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 and our submission dated 31 May 2010. 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 BILL 2010 AND DRAFT EXPLANATORY MEMORANDUM

MAIN AMENDMENTS

2. INCOME TAX: MISCELLANEOUS INDIVIDUALS AND SAVINGS AMENDMENTS

2.4 NARROWING THE INTEREST THRESHOLD EXEMPTION

Clause 19 / Proposed section 10C of the Income Tax Act, No. 58 of 1962 (“the Act”)

Problem Statement

The proposed amendments in this section make frequent reference to “him or her”.

Proposed Solution

The proposed amendments in this section should refer consistently to the word “natural person” instead of “him or her.”
2.8 TAX-FREE FRINGE BENEFITS FOR EMPLOYER-PROVIDED PROFESSIONAL FEES AND INDEMNITY INSURANCE

EM page 31 – II Reasons for change

Problem statement

The EM provides “Reasons for change”. It is stated “... a working condition fringe”. This should read “... a working condition fringe benefit”.

Under the next point again the second paragraph, the second sentence ends with “... working condition fringe” this should read “... working condition fringe benefit”.

Proposed solution

Wording corrections as proposed above.

2.9 FURTHER REVISION TO EXECUTIVE SHARE SCHEME

Clause 12 / Proposed amendment to Section 8C; section 10(1)(k)(i) and section 64B(5) of the Act

Problem statement 1

The proposed addition to section 8C(1)(a) reflected in clause 12(1)(c) of the Bill is too wide as it excludes the causal connection of an employee or director acquiring the equity instruments "by virtue of his or her employment" and therefore causes the section to have a much wider application.

Proposed solution 1

The proposed amendment should be refined to specifically target the practices it is intended to target.

Problem statement 2

The addition to subsection (1)(a) of subparagraph (iii) is stated as follows:

"(iii) during the period of his or her employment by or office of director of any company from – (aa) that company or any associated institution in relation to that company..."

Paragraph C2 on page 34 of the EM explains that to ensure that those employees who swap restricted equity instruments with other employees or directors of the same company or an associated company benefit from the rollover relief offered by section 8C, this amendment has been made so that the employee is presumed to have received the (replacement) restricted equity instrument "by virtue of employment".

However, while being an advantage on the one hand, this amendment has a highly prejudicial effect. There are many entrepreneurs of businesses who, while holding shares in the company, become
directors of the company in order to protect their shareholding. In the event that these directors acquire additional shares, there may be situations where these acquisitions are not linked to employment (or services rendered), but instead are linked to "ownership" in the company. This amendment therefore widens section 8C to subject employees to income tax on gains arising on the vesting of equity instruments even where the acquisition of the equity instrument is not linked to employment (or services rendered). The amendment to section 8C removes the opportunity of any enquiry as to whether the acquisition of equity instruments is linked to employment.

**Proposed solution 2**

The proposed amendment should be refined to specifically target the practices it is intended to target.

**Problem statement 3**

Disparity between the EM and the Bill: Page 33 of the EM under the heading "2. Proposal" states as follows:

"The treatment of capital distributions and dividends in respect of restricted shares will be aligned to one another. Both events will generally trigger ordinary revenue (and no Secondary Tax on Companies) in recognition of this partial cash-out. (our emphasis)"

The EM refers the taxpayer to section 64B(5) for the proposed amendment exempting the company from STC in the above circumstances. However, the Bill fails to make any amendment in this regard at all, with the result that if the Bill is promulgated as is, there will be no exemption from STC in the above circumstances.

Furthermore, STC is a tax on companies. The proposed new dividends tax is a tax on shareholders. The proposed change to section 64B(5) must accommodate an exemption under STC and dividends tax.

**Proposed solution 3**

All relevant sections and paragraphs contained in the Act should be amended to accommodate the intended changes.

**Problem statement 4**

The Bill proposes subparagraph (dd) be added to the proviso to subparagraph (i) of subsection 10(1)(k). The Bill proposes that Section 10(1)(k)(i)(dd) state as follows:

"There shall be exempt from normal tax...dividends (other than foreign dividends) received by or accrued to or in favour of any person: Provided this exemption shall not apply – to any dividend in respect of an equity instrument as defined in section 8C, unless the dividend constitutes an equity instrument so defined. (our emphasis)"

Once again, there is disparity between the proposals on page 33 of the EM under the heading "2. Proposal" and the Bill. The EM states that
"The treatment of capital distributions and dividends in respect of restricted shares will be aligned to one another. Both events will generally trigger ordinary revenue (and no Secondary Tax on Companies) in recognition of this partial cash-out. However, if the capital distribution or dividend consists of another restricted equity instrument, the capital distribution or dividend will be treated as a non-event. (our emphasis)"

In other words, the EM proposes that dividends received in respect of restricted equity instruments be subject to income tax, unless the dividend itself is a restricted equity instrument. The change proposed in the Bill refers to "equity" instruments.

