Dear Sir

CALL FOR COMMENT: DRAFT TAXATION LAWS AMENDMENT BILL 2010, DRAFT TAXATION LAWS SECOND AMENDMENT BILL 2010 (“DTLAB 2010”) 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 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 BILL 2010 AND DRAFT EXPLANATORY MEMORANDUM

MAIN AMENDMENTS

2. INCOME TAX: MISCELLANEOUS INDIVIDUALS AND SAVINGS AMENDMENTS

2.1 EMPLOYER-PROVIDED MOTOR VEHICLES

Clause 87 / Paragraph 7 of the Seventh Schedule to the Act

Paragraph 7 of the Seventh Schedule determines the value of the private use of an employer provided motor vehicle. The proposed amendment to the paragraph will change the definition of the determined value to include the value added tax paid on the vehicle, the rate charged on the determined value for calculating the value of the fringe benefit tax from 2.5% to 4% and allow for further deductions against the fringe benefit amount charged upon assessment. The EM also states that the value of maintenance / service plans will be included in the determined value, a concession that is currently granted to employees by SARS in the EMP10 Guide for Employers in respect of Employees’ tax.
Problem statement 1

1. The inclusion of the value added tax in the determined value of the vehicle, based on the presumption that employers are unable to claim the input credit on these vehicles is problematic. Employers are able to claim the input VAT on certain vehicles, such as non-passenger vehicles. It should also be noted that the employer also has to account for output VAT on based on the determined value of the vehicle on a monthly basis. The Value Added Tax Act clearly distinguishes between vehicles on which input VAT can be claimed (0,6%) and where no input VAT is claimable (0,3%) based on the determined value of the vehicle.

2. Some vehicles are purchased without a maintenance / service plan either by choice or by default. Vehicles that include maintenance / service plans will, if the amendment is effected, carry a higher fringe benefit rate when compared to vehicles that do not have maintenance plans. The employer can pay for all required maintenance on these vehicles without incurring an additional fringe benefit cost for the employee. In addition, some vehicles’ maintenance plans / service plans might have expired but the employee still has the use of the vehicle post this expiry date. Also, some employers might have chosen to extend the maintenance plans / service plans post expiry, paid the additional cost, and some might not have. It is unclear if these expired or extended plans will be included in the determined value as indicated in the EM. It is also submitted that part of the 4% monthly fringe benefit value already includes a portion for the fringe benefit relating to the employer incurred maintenance cost. By also adding the cost of the maintenance plan to the cost of the motor vehicle for the purpose of applying the 4% fringe benefit rate, it is submitted that the taxpayer is being ‘penalised twice’.

3. The CO2 tax, or carbon emissions tax, was announced in the Budget speech and is due for implementation in September this year. It is estimated that the new tax will increase the cost of a new vehicle from R2000 upwards to an amount as much as R20 000, depending on the amount of carbon emissions the vehicle produce. We don’t believe that consideration has been given to whether or not this new tax will be included in the determined value of a vehicle. In reading the draft Bill and EM, one can assume that the intention is to include all costs and taxes, i.e. to tax the full cost to the employer of the vehicle; which will also include the CO2 tax. Employees will now suffer a monthly fringe benefit tax on the cost of the vehicle including tax; VAT and CO2 taxes.

4. There is no distinction made between “tool of trade” vehicles and the company car “schemes”. By “tool of trade” we mean that the vehicle is an essential tool that enables the employees to perform his / her duties, for example a delivery man that has the dedicated use of a small bakkie, van or delivery vehicle. The assumption is that all employees that have the use of an employer provided vehicle is given the use of the vehicle as a benefit aimed at assisting the employee in his/her personal capacity. It also assumes full private use with some relief provided on a monthly basis. Even though some employers have benefit “schemes” whereby employees are provided with vehicles as a benefit, there are many employers that provide employees with vehicles to fulfil a real business need. These would include, in the financial services industry, home assessors, client relations officers, IT support personnel who on a regular, daily basis use the vehicles to support
essential services or service customers. It is not always efficient for these employees to go to the office to collect a pool vehicle for the day and return it after their working day. Also, employees who are on standby or call-out might need instant access to a vehicle to enable them to go to a site (ATM’s for example) or clients at any time of the day. In these instances, the requirement to keep the vehicles at the employers’ offices is not practical. We also believe that, from a risk and insurance point of view, pool vehicles historically have had higher incidents of damage to the vehicles, traffic fines and claims.

5. We submit that the 4% value applied against the value of the vehicle is not in line with the actual cost of maintaining and running the vehicle. For example, the monthly cost of running a vehicle with a cost price (VAT inclusive) of R200,000 (30% residual value financed over 54 months and travelling an average of 25,000 km per year) is approximately R7,186 calculated by using the Automobile Association’s rates for maintenance, fuel etc. and including any repayments and insurance arrangements. The current fringe benefit on that vehicle would be R8000, to be included monthly at 80% (R6400 would be included in the employee’s monthly employees’ tax calculations). The fringe benefit is clearly higher than the benefit received.

6. Some employees that currently make use of an employer provided vehicle could be in a position whereby they would not be able to finance a vehicle in their own, private, capacity due to their credit scoring / debt review process. Where these employees are required to have a vehicle available to them for business, the employee would be in a position whereby he / she would be taxed on an increased fringe benefit tax value but would also not be able to apply for financing in their own capacity. This would put both the employer and the employee in a very difficult position.

Proposed solution 1

1. Where an employer is able to claim the input VAT on a vehicle, the determined value should not include the VAT portion.

2. The maintenance plan should be excluded from the determined value to achieve an equitable outcome for all vehicles as it relates to an operating expense.

3. We propose that the legislation be amended to distinguish between benefit “schemes” such as those that allocate funds from a Cost To Company package and a “tool of trade” vehicle given for legitimate business use. This can be achieved by providing an exemption for this purpose in paragraph 7 to the Seventh Schedule to the Act.

4. The rate of 4% should be revised to bring it in line with the actual benefit received, i.e. the expense incurred by the employer or the expense that the employee would have incurred if he/she had purchased, maintained and run the car themselves.
Problem statement 2

It has been proposed that current paragraph 7, subparagraph (9) of the Seventh Schedule is to be deleted. This would mean that the value to be placed on the private use of a vehicle is no longer subject to objection and appeal. There is no explanation in the EM as to why the right to object or appeal is to be removed.

Proposed solution 2

We propose that it be clarified as to what the reason for this change is.

Second Amendment Bill: Clause 18 / Paragraph 1 of the Fourth Schedule to the Income Tax Act, No. 58 of 1962 (“the Act”) definition of “remuneration”

The proposed amendment (clause 18) includes 80% of the fringe benefit due on employer provided motor vehicles, as determined in terms of paragraph 7 of the Seventh Schedule to the Act, in the definition of remuneration.

Problem statement

1. The Skills Development Levies Act, No. 9 of 1999 (“SDL Act”) and the Unemployment Insurance Contributions Act, No. 4 of 2002 (“UIF Act”) both define remuneration, to be used to calculate the relevant levies due, with reference to the Fourth Schedule to the Act. The EM explains that the starting presumption for the calculation of the fringe benefit due on the use of an employer provided motor vehicle is that all use is deemed to be private unless the contrary is proved. The proposed amendment also allows for a reduction in the fringe benefit upon assessment to be calculated as a ratio of actual business mileage over total mileage and expenses incurred by the employee.

This proposal will also now include 80% of the deemed private use of the vehicle (4%) in the calculation for amounts due for Skills Development (“SDL”) and Unemployment Insurance Fund (“UIF”). The presumption of private use is, therefore, extrapolated to the SDL and UIF contributions due for these employees regardless of actual business use. It is true that the UIF contribution is limited per employee but we submit that employees whose earnings fall below the threshold for UIF contributions that have the use of a dedicated pool vehicle for legitimate business reasons will also be negatively impacted. Employers also suffer a substantial increase in SDL levies due. There is no reciprocal reduction in the contribution due by the employer/e for SDL or UIF in the case of legitimate business use.

