 3.25 Anti-avoidance: Third-party Backed Shares

**Clause 21 / Section 8EA**

**Problem statement**
It is not apparent what the mischief is that is intended to be addressed by the proposed introduction of section 8EA, while the outcome could adversely affect ordinary commercial arrangements. The types of financial arrangements identified in the EM are normal commercial arrangements that are utilised in everyday commercial transactions that do not have as intended result the avoidance of tax. It is common, for example, to provide for the buy-back of shares in an employee share incentive scenario, or in relation to BBEE deals where the target company has provided vendor finance. In addition, it may be that a company disposes of the shares in a subsidiary but agrees to reacquire the shares should the subsidiary not meet certain agreed profitability targets. It holding company in this scenario may instead have guaranteed the profitability of subsidiary, which would then also result in any dividend declared in respect of the shares to be taxable in full.
Proposed solution
It will be apparent that the introduction of the proposed section 8EA will adversely affect a number of genuine commercial transactions and should not be adopted. While provision has been made for SARS to rule that a particular transaction will not fall within the ambit of the proposed new provisions in certain circumstances, the relief measure is subject to a cut-off date. While it may seem that concerns regarding the broad application of the proposed new section may be addressed by merely giving SARS unrestricted discretion to rule that a transaction will not fall within the ambit of section 8EA (i.e. do not provide for a cut-off date), this procedure will be burdensome both for taxpayers and SARS and does not seem to us to be a solution.

4. INCOME TAX: INTERNATIONAL

4.1 Re-haul of the Controlled Foreign Company (CFC) Regime

Clause 27 / Foreign financial instrument holding company (“FFIHC”)

Problem statement (i)
The removal of this concept from section 9D is welcomed. However, it is retained for both section 10(B) and Paragraph 64B of the Eighth Schedule.

Historically the provisions have seemingly been aimed at trying to combat avoidance arrangements where money lenders have set up operations for the main purpose of round tripping funding structures. Currently, it is rare to find a foreign company that meets the definition of a FFIHC.

This is because the companies typically hold the following types of financial assets which are either wholly or partly disregarded in the calculation:

Cash in a bank account – base cost = market value
Intra-group loans – typically disregarded (through various provisions in the legislation)
Non-intra-group loans – typically interest bearing 24J instruments that are disregarded
Intra-group shares – typically disregarded

The reason for retaining these provisions is seemingly difficult to understand and the administrative burden (especially when considering the need to look at market values) is often overwhelming.

Proposed solution
It is therefore suggested that the test be removed from the Act entirely. The provisions relating to round trip financing should be sufficient to prevent abuse of the law.

Problem statement (ii)
The current section 9D(9)(b)(iii) provides an exemption for foreign currency gains which arise in the CFC’s normal course of business (and the CFC must not be a so-called FFIHC).
The proposed amendments, however, do not provide an exemption for such foreign exchange gains arising in the CFC’s normal business operations. Instead, all foreign exchange gains are treated as "bad" passive income. For example, if a CFC has significant trade debts which are outstanding for a period and in respect of which an exchange gain is realised, that exchange gain could be subject to tax in South Africa.

**Proposed solution**

We suggest that it would be equitable to reintroduce the exemption for foreign currency gains which arise in a (non-FFIHC) CFC's normal course of business.

It is completely inequitable and displays a fundamental lack of understanding of commercial reality to treat foreign exchange gains made in the ordinary course of business as if they were akin to passive investment income. Unlike passive investment income, taxpayers have absolutely no control over the size of any exchange gains or losses that might be triggered on normal trade debt. SARS should not have to allow deductions in this regard and taxpayers should not have exchange gains derived by active trading CFCs imputed to them for SA tax purposes.

**Clause 27 / Section 9D(9A)(a)(iv)**

**Problem statement**

The proposed section 9A(a)(iv) of the Act proposes that notwithstanding the existence of a foreign business establishment (FBE), the income of a controlled foreign company which arises by way of rental in respect of movable property must be attributed to the South African shareholder, unless that movable property arises in terms of an operating lease, as defined.

Operating leases are essentially defined as leases which are less than 12 months, and in which all the risks and rewards of ownership are retained by the owner.