It is our view that the two references to "equity" in section 10(1)(k)(i)(dd) must be changed to "restricted equity" in order to correspond with the intention as set out in the EM. It would be grossly unfair to tax holders of unrestricted equity instruments on dividends received in respect thereof. Furthermore, it is clear that in circumstances where one restricted equity instrument is swapped for another, there is no tax event in respect of section 8C.

**Proposed solution 4**

All relevant defined terms used in the sections and paragraphs contained in the Act should be amended to accommodate the intended changes.

Further, we propose that dividends received in respect of section 8C equity instruments, be they restricted equity instruments or not, should not be taxed. Dividends (except foreign dividends) received or accrued in respect of shares were always exempt as they represent profits which have already been subject to income tax in the hands of the company. To subject these dividends to income tax in the hands of employees results in an extremely high effective tax rate i.e. 57%.

**Problem statement 5**

Clause 17(1)(l) has added the following:

By the addition in subsection 10(1)(k) to the proviso to subparagraph (i) of the following paragraph:

"(dd) to any dividend in respect of an equity instrument as defined in section 8C, unless the dividend constitutes an equity instrument as so defined"

The dividend paid on an unrestricted equity instrument will be exempted from STC. However any capital distribution or dividend paid will be treated as revenue in the hands of the shareholder. Our concern is that the dividend has been taxed in the company at a rate of 28 per cent and will be subject to a further tax of 40 per cent in the hands of the taxpayer if an individual. This is almost an effective 57 per cent tax on the dividend received on a restricted equity instrument (28 percent on R100 in the company and another 40 percent on the R72 balance received by the taxpayer, if an individual). As these taxpayers don’t necessarily have a say in the dividend declaration it seems harsh to tax the taxpayer on the full dividend, unless the taxpayer is able to gross-up the dividend for the tax paid within the company and claim relief on such taxes paid by the company. This will ensure that the maximum tax contribution will be limited to 40 percent.
Proposed solution 5

Based on the above problem statement, a proposal is suggested that National Treasury should consider granting the taxpayer relief based on the taxes paid in the company before the dividend is declared.

2.10 DISCONTINUATION OF STANDARD INCOME TAX ON EMPLOYEES (SITE)
ADMINISTRATIVE PROVISIONS

Clause xx (1) / Amendment of Section 6 of the Act

Problem statement

xx. (1) Section 6 of the Income Tax Act, 1962, is hereby amended by the insertion of the following subsection:

“(5) Where a taxpayer’s taxable income consists solely of ‘net remuneration’ as defined in the Fourth Schedule, the normal tax determined in respect of that year of assessment must be reduced, in respect of— (a) the year of assessment commencing on or after 1 March 2011, by an amount equal to two-thirds; and (b) the year of assessment commencing on or after 1 March 2012, by an amount equal to one-third, of the difference between the normal tax payable before the application of this subsection and the aggregate of the Standard Income Tax on Employment (SITE) paid by that taxpayer in respect of that year of assessment.”. (2) Subsection (1) comes into operation as from the commencement of years of assessment commencing on or after 1 March 2011.

Proposed solution

“xx” should be clause 8.

4. INCOME TAX: MISCELLANEOUS SPECIAL BUSINESS AMENDMENTS

4.3 ISLAMIC FINANCING

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

Problem Statement

Specific deeming provisions will be added to the VAT Act to place Islamic finance on equal footing with traditional western finance as Islamic law prohibits interest being charged or received.

Fees, commission and similar charges will remain taxable (e.g. management fees).

Proposed Solution

We recommend that the Murabaha premium and Diminishing Musharaka rental should be added to the definition of “financial services” as opposed to including a deeming provision in section 8 (i.e. section 8A). This is due to the fact that section 2 of the VAT Act defines the term “financial services” and section 12(a) of the VAT Act deals with the exemption of financial services.
The only deeming provision to be included in section 8 (i.e. section 8A) should be where the bank is deemed to be acting as an agent and not a principal.

4.7 DEFAULT ELECTIONS INVOLVING INTRA-GROUP ROLLOVERS

DEFAULT ELECTIONS INVOLVING AMALGAMATION ROLLOVERS

Commentary re proposed amendments not included in EM

Problem statement

The EM does not include any commentary regarding the proposed amendments to section 44 of the Act.

Proposed solution

Commentary should be expanded to include the proposed amendments to section 44 of the Act.

4.16 REVISED RELIEF FOR RESIDENCIAL ENTITIES SEEKING TO TERMINATE

Clause 98 / paragraph 51 of the 8th Schedule of the Act

Problem Statement 1

The draft Bill proposes a requirement for both corporate entities and trusts (“entities”), as a condition of the rollover relief, the entity be liquidated after the ‘primary residence’ has been transferred to the natural person, and in addition to the liquidation requirement, the market value of the primary residence be at least 90% of the market value of all the assets of the entity. These requirements are problematic due to the fact that the primary residence together with other assets, are held in these entities. In these examples the primary residence will not necessarily make up 90% of all the assets of the entity and it might not be possible to liquidate such entities after the primary residence has been transferred. This will exclude a number of primary residences held in entities from utilising the proposed revised paragraph 51 rollover relief.