2. Employees that do travel frequently for business would have a higher percentage of business travel mileage than 20% of their total. It follows that such employees would only be able to claim relief on assessment. We believe that the delay experienced between the monthly employees’ tax charged and the refund upon assessment could create hardship for employees. We further believe that the monthly effect of the increase is substantial when compared to the previous legislation.
**Proposed solution**

1. The SDL and UIF contribution should both exclude a travel allowance and the fringe benefit on employer provided motor vehicles.

2. The employer should have the ability to, on a discretional basis; lower the percentage from 80% to a lower percentage for the purposes of withholding employees’ tax on a monthly basis. This would be only in instances where the employees have provided the employer with some form of proof of their actual business mileage for the prior tax year or their estimated future business mileage. Alternatively, the employee should have the option to apply to SARS for a hardship directive to fix the percentage of tax withholding on a monthly basis in this regard.

**Explanatory memorandum – 2.1 Employer-provided motor vehicles**

**Problem statement**

1. The memorandum refers to the Ministerial regulation GN177 Government Gazette 28850 of 24 February 2006. This memorandum was replaced by GN 216 Government Gazette 30796 of 22 February 2008.

2. The memorandum states that an across-the-board-use percentage reduction is calculated by reducing the fringe benefit (4%) with the result of the cost scale method as determined in the Government Gazette (see above). The new proposed paragraph provides merely that, upon assessment, the fringe benefit calculated by applying the 4% against the determined value must be reduced by the result of actual business kilometres (as per a logbook) divided by total kilometres travelled multiplied by the full fringe benefit. Only subparagraph (8)(b) of the Seventh Schedule to the Act refers to the rate published in the Gazette for the calculation of the cost of fuel. Subparagraph 7 of the Seventh Schedule to the Act does not refer to the regulations in the Government Gazette. It follows that all the examples are incorrect in that it applies these rates against the fringe benefit.

**Proposed solution**

1. The memorandum should refer to the correct Government Gazette.

2. The correct position in Example 1 is:
   
   Gross Fringe benefit (R144 000) x Business kilometres (10000)/ Total kilometres (40000)
   
   =R36 000
   
   Amount taxable amount upon assessment is R144 000 less R36 000 = R108 000

   The correct position in Example 2 is:
   
   R144 000 – R36 000 – R23 700
   
   = R84 000
2.2 MERGING LUMP SUM TERMINATION EMPLOYMENT PAYMENTS INTO THE PENSIONS WITHDRAWAL TAX TABLE

Clause 6(1)(zA) / Section 1 “severance benefit” definition and Appendix 1

Problem statement
The tax tables taxes the severance benefit. The section 23(i) prohibition does not, AND SHOULD NOT, apply to the severance benefit. The gross amount (accrued or received) in respect of these benefits can be reduced by deductions, such as retirement fund contributions or medical expenses.

Proposed solution
The table should only apply to the “taxable” portion of the severance benefit.

Clause 7 / Section 5(10)

Problem statement
The proviso only refers (and excludes lump sums). The definition of lump sum does not include severance benefits.

Proposed solution
The formula must exclude severance benefits as well.

2.3 KEY EMPLOYEE INSURANCE SCHEMES

Clause 20(1)(j) / Section 11(w)

Problem statement 1
It is not clear if all the requirements or only one of the requirements listed under items (i) to (iv) should be present.

Proposed solution 1
Items (i) to (iv) should be separated by either an “or” or an “and”.

The Budget Speech – Tax Proposals on page 6 when dealing with the employee deferred compensation and insurance schemes, comments that “(P)roblems also exist with employer provided group life insurance schemes.”

Problem statement 2
The proposed legislative amendments do not deal with employer provided group life insurance schemes at all. It is submitted that there is wide spread confusion as to the exact tax implications in relation to these so-called unapproved schemes covering group life, disability and dread disease. The
group life insurance contracts are usually between the employer and the insurance company. In terms of the contract the employer is liable for the payment of the premium and also receives the payment from the insurance company upon the happening of an insured event, typically death or disability.

Since there is no liability on the employee to pay the premium, a fringe benefit does not arise if the premium is paid by the employer. The fringe benefit may arguably be that the employee is receiving a service funded by the employer, but there are differing opinions as to whether a fringe benefit does in fact arise.

The employer usually deducts the premium in terms of section 11(a) and not section 11(w). The payment received by the employer is included in gross income by virtue of paragraph (m) of the gross income definition which includes in gross income, inter alia, any amount, whether of a capital nature or not, received or accrued to the taxpayer under any policy of insurance upon the life of any person who, at any time while the policy was in force, was an employee or director of the taxpayer, if any premium paid in respect of such policy is or was deductible from the taxpayer’s income, whether in the current or any previous year of assessment under the provisions of section 11.

The payment of the lump sum to the employee or his/her dependents/estate is again deductible in terms of section 11(a) if it is company policy to make such payments.

The payment received by the employee or his/her estate or dependants may or may not be gross income. While clearly of a capital nature, the amounts will be gross income if they fall within the scope of paragraphs (c) or (d) of the gross income definition. Whether these payments fall within the scope of these paragraphs depend on whether they were received by virtue of employment or in respect of services rendered (paragraph (c)) or in respect of the loss or termination of office (paragraph (d)).

In Stander v CIR¹, Friedman JP held that the phrase “in respect of or by virtue of” means that services rendered or to be rendered must be the causa causans of the amount received and that it was not sufficient if such services were merely a causa sine qua non of the amount received. A particular causa sine qua non, being a factual cause, is not a causa causans, being a legal cause, if an independent, unconnected and extraneous causative fact or event intervenes which isolates the services of the employee from the final result, thereby relegating the causa sine qua non to the status of a mere historical antecedent or background feature. Other cases agree – refer De Villiers v Commissioner for Inland Revenue², Stevens v CSARS [2006] SCA 145 (RSA), CIR v Shell Southern Africa Pension Fund (46 SATC 1) and Commissioner for South African Revenue Service v Kotzé (64 SATC 447) to name a few.

It could be argued that the causa causans of these payments if the event that resulted in the disability or death of the employee and not the employment policies (i.e. not the services rendered or the employment or the loss of office).

SARS seems to confirm this view in the Income Tax Practice Manual on page A-419:

¹ 1997 (3) SA 617 (C)
² 1929 AD 227
“Where the proceeds of an accident or stated benefits policy, received by an employer as a result of an accident occurring to an employee, are paid over to the employee concerned or to his estate, widow or dependants the receipt is not subject to tax thereon. Such payments would be made in respect of injury or death suffered by the employee, and, being unconnected with services rendered, are not taxable”. (our emphasis)

There is also a lot of confusion amongst taxpayers in relation to "approved" (group life and permanent disability) and "unapproved " benefits of a retirement fund with regard to the tax treatment (corporate deduction and employees' tax) thereof.

**Proposed solution 2**

We propose that premiums paid by employers to insurance companies in terms of group personal accident schemes are deemed to be a fringe benefit irrespective of who the contracting parties in the contract of insurance is. This will result in the employer claiming the deduction at the same time as the amount being included as a fringe benefit in the hands of the employee.

Upon the happening of an insured event, the amount paid to the employer by the insurance company will still constitute gross income in the hands of the employer with a corresponding deduction upon payment to the employee, which will not form part of gross income of the employee nor will it be subject to Capital Gains Tax.

In relation to approved benefits, legislation should state that approved benefits will not result in a taxable benefit and that the amounts paid out will be taxed in the hands of the individual in terms of the 2nd Schedule - therefore no PAYE obligation placed on the employer.

**Problem statement 3**

Employees are often required to travel offshore for business purposes and more often than not, are required to be insured for death or disability. Employers often take up short term insurance policies from offshore insurers. Upon the happening of an insured event, the offshore insurance company pays the employee directly to cover the costs associated with the happening of the event outside South Africa.