This, very broadly, results in all income from finance leases and operating leases with duration of more than 12 months being attributable to South African resident shareholders in a CFC. It is supposed that Treasury expects that such income would generally arise in banks, which are covered under elsewhere in the section. However, we are aware of circumstances where fully fledged businesses owned by foreign companies (not banks), which incorporate the ownership and management of assets (e.g. office equipment like photocopiers, and aircraft), which are leased for more than 12 months, and in which the risks and rewards of ownership are assumed by the lessee albeit that they are managed by the owner through their managing arms (extensive business operations) would be drawn into the attribution net (the tax paid in the owning companies’ countries of residence being less than 75%). This is surely not the intention.

Furthermore, in some circumstances the remedy may be for a South African shareholder to reduce its ownership below 50% because the net after-tax return may be higher even with the lower shareholding. This would reduce the net inflow of monies into South Africa. Surely this is not the desired result.
Proposed solution
In order to solve this problem it would be necessary to remove the reference to operating lease in the proposed legislation and to rely on the requirements of the FBE to ensure that ‘dormant’ CFC companies which own movable assets with operating leases that are greater than 12 months or finance leases are not exempted from the CFC attribution requirements.

Clause 27 / Section 9D(9A)
Problem statement
The proposed new rules may result in the need for South African residents to attribute certain income from CFC’s which are companies whose shares are listed on an internationally recognized stock exchange (especially passive type income from companies below the listed companies) into their hands. It may be difficult for the South African residents to determine the amounts that are required to be attributed (only consolidated AFS are issued).

Proposed solution
The extension of para (a) to the proviso to the definition of controlled foreign company to cover participation rights and not just voting rights i.e. to state that ‘no regard must be had to any participation rights in any foreign company (i) which is a listed company; or (ii) if the participation rights in that foreign company are exercisable indirectly through a listed company;’ (suggested changes reflected in italics) would alleviate this problem. The references to voting rights only in this proviso are, in any event, somewhat perplexing.

Clause 27 / Section 9D
Problem statement
The definition of CFC is being extended to cover the situation where any person that is a resident or any resident companies that is or are ‘entitled to remove or appoint the majority of the members of the Board of Directors of that foreign company, the majority of some other body of persons with comparable authority or some other person with comparable authority’. Although the Board of Directors is clear, the reference to ‘some other body of persons with comparable authority’ is confusing since who else would run a company than the Board of Directors. This needs to be made clearer.

Proposed solution
It needs to be stated that the other body of persons refers to the equivalent of the Board of Directors for the entity which falls into the definition of company or in a country where different terminology is used.

Clause 27 / Section 9D - Foreign company definition
Problem statement (i)
Prior to the amendments in the TLAB, a headquarter company was excluded from the definition of a "controlled foreign company" ("CFC") in section 9D. The TLAB proposes to amend the definition of "controlled foreign company" to remove the words "other than persons that are headquarter companies". In addition, headquarter companies have been included in the definition of "foreign company" in section 9D.
Accordingly, it now appears that a headquarter company could qualify as a CFC, and the headquarter company's income could be imputed to its South African shareholders, for South African income tax purposes. We understand that National Treasury has suggested this amendment because National Treasury views the use of a headquarter company which is interposed between South African shareholders and foreign subsidiaries as undermining the CFC regime. However, we do not believe that the current legislation allows for a headquarter company which is held by South African shareholders to undermine the CFC regime. The reason for this is because the South African shareholders would ultimately still have been taxable on the foreign subsidiaries' income in terms of the CFC rules, if the foreign subsidiaries had qualified as CFCs, even though a headquarter company was interposed between the South African shareholders and the foreign subsidiaries.

The amendment creates confusion as now it would seem that the South African tax resident direct or indirect shareholders in a headquarter company (if more than 50% of the participation rights in the headquarter company are held by South African residents) will have the headquarter company’s income imputed to them for CFC purposes. This would be in addition to having the income of the headquarter company’s foreign subsidiaries imputed to them as well.

**Proposed solution**
We believe that this amendment is unnecessary as the existing legislation should adequately cater for the situation where South African shareholders ultimately hold foreign subsidiaries via a headquarter company.

**Problem statement (ii)**
The inclusion of the Headquarter company as a foreign company would mean that when preparing a tax return for a South African shareholder that owns a share in a HQC, it would be necessary to treat the HQC as a CFC. This does not seem appropriate as the HQC would be taxed in its own right as a SA resident.