Proposed Solution 1

We recommend that the “liquidation and 90% assets” requirement contained in the revised paragraph 51 be reconsidered.

Problem Statement 2

It is proposed that the revised paragraph 51 (with the liquidation and 90% market value requirement) replace the current 2009 paragraph 51 with effect from 1 October 2010. The ‘old’ version of paragraph 51 will therefore only be valid for transfers done until 30 September 2010. This will be problematic for taxpayers who have already taken steps to utilise the rollover relief in terms of the ‘old’ paragraph 51 rules as the transfer of the property might not be concluded by 30 September 2010, and the transaction might not qualify for the revised paragraph 51 rollover relief.
Proposed Solution 2

We recommend that a longer period be given for transactions entered into in terms of the ‘old’ paragraph 51 rollover relief rules, to ensure that transactions already in progress can be concluded in terms of the rules and requirements that existed when the transactions were entered into (note, the initial paragraph 51 deadline of 31 December 2011).

4.17 CO-ORDINATION WITH COMPANY LAW REFORM

Clause 6(1)(zB) / Definition of “shareholder” section 1 of the Act

Problem statement 2

It is unclear what is meant by the term "benefit of the rights" contained in the proposed amendment to the definition of "participation rights". This is also not dealt with in the EM.

Proposed solution 2

The EM should incorporate comments re the meaning of "benefit of the rights".

4.18 MICRO-BUSINESS TURNOVER TAX REFINEMENTS

Clause 112 / Section 23 – VAT registration – Micro Businesses

Problem Statement

Deletion of subsection (8) which precludes a person registered as a micro business in terms of the 6th Schedule of the Income Tax Act from registering as a VAT vendor. Micro businesses may potentially be able to register as a VAT vendor even though they are registered in terms of the turnover tax regime.

Proposed Solution

The EM does not include the deletion of this preclusion as part of the discussion on the ‘exit and re-entry into the VAT system’. The removal of the prohibition on dual registration defies the intention on the Turnover Tax regime as stated in prior year EM. We therefore request clarification in the EM to obtain a better understanding as to why this subsection is to be deleted.

The proposed new paragraph 3(h) of the 6th Schedule of the Income Tax Act will preclude registered vendors from qualifying as micro businesses from a Turnover Tax perspective. Registered vendors therefore need to deregister for VAT before being able to use the special Turnover Tax dispensation.

Even though the amendment to paragraph 3(h) might have the same effect as section 23(8) of the VAT Act, we would recommend that the VAT Act retains the prohibition clause as the VAT Act is an Act independent from the Income Tax Act or alternatively that section 23(8) remains in the VAT Act and merely refers to paragraph 3(h) of the 6th Schedule of the Income Tax Act.

5. INCOME TAX: MISCELLANEOUS INTERNATIONAL AMENDMENTS
5.2 RESTRICTING THE CROSS-BORDER INTEREST EXEMPTION

Clause 18 / Proposed section 10B of the Act

Problem statement 1

The previous Minister of Finance stated on a few occasions that the South African economy is dependent on foreign investment in order to grow. Examples of these comments are:

ADJUSTMENTS ESTIMATE and THE 1998 MEDIUM TERM BUDGET POLICY STATEMENT
"We cannot avoid the impact of the changed outlook for the world economy. Two thirds of our exports are commodities, which means that the decline in commodity prices has impacted negatively on export earnings and our national income. Our manufacturers now face more difficult international trading conditions and tougher competition from Asian and other countries. And, we remain heavily dependent on foreign investment because we save too little ourselves”.

"Domestic savings are still too low, which means that we need to attract higher levels of foreign investment if the economy is to grow. Capital from abroad not only finances investment and growth, but also provides the liquidity in money and capital markets which we need to bring down our interest rates”.

1998 BUDGET SPEECH
"Investment must be financed by savings. Since we do not generate sufficient domestic savings to finance the levels of investment we need, we must attract foreign savings as well".

"Attracting foreign investment remains important to an economy such as ours. As a nation we do not generate enough savings to finance the levels of investment that we require to create jobs. We therefore have to attract foreign investment, making our international relations a key focus of economic policy"

2000 BUDGET SPEECH
"And as a nation, we must save more. We will continue to rely on foreign investment to complement our own savings effort, but sustained higher rates of economic growth cannot be achieved unless we increase the share of national income we make available for productive investment".

"Attracting foreign savings and investment remains an important part of our strategy. It enables us to finance increased levels of investment, which over time will create more jobs. Foreign investment brings with it access to markets and new technology, while allowing us to meet the deficit between our export earnings and spending on imports from abroad”.

PROMOTING INVESTMENT FOR DEVELOPMENT: BUILDING A SHARED STRATEGY TOWARDS A SHARED GOAL OECD Global Forum on International Investment MONDAY, 17 NOVEMBER 2003
"Governments should provide appropriate enterprise development policies and an environment conducive for business. This will help the African private sector to develop and stimulate growth, which would in turn lure foreign investment. Achieving price stability complements other policies that lower uncertainty in the investment environment, thereby encouraging higher levels of investment and improving the effectiveness of other policy measures to promote investment".
2005 BUDGET SPEECH
"It is important that we should continue to attract foreign investment and portfolio inflows, providing the external capital required to finance the shortfall between our export earnings and import costs".