Paragraph 53 of the Eighth Schedule excludes capital gains and losses in the hands of a natural person (or special trust) determined in respect of the disposal of personal use assets. Short term insurance policies are not deemed to be personal use assets but only to the extent to which the policies relates to any asset which is not a personal use asset. This paragraph applies only to short term policies as defined in the Short Term Insurance Act, i.e. provided by South African registered insurance companies.

This means that payments to an employee in terms of short term insurance policy with an offshore insurer will not be exempt.

**Proposed solution 3**

We propose that the Eighth Schedule be amended to also refer to short term insurance policies issued by insurance companies registered as such under the laws of a country other than South Africa.
2.4 NARROWING THE INTEREST THRESHOLD EXEMPTION

Clause 17(h) and (i) / Section 10(1)(i)(xv) of the Act

Problem statement 1

It is respectfully submitted that the proposed narrowing of the interest threshold exemption poses the following problems:

Taxpayers are entitled to consistency on the part of Treasury and to have confidence and certainty in the application of laws, regulations, policies and procedures pertaining to the making of long term investment decisions and estate planning. The current proposal will achieve exactly the opposite.

The proposed amendment favours certain categories of interest bearing products and institutions thereby interfering with the free market system and the creation of monopolies in the financial sector.

The proposed amendment will discourage the establishment and growth of new and existing investment products by institutions that may find it difficult to compete with the larger organizations preferred by Treasury and/or meet its criteria for inclusion.

There are several existing and potentially new investment products besides those earmarked by Treasury, which adequately promote comparable savings by middle and lower income groups that flow into the general economy. The proposed amendment will unjustly discriminate against these products.

The proposed amendment will stifle future economic growth by discouraging shareholders or connected persons from providing loan capital as a means of financing to closely held companies or small businesses. This may outweigh the intended benefits to be derived from the proposed selective narrowing of the exemption. The impact is widespread.

The proposed amendment will similarly stifle future economic growth by discouraging disconnected persons/investors from providing loan capital as a means of financing distantly held or unconnected companies or small businesses.

The proposed amendment will have a negative impact on existing estate planning structures and investments which may prove difficult, costly and in some cases impossible, to convert or transform.

Proposed solution 1

It is respectfully submitted that the proposal should be removed altogether.

Problem statement 2

The proposed amendment will limit the interest exemption available to interest earned from certain specific sources such as banks, collective investment schemes etc. It is proposed that interest earned from other sources, for example personal loans, loan accounts with entities etc should not qualify for the annual interest exemption available to natural persons. As a result of this amendment, some taxpayers will suffer undue hardship. This can be best illustrated by way of an example:
A taxpayer sold his primary residence that he lived in to an unconnected natural person. Due to the economic conditions, or other reasons, the purchaser is unable to obtain a loan from a financial institution. The seller in his private capacity therefore provides a personal loan (20 year term) to the purchaser and registers a mortgage over the property as security. As these are unconnected parties the terms of the loan (interest rate etc) are market related. The seller would therefore receive interest on the loan for the next 20 years. Unfortunately, if the above proposed amendments are accepted, the seller would not qualify for the annual interest exemption. This result surely does not appear fair and equitable and could not be the intention of the legislator? If the purchaser would have obtained a loan from a bank, the seller would then have received the whole amount of the selling price at the date of the sale. If the seller had chosen to invest these funds with a bank and earned interest, the seller would have qualified for the interest exemption for natural persons in its amended form, compared to no interest exemption if a personal loan was provided. Surely the result should be the same?

There are also other examples such as retired individuals who have invested in private projects earning interest on the amounts invested as part of their retirement income. These retired individuals would according to the proposed amendments not qualify for the interest exemption for natural persons, and their monthly income would as a result be reduced due to the fact that they would have to make provision for the additional tax liability. Such taxpayers might be contractually bounded to these agreements and would not be able to change their ‘investments’ as a result of the tax legislation be amended. They would definitely suffer hardship.

The proposal will also have a huge impact to small businesses as it is common that a small start up business would normally struggle to obtain financing from a financial institution. This is normally due to the small business not having any past trading activity. In such instances it would then be common that an individual investor could be found to invest into the business. Now the individual will weigh up his/her net return when deciding on the investment options available. Alternatively the owner could obtain finance from the bank and on lend to the business. The business then pays the owner interest, which then pays this interest to the financial institution. This interest payment is therefore an expense in the hands of the business while the interest paid to the owner is taxable but he/she would have been entitled to claim interest exemption against this interest received.

There are numerous other examples of taxpayers that would suffer undue hardship as a result of the proposed amendments.

**Proposed solution 2**

If National Treasury and SARS is not prepared to retain the section 10(1)(i) exemption in its current form, the amendment should rather focus on the avoidance schemes where it is perceived that taxpayers are getting an undue benefit from this section through tax planning. Firstly it should be considered if the current anti-avoidance provisions contained in sections 7(1) to 7(11) would not address the perceived abuse. Potential application of the GAAR contained in section 80A to K should also be considered. If the current anti-avoidance rules are not sufficient, consideration should be given to adding anti-avoidance provisions to for example section 10(1)(i) to combat the specific avoidance but which will still allow the interest exemption in “legitimate” scenarios as discussed above. An extended consultation period in this regard is suggested to formulate a fair and reasonable solution that will address the concerns of all parties.
**Problem statement 3**

In terms of the limitations, the threshold exemption will be limited to, amongst others, interest from portfolios of collective investment schemes. The draft legislation specifically defines ‘portfolio of a collective investment scheme’ as any portfolio of a collective investment scheme as defined in section 1, other than a portfolio of a collective investment scheme in property.

The debate is thus around whether or not PLS and PUT's fall within the category of interest bearing products listed on the JSE.

The interest exemption for non-resident natural persons is also affected. Where PLS and PUT's fall outside the "Interest bearing products listed on the JSE" definition, the income from these would be subject to tax.

**Proposed solution 3**

There is some doubt if the current exemption would continue to apply against income received from a collective property scheme or not. Clarity must be provided.

**Problem statement 4**

There is a discrepancy between the dates given as the effective date for this legislation in the Explanatory Memorandum and in the Draft Bill. The Memorandum provides that the measure will be effective for interest received or accrued from years of assessment ending on or after 1 January 2010. The Draft Bill gives the effective date as on or after 1 March 2011.

**Proposed solution 4**

The Draft Bill or the Explanatory Memorandum needs to be amended to have the effective dates match.

**2.8 TAX-FREE FRINGE BENEFITS FOR EMPLOYER-PROVIDED PROFESSIONAL FEES AND INDEMNITY INSURANCE**

Clause 88 / Paragraph 13(2)(b) of the Seventh Schedule to the Act

**Problem statement 1**

The proposal essentially changes the requirement for the exemption from fringe benefit tax applicable for payment of an employee’s membership of a professional body from a condition of employment or employer requirement to a requirement that membership must be conditional for practicing within the profession.

While this proposal is relevant to certain professions, such as the medical profession, for example, many other professions do not require membership as a condition for practicing within the profession as such. An example is the Accountancy profession, where members outside the audit profession may be (but are not required to be) registered as members outside public practice (employed in commerce
and industry). Such membership has distinct advantages to the employer, as the employee is then more likely to stay abreast of important technical developments, but no professional compulsion is involved.

The concern is raised as a result of the wording used in the EM, the first condition namely "the duties of employment must involve the practice of the profession to which the fee relates". This appears to exclude commerce and industry employments. However the actual wording in the draft Bill does not appear to be that strict "the services rendered by the employee to the employer relate to that profession". The draft Bill therefore appears to include commerce and industry employment in the tax free fringe benefit proposal.