**Proposed solution**
Remove the reference to HQC in the definition of foreign company.

**Problem statement (iii)**
A new definition of "foreign company has been inserted in section 9D (in addition to the definition of "foreign company" which already exists in section 1). We assume that the new section 9D definition applies for purposes of section 9D (and other sections where it is specifically mentioned, such as the amended paragraph 64B of the Eighth Schedule), whilst the section 1 definition of "foreign company" applies to the rest of the Income Tax Act, No 58 of 1962, as amended.

**Proposed solution**
It would be helpful if this assumption could be clarified.

**Problem statement (iv)**
The definition of "CFC" has been extended to include foreign companies that are under the control of South African residents. The term "govern" is used in paragraph (b)(ii)(aa) of the amendment to the definition of "CFC". It would be helpful if "govern" were defined in the legislation in order to provide taxpayers with certainty as to how this concept should be interpreted.

On page 90 of the EM it states that "If a foreign company becomes a CFC by virtue of de facto control, the tainted income will be attributed completely to the South African person having de facto control. If a South African group jointly has control, SARS will nominate the appropriate company for attribution."

We are of the view the power to nominate the company to which the income should be attributed could be very unfair in some instances, for example, where the Commissioner attributes a CFC's income to a South African company which has control over a CFC, but does not have any entitlement to, and will never have any entitlement to, the CFC's income. In this case, the South African company may not have any funds of its own to pay the tax on the attributed income, and without a right to the CFC's income it may be impossible for the South African company to meet the South African income tax obligations which have been imposed on it by the Commissioner.

Proposed solution
We believe the whole issue of how to allocate a CFC’s income in the situation where several South African residents (not necessarily forming part of a group of companies) have de facto control over the foreign company requires considerably more thought. At this point, it is impossible for taxpayers to be able to assess whether or not they might have any liability in this regard (unless the circumstances involve a single South African tax resident having de facto control over the CFC).

Clause 27 / Section 9D(9A)
Problem statement
The proposed changes to the diversionary rules provide far greater clarity on the application of the law. There are a few anomalies, however.

Proposed solutions
It is suggested that the proposed diversionary rule relating to inbound sales to a connected party resident also be removed and for such transactions to be policed through transfer pricing. Alternatively, if the rule is retained, perhaps include a de minimus rule, which is simple to apply. For example: limit it to inbound sales to connected party residents that are priced in accordance with the provisions of section 31 and do not exceed 10% of the gross amount of sales of the CFC.

Furthermore, with regard to the de minimus rule on passive income streams (the proposed subsection (9A)(a)(ii)BB), it is suggested that the current 10% threshold be retained. Currently interest rates overseas are very low, so the 5% would seem reasonable, however
currency fluctuations, which are completely out of the control of a CFC, have become increasing volatile in current market conditions so a slightly higher threshold would seemingly be reasonable to cater to such amounts that are uncontrollable.

**South African matching deduction**

**Problem statement**
The exemptions provided under the new mobile income rules will not apply where a South African connected person enjoys a deduction of the income received by the CFC. However, this could lead to inequities, for example, in the case of royalties, where a South African company could have paid the same royalty to an independent third party, claimed a tax deduction for the payment, and the royalty would not have been imputed back to South Africa, but because the South African company pays the royalty to a connected CFC that amount no longer qualifies for the CFC exemption even though the IP to which the royalty relates may have been owned by the CFC for years prior to the CFC being acquired by a South African owned group and hence becoming a CFC. There are taxpayers who have deliberately acquired companies abroad which own IP because South Africa has been making use of the IP concerned. The transfer pricing rules in the foreign country generally prevent the IP from being licensed to SA royalty free.

**Proposed solution**
We believe the imputation of royalty income is already more than adequately covered by the proposed section 9A(9(a)(v) and (vi).

**Working capital exemption**
The revised mobile income rules have deleted the 10% *de minimis* exemption in respect of passive income, and have introduced a "working capital exemption" in terms of which financial instrument income must not exceed 5% of the CFC's total receipts and accruals. However, as the denominator in the working capital exemption includes amounts arising from exchange gains, it is wider than the denominator in the *de minimis* exemption. In addition, the percentage threshold has halved from 10% to 5%. We believe that the combination of these two factors is potentially unfair, and could subject a CFC's legitimate business income to South African tax, where it would have been exempt under the existing rules.

**Rental income**
The proposed exemption from imputation of rental income only extends to operating leases. We believe the exemption should apply equally to financial leases.