We are not aware of a change in policy as regards the need to attract foreign investment. The proposed introduction of section 10B will however cause foreign investors to invest in more attractive markets.

Proposed solution 1
Section 10B should not be introduced in its entirety.

Problem statement 2
The proposed section 10B will have a major negative impact on any proposed "headquarter company" regime.

Proposed solution 2
Section 10B should exclude headquarter company interest.

Problem statement 3
The current exchange control regime provides that the interest rate of Rand denominated loans may not exceed either the prime rate plus 3% in respect of third party loans, or the base rate in the case of shareholders' loans. Most South African multi-currency loan agreements are based on the Loan Market Association ("LMA"), an organisation which acts as Europe's trade association for the syndicated loan markets by establishing uniform principles of sound widely accepted market practice. These LMA agreements contain so-called "gross-up" clauses, providing that should interest on the loan be subject to tax in South Africa whether by virtue of withholding or in any other manner, then the interest due will be grossed-up to include these taxes due. The numerous existing agreements in place which have such a grossing-up clause will place the borrower in breach of the relevant exchange control restrictions in relation to the interest rate. These grossing-up clauses have generally not been approved by the relevant Authorised Dealer. The excess interest will therefore not be remittable. Most of these agreements provide such non-remittance is a loan default event triggering an immediate repayment obligation. We therefore foresee that there will be a significant defaulting by South African debtors upon introduction of this new tax, caused by the above technical (exchange control-related) reasons. This may have an impact upon various credit ratings and may have other unforeseen economic circumstances.

Proposed solution 3
Section 10B should not be introduced in its entirety.

Problem statement 4
Section 10B will generally have the effect that interest on cross-border intergroup loans and private/family loans from creditors based in tax havens like the British Virgin Islands will be taxable. This conforms with the G20 initiatives against tax havens. However, South African has concluded DTAs with numerous tax havens, with the result that creditors based in Cyprus, Luxembourg, Malta and Mauritius and similar tax havens will benefit from the new section 10B. For example, in terms of the DTAs concluded with Cyprus, Luxembourg and Mauritius, the exclusive taxing rights under the article 11 interest articles are given to the residents of these countries i.e. South Africa is prohibited from taxing the interest payable to these residents. This unfairly benefits these particular tax havens and therefore does not conform to the G20 anti-tax haven initiative. Further, it will be a simple matter to assign loans from non-DTA tax havens, to these tax havens. Therefore, not only will certain tax havens will be placed in a more favourable position than other non-tax havens but treaty shopping will be encouraged, a result which flies directly in the face of the OECD "Anti Tax Haven Abuse" and G20 initiatives against tax havens. The introduction of a definition of "beneficial ownership" will assist in discouraging, but will not prevent, such treaty shopping. Introducing a new tax which is so easy to avoid makes no sense at all.

In contrast, there are a large number of high tax countries which have not signed tax treaties with South Africa. These countries will be prejudiced by this proposed amendment. A non exhaustive list of jurisdictions which have not concluded a tax treaty with South Africa (and which are also not on the current list of new or renegotiated treaties) include: Albania, Argentina, Bolivia, Colombia, Costa Rica, the DRC, Iceland, Lebanon, Libya, Mexico, Morocco, Panama, Peru, Philippines, Serbia and Venezuela to name a few. These high tax jurisdictions will be prejudiced when compared with tax treaty tax havens.

*Proposed solution 4*

Section 10B should not be introduced in its entirety. If this is not feasible, we note that the following issues should be addressed:

The effective tax rate will be very high when compared with the tax rates applicable in other countries in similar circumstances. In terms of the proposed section 10B, non-resident company recipients of taxable interest will be liable for tax on interest at a rate of 33%, and non-resident individuals at 40%, which tax rates are substantially in excess of the applicable tax rates in other countries. In the case of corporates, the tax rate on interest of 33% will rank as one of the highest taxes on cross-border interest remittances in the world. The tax rates applicable to foreign exempt pension funds and to foreign university endowment funds, which are both major private equity investor fund categories, could also be as high as 40% depending the legal nature of these funds. In Australia, in contrast, the withholding tax rate on interest is limited to 10%.

As section 10B does not create a withholding tax system, non-resident recipients of taxable interest will be required to register as taxpayers with SARS under section 67 of the Act, which will not only add further pressure to an already heavily burdened collection system but will cause considerable inconvenience and administrative obligations for foreign creditors. We therefore strongly recommend that instead an interest withholding tax system be introduced. A withholding mechanism is seen globally as an international best practice for the purpose of collecting taxes from non-residents. However, if levied as a final tax, it does have certain drawbacks for non-resident creditors, such as the fact that if imposed on the gross amount, no deductions may be claimed. Further, a non-resident creditor which has had tax withheld, would arguably not be relieved of their obligation to register for
tax in the first place, as in terms of section 67 of the Act every person who becomes liable for tax or who is required under section 66 to submit a return has to register as a taxpayer. To address these issues, we recommend that the tax on interest be implemented as a withholding tax but not as a final withholding tax, thereby allowing the foreign creditor at its election to register and file a tax return, should it so wish. Further, if the foreign creditor elects not to file a tax return, he must be relieved of his section 67 tax registration obligation.