**Proposed solution 1**

We suggest that the current employer requirement should remain and can be supplemented with an additional exemption where the employee is required to be a member of a professional association before he / she can practice their profession. From the wording in the draft Bill it appears to be the intention that commerce and industry employments be included in the new proposed tax-free fringe benefit regime with regard to professional subscription fees paid by the employer. It is suggested that the wording in the EM be reconsidered and potentially amended to give effect to his intention.

**Problem statement 2**

The proposed amendment will allow employers to pay professional subscription fees and indemnity insurance of employees, subject to certain conditions, without creating a taxable fringe benefit in the hands of the employee. This however will only solve part of the problem that taxpayers are currently experiencing.

As indicated on previous submissions by SAICA to National Treasury, professionals enjoying employment are in some cases forced to pay their own professional subscription fees to professional bodies and indemnity insurance payments, although for example membership of such professional body might be a implied condition of employment. The employee will however not qualify for a tax deduction relating to the payment of the professional subscription fees or professional indemnity insurance payments as such deductions are prohibited by section 23(m) of the Act.

A good example illustrating this problem is certain health professionals such as medical doctors working for the State who are required to pay their own membership fees to the related professional bodies and in some cases even their own professional indemnity insurance. These taxpayers would however not qualify for a tax deduction by reason of section 23(m). If the employer, namely the State, in this example paid the professional subscription fees or professional indemnity insurance payments on behalf of the employees it would have qualified as a tax free fringe benefit in terms of the current proposal. Surely the result should be the same.

**Proposed solution 2**

That section 23(m) of the Act is amended to at a minimum allow taxpayers paying their own professional subscription fees and professional indemnity insurance to claim such payments as a deduction for tax purposes. Conditions similar to the tax-free fringe benefit proposal could also be built into the legislation.
2.9 FURTHER REVISION TO EXECUTIVE SHARE SCHEME

Clause 12 / Proposed amendment to Section 8C of the Act

Problem statement

It appears as though the amendment is to be brought into section 8C in order to avoid possible collusion between employees in the acquisition of restricted equity instruments falling under 8C. When the above is implemented, the presumption will be that the instrument was acquired by virtue of employment.

However, a possibility may exist where a taxpayer may acquire a restricted equity instrument from a fellow employee without carrying any knowledge of the identity of the seller (for example, if the purchase is done through an independent broker).

Therefore, a taxpayer in such circumstance may inadvertently be brought into the section 8C tax net, which is clearly inequitable.

Proposed solution

The current view is that the proposed insertion above is too vague / harsh. It is suggested that the insertion be more defined to specifically target the collusion practices noted.

4. INCOME TAX: MISCELLANEOUS SPECIAL BUSINESS AMENDMENTS

4.1 ANTI-AVOIDANCE RULE TO PREVENT FINANCIAL INSTRUMENT MISMATCHES

Clause 42 / Section 23K: Limitation of deductions in respect of financial instruments

Problem Statement 1

This proposed measure introduces a deemed disallowance of certain costs associated with financial instruments that yield exempt income. The following suggestions are made in relation to this proposal:

Affected exempt income:
This proposal should not affect all categories of exempt income, or major anomalies would result. Examples of categories that should be excluded are:

- Intra-group dividends: In any corporate group structure, a cascading tax effect would result from this tax proposal, with the same income being taxed repeatedly as it passes dividends up the corporate chain.

- Dividends from trading stock: Where financial instruments are held as trading stock, they should remain unaffected by this provision. The expenditure aspect of this exclusion has already been put into effect in the proposed section 23K(2), but the income aspect has not been dealt with. In addition, consideration should be given to exclude not only the cost price of financial instruments held as trading stock but also the financing and related costs associated with the
acquisition i.e. not only the direct cost of acquisition. If the latter amendment is not made, then any productive expenditure (other than the cost of acquisition) would not be allowed in terms of this section.

- From time to time, extraordinary exempt income may accrue to a taxpayer, where it would be anomalous to apply these new rules. One example is a dividend received as a result of an unbundling transaction in terms of section 46 of the Act.

Proposed Solution 1

We suggest that this anomaly could easily be overcome by defining a term “affected exempt income”, to which the provision would apply. This definition would accordingly exclude dividends from subsidiaries and associates, dividends from financial instruments held as trading stock, and extraordinary dividends (to be defined in detail, and to include unbundling dividends, amongst others). Note that where a company expressly borrows to purchase shares in a subsidiary or associate, the financing costs would remain disallowable under existing tax provisions.

Problem statement 2

Aggregate finance charge rule:
The current wording makes clear that any disallowance is, in aggregate, limited to the aggregate expenditure or losses incurred by the taxpayer in respect of financial instruments. We believe that this limitation is appropriate. This limitation is illustrated in Example 1 below.

Proportionality:
The measure seeks to disallow expenditure equal to the aggregate of the exempt income. In reality, expenditure in relation to financial instruments is usually significantly less than the income earned. The measure would thus result in excessive disallowances.

Proposed Solution 2

We suggest that the disallowance should be limited to a proportion of the exempt income, to represent this factor. This proportion could be a fixed proportion, say 20%, or, preferably, could be the actual proportion of the taxpayer’s “affected exempt income” (see above) to the sum of its taxable interest income plus its affected exempt income.

Example 1:
Company A invests R1 million in a preference share investment yielding an 8% dividend. This investment is sourced from the company’s general pool of funds, including interest-bearing borrowings, on which it incurs finance charges of R300 000 pa. The company’s aggregate affected investment income is R10 million, and its taxable interest income is R30 million, giving a disallowance proportion of 25% (that is, 10 / [10+30]).

Outcome: The company earns a dividend of R80 000 pa, and has a disallowance of financing costs amounting to R20 000 pa, that is, 25% of the affected dividend. Note that, in terms of the aggregate finance charge rule discussed above, if the company’s actual finance charges incurred were lower than the disallowance calculation, say, R5 000, the disallowance would be limited to R5 000.
Tracing rule:
We appreciate the existence of the tracing rule. However, as it currently reads, this rule can create certain anomalies, as discussed below:

First, in order to allow for greater definition (including the modifications suggested below), we suggest that the tracing rule refer to a specific term, say “tax-neutral funding” which can then be defined accordingly.

Second, at present, the rule is “all-or-nothing”. Thus, if the affected financial instrument is funded exclusively from tax-neutral funding, it is exempt, but if it is funded partially from any other source, however trivial, the entire exemption falls away. We suggest that apportionment be allowed, where mixed sources exist.

Remedy: We suggest that, to achieve the effects discussed above, the wording of subsection (3) should read as follows: “For the purposes of subsection (1), a financial instrument must not be taken into account in respect of that year in determining [the existing (a) and (b) remain unchanged], to the extent that this financial instrument was financed by tax-neutral funding.”

Tax-neutral funding would then be defined as any funding source where the cost of servicing such funding does not result in an expenditure or loss which has, is or may be taken into account in the determination of taxable income of the holder of that instrument.

Example 2:
Company A invests R1 million in a preference share investment yielding an 8% dividend. The company’s aggregate affected investment income is R10 million, and its taxable interest income is R30 million, giving a disallowance proportion of 25% (that is, 10 / [10+30]). Of this investment, R800 000 (80%) is sourced directly from a fresh issue of the company’s shares, constituting tax-neutral funding. The remaining R200 000 (20%) is sourced from the company’s general pool of funds, including interest-bearing borrowings, on which it incurs finance charges of R300 000 pa.

Outcome: The company earns a dividend of R80 000 pa. It has a potential gross disallowance of financing costs amounting to R20 000 pa, that is, 25% of the affected dividend. However, as only 20% of the investment was not sourced from tax-neutral funding, only R4 000 (20% of R20 000) is disallowable. Note that, in terms of the aggregate finance charge rule discussed above, if the company’s actual finance charges incurred were lower than the disallowance calculation, say, R3 000, the disallowance would be limited to R3 000.