### 4.2 Unification of the Source Rules

**Clause 27 / Section 9**

**Problem statement**
The proposed codification and clarification of the source rules in the revised section 9 is welcomed. It is noted that foreign annuities and pensions are to be sourced in the same way as earnings from employment services rendered, by straight time apportionment. This principle...
applies only to retirement annuities and not lump sums, since it is SARS’ view that the section 10(1)(gC) exemption applies only to annuities, not to lump sums.

The Second Schedule para 2(1) however remains “subject to section 9(1)(g)...”.

**Proposed Solution**
National Treasury to confirm by what mechanism the foreign-sourced portion of retirement lump sums should be exempted, if at all, if section 10(1)(gC) applies only to annuities. Furthermore, National Treasury to confirm whether and how the Second Schedule and the gross income definition is to apply to lump sums paid by foreign pension funds (in cases where South Africa has taxing rights under a Double Tax Agreement).

4.3 Special Foreign Tax Credits for Management Fees

**Clause 12 / Section 6quin**

**Problem statement**
No provision is made for carry forward of unused rebates as is the case with section 6quat.

**Proposed solution**
Provision should be made for unused rebates. Clause 12 / Section 6quin(4) should refer to subparagraph 2(b) and not subparagraph 2(a).

4.6 Transfer Pricing: Correlative Adjustments

**Clause 62 / Section 31**

**Problem statement (i)**
It is proposed that section 31(1)(b) be amended to read as follows:

“...any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm’s length.”

Thus it would be necessary to determine whether the entire cross-border connected party transaction was concluded on arm’s length principles, and that not only the price at which a transaction is concluded needs to be considered. We understand that such consideration would encompass thin-capitalisation. However, it is not certain in all instances as to how the arm’s length nature of an agreement, as whole, is to be determined.

**Proposed solution**
Clarity and guidelines need to be provided as to how the arm’s length nature of a transaction, as a whole, is to be determined and what taxpayers would need to evidence in order to show compliance with the proposed requirements.
Problem statement (ii)
The proposed section 31(3) reads as follows:

“...the Commissioner may deem the amount of that difference to be a dividend for the purposes of section 64D.”

Any difference in the value of a transaction and its arm’s length value will no longer automatically be deemed to be a dividend. Instead, the Commissioner will now have the power to make secondary adjustments and, in particular, to create a deemed dividend. However, Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, on which the agreements for the avoidance of double taxation entered into by South Africa are generally based, does not provide relief in respect of secondary adjustments and thus a secondary adjustment could result in double taxation. Many countries reject secondary adjustments, and the OECD, in the 2010 OECD Transfer Pricing Guidelines, cautions tax administrations from imposing secondary adjustments. In addition, this proposal provides SARS with a discretion regarding the imposition of secondary adjustments, which may lead to discriminatory, or at least to perceived discriminatory treatment of taxpayers. Furthermore, the (revised) general penalty provisions in the Act provide that such penalties may be imposed where taxpayers enter into cross-border connected party transactions which are not at arm’s length. Thus, the need for secondary adjustments as additional penalties and deterrents is obviated.

Proposed solution
The provision for secondary adjustments should be removed from section 31, or, at the very least, clear guidance should be provided as to the circumstances, in which SARS is to make secondary adjustments, as contemplated in the proposed new section 31(3).

4.8 Foreign Currency: Matching Exchange Item Relief

Clause 56 / Section 24I(1) removal of definition of “affected contract”

Problem statement
An affected contract is generally the same as a cash-flow hedge in accounting. If hedge accounting was applied by a taxpayer, the mark-to-market of the relevant FEC would be recognised in the statement of changes in equity, and not in the income statement. The tax treatment of an affected contract required that no foreign exchange differences were recognised for such FEC until it is realised, which therefore followed the accounting treatment. The proposed change may result in a mismatch between tax and accounting treatments for FECs where hedge accounting is applied. Once again, an unrealised foreign exchange difference is brought into account for tax purposes, but not included in the company’s income statement for accounting purposes.
Proposed solution
Tax treatment for cash-flow hedges should follow the accounting treatment thereof, which means that the tax treatment of unrealised foreign exchange differences should not be brought into account for tax purposes. Only realised exchange differences should be subjected to tax.

Clause 56 / Section 24I
Problem statement
Clause 56(1)(g) in terms of which section 24I(11) is amended, will have a negative impact on companies.