A creditor which is a tax resident of a country with which South Africa has a signed Double Taxation ("DTA"), can potentially claim relief under the DTA, which could have the effect of reducing or even eliminating this tax. South Africa has 68 DTAs in force, most of which will potentially give partial or full relief for this tax. Generally, treaty relief would restrict the South African tax rate to 10%, although several DTAs eliminate the South African tax liability completely. However, a DTA would not automatically apply to eliminate the creditor's tax liability or reduce the withholding tax due. The reason is that most of these tax treaties contain a "beneficial ownership" test in the relevant interest relief article, which is a specific anti-avoidance mechanism to avoid "treaty shopping" through tax havens and other tax jurisdictions with lower tax rates than those of the source country. However, none of South Africa's DTAs contain a definition of "beneficial ownership", nor is any such definition contained in the Income Tax Act for interest tax purposes. There is also a great deal of uncertainty about the meaning of this term internationally. In order to eliminate the relevant uncertainty in this regard, we therefore propose that a definition of "beneficial ownership" be inserted into the Income Tax Act for interest tax purposes. (While a definition of "beneficial ownership" already exists in the Income Tax Act, it only applies to the (yet to be introduced) dividends withholding tax and as currently worded it is any case not suitable for this particular purpose).

The current regional holding company regime proposal does not provide for relief against the taxation of interest in terms of the proposed section 10B where the non-resident lender is a shareholder in a headquarter company. It is recommended that an additional exemption be introduced to cater for interest remitted to a non-resident shareholder of a headquarter company where the shareholder advances funds to the headquarter company. An omission of the proposed interest exemption detracts from the purpose of the regime. This exemption is critical to its attractiveness as it will greatly encourage cross-border financing and the injection of loan capital into South African headquarter companies.

The provisions of section 10B(3)(b)(ii) should be amended to state that "at any time during the year carried on business through a permanent establishment in the Republic to which such interest was attributable". Such an insertion will be line with international best practice and will accord with the OECD attribution principles in its Model Tax Convention and Commentary.

5.3 TRANSFER PRICING

Clause 53 / Section 31 of the Act

Problem Statement

Although we welcome the changes on section 31 which involves the widening of this section to include the wordings; transactions, operations or schemes on the transfer pricing arrangements, we are however, of the view that the section lacks proper guidance on the requirement of how taxpayers
should arrange their transfer pricing in accordance to the arm’s length principle as this is one of the key requirements of this section.

The section requires that transactions, operations or schemes that taxpayers enters into with related parties should be at arm’s length, but does not make provisions or prescribe ways or methods or a processes which the taxpayers should follow for their transactions, operations or schemes with related parties to be at arm’s length. Taxpayers are currently relying on Practice Note 7 as guidance on how to transact at arm’s length in order to comply with arm’s length requirements in terms of section 31.

The problem is that Practice Note 7 cannot be a binding law to both taxpayers and the SARS Commissioner. The South African case law shares the same sentiment that Practice Note 7 cannot be a binding law. In ITC 1675 it was said that SARS Practice Notes cannot override the law. In rejecting the taxpayer presenting an argument that Practice Note is binding, the Judge coded Viscount Radcliffe in Inland Revenue Commissioners v Frere when saying that, ‘he had never understood the procedure of extra-statutory concessions in the case of a body to whom at least the door of Parliament is opened every year for adjustment of the tax code’. The judge further coded Scott L.J. in Absalom v Talbot case when he said, ‘The fact that such extra-legal concessions have to be made to avoid unjust hardships is conclusive that there is something wrong with the legislation.’ Also see ITC 1830 which deals with importance of and binding nature of SARS’ practice notes. It has been confirmed in this case and reiterated that under circumstances where taxpayers have placed reliance on practice notes, such practice notes have no legal binding effect on SARS.

Proposed Solution

We propose that in order for this section 31 to be modern and fully in line with the international practice as is mentioned in the EM, that section 31 should further be changed to have ways, methods and processes to comply with arm’s length requirements in the section which the taxpayers should follow when transacting or entering into operations or schemes with related parties. The practice on this type of legislation in a number of countries internationally such as Argentina, Australia, Brazil, China, Denmark, France, Netherlands, United Kingdom, United States of America and Venezuela is that their legislation is inclusive of ways, methods and processes to comply with arm’s length requirements which the taxpayers are required to follow when transacting or entering into operations or schemes with related parties.

We therefore suggest that section 31 should further be changed to include methods or ways or processes prescribing how taxpayers should with arm’s length requirements when they transact or enter into schemes or operations as the section requires.