4.3 ISLAMIC FINANCING

Clause 45/ Section 24JA: Insertion of Section 24JA (Shari’a compliant financing arrangements)

Problem statement 1

Clause 45(1) of the DTLAB 2010 sets out the proposed legislation for Islamic financial products. This is a welcome addition to the existing legislation, and will assist in eradicating the uncertainty faced by institutions that offer Shari’a compliant financing products.
However, there are a few problems in the manner in which the legislation has been drafted that need to be highlighted:

**Compliance with Shari’a**

Section 24JA refers in several places that the various arrangements covered by this section have to comply with the precepts of Shari’a law and have to be marketed as Shari’a compliant products.

- The draft legislation does not define what is meant by compliance with Shari’a.
- Shari’a comprises a wide body of law that is derived from various sources – the Qu’ran, the Hadith (utterances, observed behaviour and actions of the Prophet Muhammad Sallalahu Allaihi Wasalam) as well as the writings and fatwas (rulings) of various scholars over the last 14 centuries. There are often divergences of opinion between different scholars on various issues.
- It should also further be noted that Islam is also divided into a number of sects, and scholars from different sect often differ in opinion from other sects on Shari’a rulings.
- For example, there has already been, through international media, debate as to whether Murabaha is acceptable in the light of Shari’a or not, despite there being published Shari’a standards issued for Murabaha arrangements by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
- In this regard it should be noted that most Islamic banks seek to apply the AAOIFI Shari’a standards to their products, to ensure compliance with Shari’a.
- The problem then arises as to how a secular government (through it’s revenue collection agency, SARS) and a secular judiciary are going to be able to determine, without engaging the services of Shari’a ‘experts’, whether an arrangement is compliant with Shari’a or not, and therefore whether section 24JA applies or not.
- It will therefore be difficult for compliance with this section to be enforced, and it will further burden the relevant taxpayers with having to show that an arrangement is in fact Shari’a compliant, and has been marketed as such.
- It is therefore our view that being Shari’a compliant should not be the key determinant of whether an arrangement falls into section 24JA or not.

**Proposed solution 1**

Our recommendation is that a model similar to the UK model be adopted.

- One of the core principles underpinning the UK’s legislation for Islamic banking products was that a secular government cannot sensibly legislate for different religions.
- Instead the UK introduced laws, which applies to certain types of transactions if certain tests are met. It therefore applies to all transactions of a certain type, regardless of who carries them out and whether it was intended to be Shari’a compliant or not. The UK law refers to these arrangements as ‘alternative finance arrangements’.
- The definitions are very precise, so that the very arrangements that are meant to be covered (for example, Murabaha and Diminishing Musharakah) are in fact covered, but it obviates the need for a secular agency to make a determination as to whether the arrangement is Shari’a compliant or not.
- This will have the added advantage that other religious groupings are not discriminated against – if a specific product meets the requirements of the legislation as an alternative finance arrangement then the legislation would apply, even if one does not belong to the Islamic faith.
**Problem statement 2**

**Terminology**
The draft legislation refers to the various products by their Islamic names, which may prove to be problematic when classifying products.

In practice, there are differences in naming conventions. For example, one South African bank that essentially is offering a *Murabaha* product (on the deposit-taking side) actually used the terminology *sukuk* (certificated security) in naming the product.

In another instance, a bank offering a *Murabaha* product called the arrangement a *wakala* (agency) arrangement.

**Proposed solution 2**

Our recommendation is that Islamic terminology should be avoided in drafting the legislation.

**Problem statement 3**

**Diminishing Musharakah**
The definition of *Diminishing Musharakah* in subsection (1) of section 24JA is inconsistent with *Shari’a* as it is set out in the *Sharia* Standard No.12 issued by AAOIFI:

- In terms of subparagraph (b) the bank and the client must conclude an agreement in terms of which the client will purchase the bank’s ownership in the asset. In terms of paragraph 5/1 of the Standard No.12, the buying partner (i.e. the client) is only allowed to give a binding promise to buy, which promise must be independent of the partnership contract. Furthermore, the partnership contract must be independent of the buying and selling contract. It is not permitted that one contract be entered into as a condition for concluding the other.

- In terms of subparagraph (c) the amount of consideration payable by the client for the acquisition of the bank’s ownership interest in the asset must equal the amount of consideration payable by the bank to acquire its ownership interest in the asset. It is not permissible to stipulate in an agreement (in terms of paragraph 5/7 of the Standard No.12) that the bank’s ownership interest be acquired at its original or face value, as this would constitute a guarantee of the value of the interest of one partner by the other partner, which is prohibited by *Shari’a*. In practice, the client usually does acquire the bank’s interest in a *Diminishing Musharakah* arrangement at original or face value, but this is not stipulated upfront in an agreement – it is usually only agreed at the time each successive sale of the bank’s interest occurs.

Therefore the very definition of *Diminishing Musharakah* is inconsistent with the stipulation that the arrangement must be *Shari’a* compliant, making it impossible to apply section 24JA to this arrangement.

Further, in terms of subparagraph (d) of the definition, the client must pay a rent to the bank in respect of the bank’s ownership interest in the asset until such time the client becomes the sole owner of the asset. In terms of paragraph 5/9 of the Standard No.12, it is permissible, but not necessary that a rent be paid from one partner to another. In fact, in practice, there are *Diminishing Musharakah* products
available that do not stipulate that rent be paid to the bank in respect of the bank’s ownership interest – with this arrangement the client does not pay rent to the bank but simply buys the bank’s interest in the property gradually, and the bank charges a profit thereon. The effect of this subparagraph would be to exclude these arrangements from the application of section 24JA.

Proposed solution 3

Legislation should avoid reference to Shari’a and specific terminology used to describe products (for example, Murabaha and Diminishing Musharakah).

The requirements to qualify as an alternative finance arrangement on a diminishing ownership basis should be looked at again, so that typical Diminishing Musharakah products would fall into the definition.

Problem statement 4

Murabaha

In terms of paragraph (b)(ii)(bb) of the definition of Murabaha the client must pay the amount outstanding to the bank in equal instalments that will not vary over the lifetime of the arrangement. This does not cater for a situation where the client wishes to make an early settlement – in practice, the bank offers the client a ‘discount’ on the selling price to reach an early settlement figure.

The only Murabaha arrangement that has been covered in the draft legislation is one where the bank is the lender. However, Murabaha arrangements are also used by banks on the deposit-taking side (replicating the effects of a fixed deposit account). With the deposit Murabaha, a client would usually appoint the bank as an agent to purchase a commodity or equity shares. The bank agrees to buy the commodity or shares from the client at cost plus a profit mark up, with payment only occurring at a stipulated future date.

Consideration should be given to including these arrangements in the definition of Murabaha as well, because the form of these transactions give rise to very similar consequences for Income Tax, VAT and Securities Transfer Tax as the lending Murabaha arrangement, with difference being the client is the lender and not the bank.

Proposed Solution 4

Legislation should also cater for early settlement as well as for Murabaha transactions on the deposit-taking side.

4.7 DEFAULT ELECTIONS INVOLVING INTRA-GROUP ROLLOVER

Clause 60 / Section 45: Intra-group transactions

Problem Statement

There is a discrepancy between the draft amendments to section 45 in the DTLAB and the commentary to the amendments on page 67 of EM the DTLAB.
The EM states, when referring to the proposed section 45 amendments, that "elections should also be reversed such that the roll-over relief must not apply automatically. Taxpayers should elect that the roll-over relief provisions apply. The election should be made in writing at the time of conclusion of the agreement for the transfer of assets". This indicates that National Treasury intends reversing the amendments made on 1 January 2009 which made the application of the corporate rules automatic, i.e. an election was no longer necessary. However, the draft amendments do not provide for this change.

Proposed Solution

We therefore ask, is the comment in the EM simply an error, or has the election amendment been omitted? If it is the later we fear the suggested effective date (i.e. years of assessment ending on or after 31 December 2009 per the EM) is ill-conceived as this would have serious consequences for transactions entered into under the current regime where no election is required.