Proposed solution
We accordingly request that the proposed amendments to change from the “deferral rules” to the “exemption system” not be implemented or that the following amendments to section 24I(11) not be implemented:
“(ii) Install, erect or construct any machinery, plant, implement, utensil, building or improvements to any building;
(iii) devise, develop, create, produce, acquire or restore any invention, patent, design, trade mark, copyright or other knowledge contemplated in section 11(gA) or (gC)”

4.10 Incentive: Headquarter Company Adjustment

Clause 7 / Section 9I(1)
Problem statement (i)
The wording of section 9I(1)(c) implies that only companies who have already obtained the approval referred to in subsection (3), may actually apply to the Minister for approval as a headquarter company.

Proposed solution
It is suggested that section 9I(1)(c) be deleted, in order to correct this error.

Problem statement (ii)
The wording of section 9I(1) implies that the relevant approval must be obtained annually. This makes participation in the headquarter company regime more cumbersome. It is not evident what wrong is intended to be remedied by implementing such an onerous approval process.

Proposed solution
The approval requirement should be removed. The corporate tax return should have a question or declaration where the public officer confirm that the company met all the headquarter company requirements.

5. VALUE-ADDED TAX

5.1 Temporary for the rental of Residential Property by Developers
Clause 146 / Section 18B of the VAT Act

Problem statement
The proposed relief measure is to be welcomed. However, it is unclear why the relief measure should be limited to "developers" as defined and not to any vendor who acquires fixed property for the sole purpose of disposing thereof in the course or furtherance of its enterprise. For example, a vendor may acquire distressed residential property with the sole purpose of disposing of such property at a profit as soon as possible. The vendor may not make any improvements to the property prior to the resale thereof. However, the vendor may continue to allow residential tenants to occupy the property while it attempts to dispose of the property. There does not seem to be any reason why the vendor in these circumstances should be denied the relief.

Proposed solution
It is recommended that the proposed relief should be available to all vendors, and not limited to "developers" as presently defined.

Other: Clause by Clause Amendment

Clause 80 / Section 64C

Problem statement
It is proposed that section 64C(4)(a) is to be reinstated into the Act with retrospective effect from 1 January 2011. However, the wording of section 64C(4)(a) will not be identical to what it was prior to its repeal.

The new proposed section 64C(4)(a) will exclude an amount from being a deemed dividend if "...the amount constitutes a dividend". However, there is no reference to amounts which would have been a dividend but for the specific exclusions provided for in the dividend definition, as there was before.

A capital reduction would theoretically fall into section 64C(2)(a) and be a deemed dividend, because it is cash transferred to a shareholder. The definition of “dividend”, which was introduced from 1 January 2011, specifically excludes amounts that constitute a reduction of contributed tax capital (“CTC”) from being a dividend. Thus, to the extent that a capital reduction reduces a company’s CTC, it will not be a “dividend” as defined. Thus, although a capital reduction is not a “true” dividend in terms of existing legislation, the new section 64C(4)(a) does not exclude it from constituting a “deemed dividend”.

The same logic would apply to a distribution by a company of its own shares (which is also specifically excluded from the definition of “dividend”).

Proposed solution
Section 64C(4)(a) is to be amended to exclude an amount from being a deemed dividend not only if “…the amount constitutes a dividend”, but also if the amount would have been a
dividend, but for the specific exclusions provided for in the dividend definition, as there was before.

**Clause 40 / Section 12H**
We suggest that amendment to section 12H come into operation with effect from years commencing on or after 1 January 2011 to ensure that taxpayers may also claim a section 12H deduction for the period 1 October 2011 to 31 March 2012. It is currently proposed that the proposed amendment only come into effect for years commencing on or after 1 January 2012.

**Clause 116: para 19(3)(a) of the Eighth Schedule**
The proposal must be amended from 2 years to 18 months.

**Clause 122(a) / par 55 of the Eighth Schedule**
The proposal should come into effect on or after 1 January 2011 to apply to long term insurance policies that were ceded by employers to its employees after the 2010 amendments to section 11(w).

**Clause 124(c) / paragraph 64B(2)(a)(i) of the Eighth Schedule**
The words “in that controlled foreign company” should be changed to “in that foreign company”.

**Effective dates: 1 January 2011**
Bearing in mind that the 2011 tax year for employees ended on 28 February 2011 and most law abiding employers have already finalised their employees' tax reconciliations and issued IRP5's to their employees for that tax year, the effective date should be revised to 1 March 2011 where advised alternatively 1 January 2012.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

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