5.4 REGIONAL HOLDING COMPANY REGIME

Headquarter companies

Problem statement 1

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1. (1998) 62, SATC 219
2. (1965) AC 402 (HL) (E)) at 429A-B
3. (1943) 1 All ER 589 (CA) at 598A-B:
4. (2008) 70 SATC 123
It is proposed that section 64E of the Act be amended to exclude any dividends paid by a "headquarter company". It is unclear whether this exemption will apply in situations where the dividend was declared out of South African source income, for example a foreign entity may have a South African branch and it declares a dividend to the headquarter company based in South Africa, and the headquarter company in turn declares a dividend to its shareholders.

Proposed solution 1

The amendments should deal with dividends declared out of South African sourced income.

Problem statement 2

The proposed definition of "headquarter company" is perfect if the intended regime is a "holding company regime" but not proper if, if based on international standards, i.e. if a "headquarter company" regime is intended.

Proposed solution 2

The definition is too narrow if a "headquarter company regime" is intended.

Problem statement 3

In a proper headquarter company set-up intellectual property, trade marks, etc and interest form a major part of the transactions entered to between the headquarter company and the other operations. No specific provision is made for these transactions in respect of the proposed "headquarter company" regime.

Proposed solution 3

The proposed legislation should be expanded to accommodate these transactions.

Problem statement 4

The shareholding requirement of 20% seems to apply from inception and there are no provisions dealing with expansion of or changes to the shareholding. It therefore provides for a static situation which does not take into account changes in groups which is an economic reality.

Proposed solution 4

The definition should be re-worded to accommodate changes to the group structures as well as the shareholding of the headquarter companies.

Problem statement 5

There is no relief from normal tax to a headquarter company, with the relief only applying to controlled foreign companies and secondary tax on companies and/or dividend withholding tax.

Proposed solution 5
The proposed regime does not make South Africa an attractive tax regime compared to our regional competitors.

Problem statement 6

This problem statement deals with exchange control implications as regards any regional holding company regime. We note that it is impossible to fully comment on the applicability of the regional holding company regime without a review of the corresponding exchange control relief which will need to be implemented.

Clarity will be required from an exchange control point of view on issues such as inter alia:
- approvals for inbound and outbound loans;
- the retention of passive income offshore;
- the onward remittance of passive income to foreign shareholders;
- restrictions on outbound investment, including the requirement that foreign subsidiaries be in the same line of business and the requirement to return capital and capital gains upon disposal.

Proposal solution 6

We recommend that a headquarter company be deemed not to be an exchange control resident for all exchange control purposes.

Problem statement 7

The commitment to this incentive needs to be assured bearing in mind that a regional holding company regime was introduced some time ago (in 2001) but was withdrawn shortly after. The duration of the new regime should be guaranteed in the legislation due to the perception that such a regime may be similarly withdrawn on short notice.

Proposed solution 7

It is proposed that the regime be guaranteed to be effective for a period of 10 years after the incorporation of a headquarter company. Such a commitment will provide some degree of certainty to investors and will also serve to confirm the country's willingness and desire to serve as a jurisdiction which is conducive to the incorporation of headquarter companies and attractive for foreign investors.

Problem statement 8

The provisions of section 6quat need to be re-considered. We note that Headquarter companies, i.e. not companies that act as mere holding companies, are companies which will not only hold shares on a long-term basis but will also perform management, financial, procurement, administrative and treasury functions in a group context. As a result of these activities, it is highly likely that a large portion of the income derived by such a company will be in the form of management fees or technical fees paid by its offshore subsidiaries.
Unless there is a specific deeming provision in the applicable double tax agreement entered into between South Africa and the country in which its offshore subsidiary is a resident, which relates to the source of management fees or technical fees, the source of the income will for purposes of section 6quat be deemed to be in South Africa. Accordingly, no tax rebate may therefore be claimed.

As noted in SARS Interpretation Note 18, the source of income for purposes of claiming a tax rebate in terms of section 6quat is the location of the originating cause of that income. It is clear why this rule is followed if one considers the case-law dealing with the subject. It is submitted, however, that the section 6quat source rule is a major issue in the context of a regional holding company regime as it is unduly restrictive in the context of a headquarter company located in South Africa.

Notwithstanding that a deduction in terms of section 6quat(1)(C) is likely to be available, it is submitted that this restriction on double tax relief is a major hindrance to headquarter companies established for the purposes noted above.

**Proposed solution 8**

We recommend the following:

That a new deeming section be introduced which will be applicable in the context of headquarter companies. This deeming provision will serve to ensure that management fees or technical fees derived by a headquarter company be from a foreign source, namely from the jurisdiction in the payer is a resident. It will effectively provide that a full tax rebate be allowed to a headquarter company based in South Africa which performs the activities noted above.

**Problem statement 9**

Interest and Royalty Exemptions need to be considered. We further note that the proposed section 10B contains a number of exemptions from normal tax where interest is derived by a non-resident from a South African source. There is no exclusion from interest received by non-resident lenders, however, where the non-resident lender is a shareholder in a headquarter company. There is also no domestic exemption available in respect of royalty income in the hands of non-resident shareholders of headquarter companies.