4.8 DEVALUED FINANCIAL INSTRUMENTS HELD AS TRADING STOCK

Clause 38 / Section 22(1) of the Act

Problem statement

It is noted in the EM that financial instruments that are debts may make use of sections 11(i) or 11(j) of the Act when their value declines now that they will no longer be able to use the “lower of” rule set out in section 22. Taxpayers have no means to “write down” the value of other types of financial instruments when their values decline. It is not clear why financial instrument that are debts should be afforded special status over other types of financial instrument. Arguably, when the value of a financial instrument that is not a debt irrevocably declines (e.g. a share in a company about to be liquidated), a provision should exist which allows the decline in its value to be subtracted.

Proposed solution

We suggest that a provision be enacted to allow financial instruments that have irrevocably declined to be “written down”.

4.14 DIVIDENDS TAX: DEFINITION OF FOREIGN DIVIDEND

Foreign dividend definition

Problem statement

It is already exceedingly difficult for minority interest owners of foreign shares to obtain the necessary information needed to assess whether a dividend has accrued to that shareholder. This new development again places an incredible burden on these taxpayers. This is because they will now not only have to determine whether it is a dividend as defined, they will also need to determine whether it is a dividend in terms of the laws of the distributing company’s country of tax residence. Further, it is not clear whether you are requiring the test to be performed in the hands of the distributing company or the recipient of the distribution or both.
Paragraph 74 of the Eighth Schedule defines a capital distribution as any distribution by a company that does not constitute a dividend. It is possible that an amount that is distributed by a foreign company may by definition be a dividend, but not a foreign dividend. This would mean that the amount is taxed in full in the hands of the resident as normal gross income.

By way of example, in the UK a liquidation distribution out of profits of the company may not be treated as a dividend but rather a capital gain. However, because it is a payment out of profits it is still treated as a dividend but not necessarily a foreign dividend under our laws. This would mean that it would not fall to be treated in terms of the Eighth Schedule to the Act and the foreign dividend exemptions would not apply. This would cause a liquidation dividend to be regarded as normal gross income in the hands of the South African recipient. This could have dire consequences. For example, if these profits had previously been attributed to a resident as a result of the CFC legislation, the specific exemption relating to a foreign dividend that is distributed out of profits that have previously been attributed would not apply.

Proposed solution

We suggest that additional consideration and clarification be provided in the legislation to deal with the aspects raised above.

In addition, we note that additional anti-avoidance mechanisms are being included into the participation exemption contained in section 10(1)(k)(ii)(dd). We suggest that these mechanisms should be sufficient to address any concerns you may have with regard to the specific abuse that you are trying to address. If however you are adamant that more is required, we suggest that you rather maintain the foreign dividend definition as it currently reads but expressly exclude payments made by a foreign company that are treated as interest in the hands of the paying company, unless the amount represents amounts previously attributed to the recipient shareholder in terms of section 9D of the Act. This should target the specific mischief that we suspect you are trying to combat.

4.17 CO-ORDINATION WITH COMPANY LAW REFORM

Coming into effect of the new dividend definition and contributed tax capital definition

Problem statement

It is proposed that the new dividend definition and contributed tax capital definition come into operation on the date on which the Companies Act, 2008 (Act No. 71 of 2008), comes into operation. To this end, clause 127(3) of the draft bill gives effect to the proposed intention. However, clause 127(3) brings into effect (paragraph g) only the amendment made to the definition of contributed tax capital in section 7 of Act 17 of 2009. This would have the effect that paragraphs (a) and (b) of the definition of contributed tax capital would not become effective.

Proposed solution

It is proposed that a clause be inserted to ensure that section 4(1)(b) of Act 60 of 2008 becomes effective.
5. INCOME TAX: MISCELLANEOUS INTERNATIONAL AMENDMENTS

5.1 REFINEMENT OF THE PARTICIPATION EXEMPTION

Clause 17 (p) and (q) / Proposed section 10(1)(k)(ii)(dd) of the Act

Problem statement

We note that clause 17(p) proposes that paragraph (A) to the current proviso in item (dd) be substituted with a new paragraph.

However, clause 17(q) proposes that the proviso to item (dd) be substituted by an entirely new proviso.

Based on the above, it is unclear:

(a) whether paragraph (A) of the current proviso will remain and the new proviso will be an addition to the current proviso;

(b) or whether the new proviso will be replacing the current proviso (including paragraph (A) in its entirety).

Proposed solution

We propose that the above anomaly be clarified. In our understanding the new proviso in terms of clause 17(q) should replace the current proviso (including paragraph (A) in its entirety).

5.2 RESTRICTING THE CROSS-BORDER INTEREST EXEMPTION

Clause 18 / Proposed section 10B of the Act

Problem statement 1

The forms of domestic investments listed in proposed section 10B(2) to which the exemption will continue to apply are too restrictive. Given the stated aim of the tax exemption at increasing South Africa’s attractiveness as a destination for foreign investment, the incentive should surely be focused more on real investment (i.e. into industry or property). Instead the form of domestic investment to which the exemption will continue to apply (i.e. unit trusts, banks, bonds etc) are all investments which support a stronger rand but which can be withdrawn at any time and only indirectly contribute to growth. Investment into South African companies that house businesses that promote growth and employment are the very investments that will be affected negatively by the proposal.

Proposed solution 1

It is proposed that the forms of domestic investment to which the exemption will continue to apply be extended to forms of investment more beneficial to the South African economy.
\textit{Problem statement 2}

The narrowing of the exemption means that tax is to be imposed on interest accruing to non-residents however no provision is made in the legislation for a withholding tax on interest. If the tax is not to be withhold from interest accruing to non-residents, it is not clear how tax on this interest will be enforced unless the non-resident voluntarily registers itself for tax purposes in South Africa. Given the inability of SARS to compel registration for non-residents, this measure aimed at taxing interest income accruing to non-residents may be practically ineffective. It is submitted that it is purposeless to impose a tax that cannot be practically enforced. On the other hand, it may be noted that the introduction of a withholding tax on interest accruing to non-residents is introduced will add a costly administrative burden on the \textit{fiscus}.

\textit{Proposed solution 2}

Legislation should be drafted to create a withholding tax on interest paid to non-residents.

\textit{Problem statement 3}

There is a discrepancy between the dates given as the effective date for this legislation in the EM and in the Draft Bill. The Memorandum provides that the measure will be effective for interest received or accrued on or after the date of the amendment bill’s promulgation. The Draft Bill gives the effective date as on or after 1 March 2011.

\textit{Proposed solution 3}

The Draft Bill or the EM needs to be amended to have the effective dates match.

\textit{Problem statement 4}

Proposed section 10B(3)(b) does not exempt interest arising from debts between non-resident if that non-resident at any time carried on business through a permanent establishment in South Africa. If the debt is not related to the permanent establishment in South Africa, it is not clear the legal basis on which SARS intends to tax it the interest arising thereon.

\textit{Proposed solution 4}

Proposed section 10B(3)(b) should be amended to make it clear that the debt referred to is the debt that arose in the hands of the permanent establishment of the non-resident in South Africa.

\textit{Problem statement 5}

If this measure is introduced, it is not clear the basis on which the “thin capitalisation” rules in section 31 of the Act can be maintained. Interest denied as a deduction in terms of the thin capitalisation rule will now be taxed in the non-resident’s hands. This creates a distortion whereby interest denied as a deduction in one taxpayer’s hands, is taxed as income in another taxpayer’s hands. Effectively, this means that the same income is subject to economic double tax i.e. the denial of the interest deduction in the South African company means that income is taxed there and the interest is also taxed in the hands of the non-resident.
Proposed solution 5

It is proposed that the thin capitalisation provisions set out in section 31 of the Act be deleted upon promulgation of this new section.

Problem statement 6

Taxing interest accruing to non-residents will also not prevent the tax avoidance schemes complained of in the EM. Through careful tax planning, non-residents who engage in such schemes need simply to have the South African interest they earn routed through a treaty country which exempts interest from foreign taxes.

Proposed solution 6

It should be re-considered as to whether the tax avoidance schemes complained of in the Memorandum can be effectively addressed through the introduction of section 10B.

Problem statement 7

We note that you have omitted to remove section 10(1)(h) of the Act.

With regard to the proposed removal of this exemption, we wish to highlight the following:

Currently South Africa has several tax treaties that restrict our right to tax interest income paid to a resident of that state, for example, the treaties with the USA, the UK, the Netherlands, Cyprus, Luxembourg and Mauritius. It will therefore be relatively easy for a potential investor to ensure that they are not taxable in South Africa on their interest income generated from South Africa.

It is therefore puzzling as to why it is that you are seeking to remove the blanket exemption. In our experience this exemption is viewed most favourably by foreign investors wanting to establish long term investments in this country and adds to our attractiveness as an investment location.

Proposed solution 7

We suggest that with the proposed changed to the thin capitalisation rules it becomes unnecessary to remove the blanket interest exemption for non-residents. This is because the proposed changes impact severely on the historically used 3:1 safe harbour ratio.

If you insist on maintaining the current idea of removing the blanket interest exemption, we suggest that it is imperative that a withholding system be introduced. Calling for every non-resident that accrues interest income from SA to now register as a taxpayer in this country is likely to give rise to an administrative nightmare for both the taxpayer and SARS. A withholding mechanism, similar to section 35 of the Act would be a far easier way to manager this.

It is also proposed that the draft Bill be amended (section 10(1)(h)) to give effect to the proposed amended to the exemption of interest earned by non-residents.
5.3 TRANSFER PRICING

Clause 53 / Section 31 of the Act

Problem statement

Section 31 is proposed to be substantially amended so as to widen its application quite considerably. The result will be that the South African Revenue Service ("SARS") will no longer be restricted to adjusting a particular price on a particular cross-border transaction, but will be empowered to determine an overall tax result in a manner similar to section 80A, the general anti-avoidance provisions. Similar provisions will be introduced for thin capitalisation. However, there is no reference to the methodology of any such potential determination, creating significant uncertainty for taxpayers. For example, unlike the position internationally, there is no reference to the application of the OECD Transfer Pricing Guidelines. This is of particular concern because South Africa is not a member of the OECD so is not obliged to adhere to these guidelines.

Further, it is proposed that the connected person's definition will be widened for thin capitalisation purposes, and that the thin capitalisation provisions will be extended to apply to branches of foreign companies.

The result of all these amendments will be that SARS will have some of the widest transfer pricing powers in the world, with very little practical guidance for taxpayers as to how they will be applied. This is exacerbated by the fact that SARS is not empowered to give Advance Pricing Rulings on any transfer pricing and thin capitalisation matters, and it has to date also refused to enter into any kind of unilateral or multilateral Advance Pricing Arrangement.

Proposed solution

It is submitted that the power and/or discretion given to SARS under this proposal is unnecessarily excessive and could result in transfer pricing adjustments that have no natural basis from a taxation perspective.

5.4 REGIONAL HOLDING COMPANY REGIME

General comment

While the proposal is to be welcomed in principle, there are some issues which are unclear and which, it is submitted, need further refinement. Inter alia, the double tax relief which may be allowed in terms of the double tax agreements in force and in terms of section 6quat, in respect of certain types of passive income, is unclear, particularly as far as the application of the source rule within section 6quat is concerned. The exchange control restrictions will also need to be carefully considered and it is impossible to fully comment on this tax proposal without also seeing the matching exchange control relaxation which will have to apply.
Problem statement

The explanatory memorandum noted in paragraph E (page 101) that all interest deductions incurred by the Headquarter company in respect of foreign loans to the headquarter company are ring-fenced against the interest earned from loans on-lent to foreign investments. (It is not clear where in the legislation this is stated. The new section 10B does not bring about this result.) If the objective of the headquarter company regime is to encourage investment into Africa through South Africa, then the interest expenditure incurred on loans made to the Headquarter company should be deductible against all income earned by the Headquarter company. Such interest deductions should not be ring-fenced in any way.

Proposed solution

We recommend that the applicable provisions that “ring-fence” interest deductions on loans made to the Headquarter Company be deleted.

Headquarter companies

Problem statement

We understand that the primary reason for wanting to introduce the Headquarter Company is to attract non-residents wanting to establish a springboard into the rest of Africa and to reduce the attractiveness of Mauritius as an alternative to South Africa. In this regard, the proposed legislation relating to headquarter companies is in our view unlikely to deliver the results that you anticipate. This is because of the following:

- Taxing items such as interest, royalties, rentals, exchange gains and other forms of income accruing to these companies at our standard rate of 28% is unlikely to be attractive to a potential investor. These investors would be able to establish operations in Mauritius and pay tax on these amounts at a rate of 3%, if not less.
- Further, Mauritius does not levy capital gains tax at all. Our capital gains tax legislation is very complex, including the exemption contained in paragraph 64B. It is extremely difficult to qualify for paragraph 64B of the Eighth Schedule currently, because so many caveats have now been written into this law.
- The requirements to qualify as a headquarter company are extremely onerous, especially when compared to other typically used jurisdictions, such as Mauritius.

It is still not certain how these companies will be addressed from a SARB perspective. If exchange control regulations are to apply to these companies, they are unlikely to attract interest.

Proposed solution

To overcome this problem, we suggest that you consider introducing a deemed credit system, similar to Mauritius in respect taxes payable in South Africa by these companies. If you want to have South African residents participating in these companies subject to a higher rate of tax on their portion of the
profits, you could consider exempting distributions out of these companies only when paid to a non-resident, with a two tiered system for the taxation of profits and capital gains in the hands of a resident shareholder. This should also make it possible for you to relax the requirements to qualify as a headquarter company because currently these seem excessive in relation to a non-resident investor. Mauritius does not impose such stringent requirements on a company to qualify for its tax incentives.

5.5 REGIONAL INVESTMENT FUND REGIME

Problem statement

These tax exemptions are to be welcomed. However, the problem for foreign investors is not only tax but exchange controls.

Proposed solution

While there have been some changes to liberalise the application of South African exchange control measures in the private equity environment, further relaxation will be required before South Africa becomes an internationally competitive jurisdiction for private equity funds and other investors.

Clause 6(1)(q) / Proposed provision to the definition of “permanent establishment” in section 1 of the Act

Problem statement

The change in definition of “permanent establishment” will be effective on 1 January 2011 and will apply in respect of receipts and accruals arising during any year of assessment beginning after that date. In instances where, currently, the general partner in a limited partnership creates a South African permanent establishment for non-resident limited partners (or “qualifying investors” as defined in clause 6(1)(y)), the change in the “permanent establishment” definition will result in these limited partners no longer having permanent establishments in South Africa. This change, however, may be considered to result in the assets of that permanent establishment ceasing to be assets of a South African permanent establishment in terms of para 12(2)(b)(ii) of the Eighth Schedule to the Act. This in turn may result in a deemed disposal of these assets for South African capital gains tax (“CGT”) purposes in terms of para 12(1) of the Eight Schedule to the Act. The change in definition thus may result in CGT liability for non-resident qualifying investors. This surely was not the intention of this amendment.

Proposed solution

A provision exempting existing qualifying investors from the deeming provisions in para 12(2) of the Eighth Schedule to the Act needs to be inserted to avoid the imminent CGT liability for these investors described above.
5.7 CURRENCY TRANSLATION IN THE CONTEXT OF MULTIPLE REPORTING CURRENCIES

Functional currency

_Problem statement_

It is proposed that functional currency be determined with reference to the primary economic environment in which the business operates. However, there is no clear indication of what is mean by “primary economic environment”. We suggest that this wording is far too vague.

_Proposed solution_

Either a definition should be introduced for this term or else the current position relating to the reporting currency of the entity should be retained.