**Proposed solution 9**

We recommend that an additional exemption is introduced to cater for interest remitted to a non-resident shareholder of a headquarter company where the shareholder advances funds to the headquarter company. An omission of the proposed interest exemption detracts from the purpose of the regime. This exemption is critical to its attractiveness as it will greatly encourage cross-border financing and the injection of loan capital into South African headquarter companies.

An exemption be introduced in respect of royalty income derived by non-residents who are shareholders in headquarter companies.

The introduction of these proposed exemptions would be logical and make sense in the context of the regional holding company regime especially in light of the anticipated exemptions which are to be available in respect of STC and the dividend withholding tax.
Problem statement 10

In order to claim relief from double taxation which is provided for in certain double tax agreements in respect of certain types of passive income, there are various requirements which need to be satisfied. A source State will limit its right to tax certain types of passive income where the recipient is a resident of the other Contracting State and is the beneficial owner thereof. The OECD considers it inequitable and inconsistent to grant relief or exemption (through the limitation of a taxing right in the source State) where a resident of a Contracting State simply acts as a conduit for another person. A conduit company cannot normally be regarded as the beneficial owner of interest income if, through the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned a mere fiduciary or administrator acting on account of the interested parties.

There may therefore be an argument that a headquarter company is in some circumstances a mere conduit where passive income earned by it is remitted offshore to its foreign shareholders. This may be the case, for example, when a loan is made to a headquarter company by a foreign shareholder and interest is earned by the headquarter company on the loan when it is advanced to a foreign subsidiary on a back-to-back basis. As noted by the OECD, the double tax charge that will result, should the relief not be available, will considerably reduce the interest on the money lent and thereby inhibit the movement of capital and the development of international investment.

Generally, headquarter companies will perform management, financial, procurement, administrative and treasury functions in a group context. These companies are therefore anticipated to have a fair degree of substance over and above the mere form of a conduit entity.

Proposed solution 10

In order to strengthen the argument that a headquarter company is the beneficial owner of certain types of passive income, it is proposed that some requirement be introduced effectively ensuring that the headquarter company will for purposes of a relevant double tax agreement be a company with a degree of substance, to the extent that it exceeds having mere fiduciary or administrative powers which are performed on behalf of the foreign shareholders. Alternatively, a deeming provision may be introduced to this effect. This will ensure the attractiveness of establishing a headquarter company in South Africa from a 'treaty-shopping' point of view especially when coupled with the exemption of interest in the hands of the non-resident shareholders as recommended above.

Problem statement 11

Foreign currency issues also need to be addressed. As a headquarter company will frequently be engaging in transactions involving the cross-border flow of funds, it will be subject to tax on foreign currency gains which are likely to arise. Apart from the administrative burden which will be created in recording the transactions and the corresponding foreign exchange implications, the tax exposure in South Africa may be significant due to the number of transactions which may occur in the context of a well-developed headquarter operation.

Proposed solution 11
It is proposed that the rules which relate to the tax consequences arising in respect of foreign currency differences be relaxed in the context of headquarter companies. This relaxation should ease a headquarter company's administrative requirements as well as provide another layer of attractiveness to the regime.

**Problem statement 12**

The VAT legislation which relates to the zero-rating of services to non-residents is very restrictive and is therefore particularly relevant in the context of a headquarter company rendering management, financial, procurement, administrative and treasury services to foreign subsidiaries. No mention of any VAT provisions is made in the Bill or in the EM, specifically with regard to headquarter companies.

**Proposed solution 12**

While it is understood that a headquarter company will in principle be entitled to zero-rate many of its supplies made to its non-resident subsidiaries, there are restrictions contained in section 11(2)(f) of the VAT Act which act as a barrier to the zero-rating of particular services.

In particular, if a headquarter company provides any type of advice to a foreign subsidiary and the subsidiary thereafter carries on any business involving movable property in South Africa which is based on such advice, the zero-rating will not be applicable.

If for example, a headquarter company provides technical advice to a foreign subsidiary with regard to the purchase of South African raw materials for export to offshore jurisdictions, the supply will not qualify for zero-rating, notwithstanding the revenue generated and the ongoing benefit for South Africa.

Providing additional VAT relief to headquarter companies would act as a further incentive to incorporate such a company in South Africa and bring the regime closer to that offered in other jurisdictions (notably Mauritius). The relaxation of section 11(2)(f) in the context of headquarter companies, in order to further promote the use of the regime in future, should therefore be considered.

**Clause 6(1)(q) / Definition of “permanent establishment” in section 1**

**Problem statement**

It is proposed that the definition of "permanent establishment" be amended to exclude any act of a partnership or trust in respect of any financial instrument when determining whether a "qualifying investor" has a permanent establishment in South Africa. A new definition of "qualifying investor" will be introduced for this purpose, which is, essentially, a partner of a partnership or a beneficiary of a trust which plays what could be referred to as a merely passive role in relation to the investment. While this proposed amendment is to be welcomed as creating more certainty of tax treatment for such qualifying investors, we submit that it should be extended so that it is not only the actions of the partnership or trust itself which do not create a permanent establishment, but also the actions of any agent of such partnership or trust.