DRAFT TAXATION LAWS SECOND AMENDMENT BILL

Clause by clause comment

Clause 4(e) and 4(h) of Part A: Voluntary disclosure relief

_Problem statement 1_

One of the requirements for a valid voluntary disclosure is that the disclosure must not result in a refund due by the Commissioner (clause 4(e)). We note that this requirement may disincentivise taxpayers who wish to apply for relief as a result of late submission of their returns. In the latter scenario, such taxpayers may have a refund due by the Commissioner but still face substantial penalties as a result of the late submission. Given the intention behind the programme to allow taxpayers to regularise their affairs, we submit that it would be contrary to this intention to exclude taxpayers in these circumstances.

_Proposed solution 1_

We propose that the requirement in clause 4(e) be deleted.

_Problem statement 2_

One of the requirements for a valid voluntary disclosure is that the disclosure must be in respect of a default which occurred at least 12 months (clause 4(h)) before the commencement of the period contemplated (in paragraph 4(g)). It is submitted that the 12 month requirement makes the eligibility criteria for relief too restrictive. If a default is discovered within 12 month of the period, there seems to be no reason why the taxpayer cannot apply for relief in that instance as well.

_Proposed solution 2_

We propose that the requirement in clause 4(h) be deleted.
Problem statement 3

It is unclear in which Tax Act, Part A describing the rules relating to the Voluntary Disclosure Programme will be inserted.

Proposed solution 3

We propose that the above anomaly be clarified.

Clause 15 / Proposed section 76E of the Act

Problem statement

We noted that clause 15 proposes that paragraph (n) is included in subsection (2). This would make it a requirement for an application for a tax ruling that the applicant must be registered for tax purposes. We note that makes the advance tax ruling procedure inaccessible to potential non-resident investors who wish to make use of the advance tax ruling procedure to determine their tax status should they make an investment in South Africa. Not only would this inhibit foreign investment but this also could not have been the intention behind the amendment.

Proposed solution

We propose that wording of this new requirement be amended to permit non-residents who are not yet registered for South African tax purposes to apply for advance tax ruling given that such ruling may ultimately affect their decision to register as taxpayers.

Clause 17 / Section 89quat of the Act

Problem statement 1

Section 89quat(3) empowers the Commissioner to exercise his discretion to waive interest charged on unpaid provisional tax. This sub-clause is to be deleted and there does not seem to be a replacement or alternative. According to the Explanatory Memorandum, the deletion has been proposed in light of the Voluntary Disclosure Programme which will be instituted from 1 November 2010 to 21 October 2011. Given the finite nature of the Voluntary Disclosure Programme (the “VDP”), it seems short-sighted to remove from the Act forever a provision that allowed the Commissioner to waive interest in appropriate circumstances. If there is a view that the discretion afforded to the Commissioner by this provision could somehow interfere with the workings of the VDP, then we would recommend that the provision be suspended for the duration of the programme but not removed in its entirety.

Proposed solution 1

The deletion of sub-clause (3) should be reconsidered.

Problem statement 2

The VDP is a temporary measure. It would seem that the deletion of subsection (3) is intended to be permanent.
Proposed solution 2

The Memorandum on the Objects of the Taxation Laws Second Amendment Bill states that the reason for the removal is the voluntary disclosure programme. Since the VDP deals with the waiving of interest for the duration of the Programme, we suggest that section 89quat(3) is not deleted.

Clause 18 / Paragraph 1 of the Fourth Schedule to the Act – amendment to the definition of remuneration

Paragraph (cA) is added to the definition of remuneration in paragraph 1 of the Fourth Schedule.

Problem statement

Paragraph (b) of the definition includes in remuneration “any amount to be included in such person’s gross income under paragraph (i) of that (the gross income) definition”. Paragraph (b) and (cA) read together will result in the fringe benefit resulting from employer provided motor vehicles to be included in remuneration twice.

Proposed solution

Paragraph (b) should be amended to exclude amounts referred to in paragraph (cA).

Clause 22 / Paragraph 14 of the Fourth Schedule to the Act

Problem statement

Sub-paragraph (6) of Paragraph 14 requires an employer to pay a ten per cent penalty of the total amount of employees’ tax deducted or withheld from the employees’ remuneration if he fails to render a return as is prescribed in sub-paragraph (3) of paragraph 14. Paragraph 6 of the Fourth Schedule imposes a ten per cent penalty of the amount of employees’ tax which an employer fails to pay. Paragraph 6(a) of the Regulations issued under section 75B of the Act permits the Commissioner to impose a ten per cent penalty of the amount of employees’ tax that an employer fails to pay as and when required under the Act. At present, it appears possible for the Commissioner to levy up to 30% of fines for the non-payment and/or non-rendition of an employees’ tax return, as described above. The penalty provisions are duplicated in the Fourth Schedule and in the Regulations issued under section 75B of the Act.

Proposed solution

If the administratively punitive provision for the non-payment and/or non-rendition of an employees’ tax return are meant to be housed exclusively in the Regulations under section 75B of the Act, then the analogous penalty provisions in the Fourth Schedule should be deleted.

Clause 23 / Paragraph 3 of the Seventh Schedule to the Act

Paragraph 3 of the Seventh Schedule to the Act, is amended by the substitution for subparagraph (2) of the following subparagraph:
“(2) The Commissioner may, if such determination appears to him to be incorrect, re-determine such cash equivalent—
(a) and issue the employer with a notice of assessment for the unpaid amount of employees’ tax that is required to be deducted or withheld from such cash equivalent; or
(b) upon the assessment of the liability for normal tax of the employee to whom such taxable benefit has been granted.”

Extract from Explanatory memorandum:

Employers have an obligation to deduct or withhold employees’ tax from the value of fringe benefits granted to employees. A recent judgment has created the impression that an incorrect determination by an employer of PAYE on fringe benefits can only be remedied on assessment of the individual employees. To enable SARS to effectively administer employees’ tax in these situations, the proposed amendment enables SARS to raise an assessment on an employer where it was found that the value of a fringe benefit has not been taken into account or undervalued for employees’ tax purposes.”

Problem statement

This proposed amendment is considered unnecessary. The reference in the EM regarding the decision in the Vacation Club case is totally misplaced and out of context. The premise of the Act (in the context of Fringe benefits) is that it is the recipient (the employee) who must bear the tax on the benefit. This was never at dispute and was confirmed by the court.

The problem with the proposed amendment is that it does not require of SARS to issue the assessment within the year of assessment that the “untaxed” benefit was enjoyed. In practice it is impossible for the small business or the employee to get an answer from SARS regarding a valuation of a benefit as is required by paragraph 3(3).

The amendment does also not allow for the employee to be given the benefit for the so-called unpaid amount of employees’ tax.

In the budget speech it was stated that the employee will be given an exemption from tax if this amendment was introduced. This was not done and may lead to a double tax.

The other problem is that the unpaid employees’ tax as it is referred to will have to based on an amount (one would accept that this may well be in dispute). The value-added tax (where it applies) consequences of this will then be uncertain.

Proposed solution

The current legislation contains sufficient provisions to allow SARS to “effectively administer employees’ tax” – refer to paragraph 7 of the Fourth Schedule and the existing paragraph 3 of the Seventh Schedule.

What is required is that employers and employees alike must be given an easier access to SARS to enable them to agree on the value of benefits in dispute.
Clause 26 / Proposed section 12H of the Act

Problem statement

We noted that a word in subparagraph (8) was changed from “allowance” to “deduction”. This is now in line with the heading of section 12H: Additional deduction in respect of learnership agreements. It is unclear what the purpose of this change is and whether it is only to unify the language used in this section. It is unclear if the expense will be fully deductible or if the deduction will still be subject to the limits.

Proposed solution

We propose that the purpose of this change is clarified in the EM.

Please do not hesitate to contact us, should you have any questions regarding the above. We will provide additional comments on or before 11 June 2010.

Yours faithfully

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