**Proposed solution**
The proviso should be extended to expressly exclude any agents of the partnership or trust.

5.8 ABANDONED HYPERINFLATIONARY CURRENCIES

Clause 90 / Paragraph 20(1)(h)(ii) of the Eighth Schedule to the Act

Problem statement

The proposed section only applies to situations where the country concerned actually abandoned its currency. It does not deal with situations where the currency is still being used but from a business and economical point of view transactions are no longer taking place in the currency of the country concerned.

Proposed solution

The proposed provisions should be expanded to include situations where commercial transactions no longer take place in the currency of the country concerned even though the country has not abandoned its currency.

DRAFT TAXATION LAWS SECOND AMENDMENT BILL

Clause by clause comment

Clause 15 / Proposed section 76E of the Act

Problem Statement

Additional declarations will be required when a person applies for an advance tax ruling\(^5\) or VAT ruling\(^6\), i.e.:

a) Statement confirming that the applicant is registered for tax purposes; and  
b) Statement confirming that applicant rendered all returns as required by any Act administered by SARS and that all taxes, duties and levies due to SARS have been paid or arrangements have been made with the Commissioner in respect of the payment thereof.

A person is required to register as a VAT vendor where he carries on an activity on a continuous or regular basis in or partly in South Africa whereby goods and/or services are supplied for a consideration to another person and the value of taxable supplies exceeds or is expected to exceed R1 million within a 12 month period.

Non-residents of South Africa are only required to pay income tax in respect of income and capital gains of a South African source. South African residents are taxed on their world-wide income, subject to double tax agreements.

Residency requirements, (e.g. permanent establishment or place of effective management), for foreign entities differ significantly from the ‘enterprise’ requirement as per the VAT Act. Consequently, an

\(^5\) Section 41A(1) of the VAT Act  
\(^6\) Section 41B(1) of the VAT Act
entity may be required to register as a VAT vendor without having an income tax registration liability in South Africa.

By imputing the advance tax ruling requirements per the Income Tax Act into VAT legislation, it would seem that vendors would now be required to register for income tax before the vendor would be able to apply for rulings.

**Proposed Solution**

Clarification is required surrounding the fact that vendors will be required to register for income tax purposes before they are able to apply for a VAT ruling, since this will create difficulties for non-residents, which are registered for VAT but not for income tax purposes. Similarly, other entities, which are exempt from income tax (e.g. certain non-profit organizations), will also have a challenge in this regard. It is recommended that this requirement be clarified or removed.

Furthermore, we recommend that the provisions contained in section 76(2)(n) of the Income Tax Act (in so far as it is applicable to VAT) and after it has been considered be included in proviso (i) to section 41B(1) of the VAT Act.

**Clause 19 / Paragraph 11A of the Fourth Schedule to the Act**

**Problem Statement**

It seems that there is an opening bracket missing to the section in bold. The change from employee’s to employees’ is grammatically incorrect and inconsistent with the rest of the paragraph.

**Proposed Solution**

It is proposed that the proposed the grammar should be corrected.

**Clause 29 / Section 16 of the VAT Act**

**Problem Statement**

Currently a vendor is required to retain a valid tax invoice in order to claim an input tax deduction in respect of costs incurred in the course or furtherance of the vendor’s enterprise. The proposed amendment will include any other document as is acceptable to the Commissioner to substantiate an input tax deduction.

This amendment will give the Commissioner the discretion to accept alternative documentation where a vendor did not obtain/retain a valid tax invoice to substantiate the input tax deduction.

**Proposed Solution**

Guidance should be provided in respect of the ‘alternative’ documentation which would be acceptable to the Commissioner.
Clause 30 – Section 20 of the VAT Act

Section 20(6) – Supplies less than R50

Problem Statement 1

Currently, a supplier is not required to provide a tax invoice where the total consideration of a supply does not exceed R50. It will now be required to provide a document as is acceptable to the Commissioner where the value of the supply is less than R50.

Recipients will need to retain supporting documentation in respect of supplies where the consideration is less than R50, i.e. petty cash expenses.

Proposed Solution 1

We seek clarification as to which documents will be acceptable to the Commissioner, e.g. parking tickets and till slips.

Section 20(8) – Second hand goods acquired from non-vendors

Problem Statement 2

Currently, suppliers are only required to obtain supporting documentation where second-hand goods valued at more than R 1 000 is acquired. The proposed amendment decreases the threshold to R50.

In addition, vendors will also be required to retain proof of payment in order to qualify for the input tax deduction.

The significant decrease in the documentary requirement threshold will result in vendors having to retain detailed supporting documentation for relatively small expenses.

Proposed Solution 2

The significant decrease in threshold value might not be commercially viable from an administrative point of view. It is thus recommended that no amendment to the current value (i.e. R 1 000) be considered.
We trust that the above is of assistance.

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

Yours faithfully

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