Dear Sir

CHANGES TO POVISIONAL TAX: PARAGRAPH 20 OF THE FOURTH SCHEDULE TO THE INCOME TAX ACT

The meeting held on 27th March 2009 at SARS offices refers. We thank the SARS senior management technical team for meeting with SAICA and SAIPA representatives to note the practical difficulties that the changes to the legislation creates and explore possible alternative solutions.

The changes introduced to the legislation create the following practical difficulties:

- The unfairness of an automatic penalty for missing a target that is uncertain (reliant on future uncertainties).
- The additional workload / systems strain as a result of having to put together a detailed tax computation before year-end.
- As the vast majority of provisional taxpayers have a February year end, tax practitioners would not have time to attend to all their clients’ needs in February.

We confirm that during this meeting SARS requested the following:

1. Possible solution(s) to the problem.
2. An analysis of practical problems experienced during the computation of the March 2009 provisional tax payment (second payment).

Proposed solution(s):

Preferred solution
As our primary proposal, SAICA supports the reinstatement of the “basic amount” system for the 2nd provisional tax estimate, but subject to an automatic annual increase in this factor. Whilst a similar practice was previously applied by SARS (i.e. a 10% increase) our proposal differs in that:

- whereas (previously) the 10% increase was typically recommended where the taxpayer’s immediately preceding tax year was not yet assessed (i.e. the most recent assessment was for 2 or more years prior to the current tax year), our current proposal suggests an immediate automatic increase on the assessment of the immediately preceding tax year. It also follows that if the immediately preceding year is not yet assessed, the basic amount would be subject to compounded annual increases depending on which tax year the most recent assessment does relate to.

- whereas the 10% increase was previously merely an unlegislated “suggestion”, our proposal is for a legislated automatic annual increase.

In our view, the two main areas for further consideration would be:
(a) an appropriate annual increase factor (e.g. 10% or CPIX, etc.); and
(b) whether this new rule should be applied for the 2nd payment only, or whether the increased amount should apply for the 1st payment as well. (In the latter case, the legislative solution would simply be to amend the “basic amount” definition in para 19(1)(d), 4th Schedule ITA, and then to reinstate the para 20(1) rules on the 2nd payment to the way they were before the 2008 Revenue Laws Amendments.

Alternative

As an alternative proposal, there is also support for the retention of the existing 80% rule, but subject to a deletion of the 20% penalty rule –and applying instead an interest charge to any underestimate below 80% of the actual taxable income. However, we would emphasise that this alternative proposal – albeit certainly preferred to the current penalty regime – enjoys substantially less support compared to our primary proposal.

Practical problems – March 2009 experience:

We include in appendix 1 an analysis of practical problems experienced by taxpayers during the computation of the March 2009 provisional tax payment (second payment).

Please do not hesitate to contact me should you wish to discuss the above.

Yours faithfully
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APPENDIX 1

We present herewith:

- General comments from tax practitioners as regards their first experience with the new 80% rule (2nd provisional tax estimate for the tax year ended 31 March 2009); and
- Specific examples of practical problems identified by practitioners and taxpayers.

General comment from tax practitioners – 31-Mar-09

For years of assessment ending 31 March 2009, tax practitioners report a substantial increase in the time spent assisting their clients with the 2nd provisional tax estimate. A typical report is as follows:

<table>
<thead>
<tr>
<th>Time spent (hours) – Y/E 31-Mar</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>2nd provisional tax estimate (actual hours)</td>
<td>1.00</td>
<td>23.00</td>
</tr>
<tr>
<td>Final tax computation (2008-Actual; 2009-Estimated)</td>
<td>12.00</td>
<td>10.00</td>
</tr>
</tbody>
</table>

Although we concede that time constraints mean that our data collection cannot represent a sufficient sample to make generalisations with absolute certainty, we would also stress that the above example is not an extreme case.

Two important observations must be highlighted:

(i) The time spent on the 2nd provisional estimate (for 2009) far exceeds the time spent on the actual tax calculation (for 2008). This was because the 2009 provisional estimate required substantial projection work, additional internal consultation (with various role-players in the taxpayer’s management) and “educated guessing”, whereas the final computation is simply based on actual figures that already exist at the time of the calculation.

(ii) The additional time spent on the 2nd provisional estimate does not meaningfully reduce the time that will need to be spent of the final tax calculation. Most of the figures that fed into the provisional estimate (e.g. projections) will be meaningless since the taxpayer will then simply use the actual figures.

The specific examples listed below confirm these conclusions.

Specific examples of practical problems

Companies with a March year end:

Example 1: Property Company
A property company having sold the building in the previous year now only had cash in the bank. Having declared a dividend in the current year one had to check the bank statements to calculate the interest earned for the year to date as well as to extrapolate this till the end of March in order to calculate the taxable income for the year. This took an extra hour of time.

This is regarded as “wasted” time as this will have to be re-done once the final IT3 certificate from the bank is received.

**Example 2: Consultancy Business**

This is a trading consultancy business. In this case the client was able to provide the tax practitioner with management accounts up to 31 January 2009.

The practitioner had to estimate the income for February and March which places the entity at risk (this is not always possible for small and medium sized clients).

The practitioner had to also estimate expenses for these 2 months and to calculate wear and tear allowances for the year as well as examine additions / disposals of assets during the year. They had to examine payments for instalment sales and allocate the payments between finance charges and capital repayments (estimating for the 2 months due to the changes in interest rates).

The practitioner had to go through the trial balance / draft annual financial statements with the client to highlight any unusual items and make the necessary adjustments. This entire exercise took at least 5.5 hours of additional work. One can assume that about 1.5 hours of this would have had to be done at year-end which still leaves an additional 4 hours on this client.

**Example 3: Trading Close Corporation**

This is a trading CC. The practitioner had to go through the steps listed above.

In addition, they also had to make the best estimate of closing stock, debtors and creditors at year-end. This entailed an additional 6.5 hours of work of which a maximum of 1.5 hours can be used to produce the final figures. This equate to 5 hours of additional work and cost to the client.

**Example 4: Manufacturing Company**

The time required to prepare and complete the tax return is approximately 6 months.

They are unable to estimate items like forex variances on cross currency and interest rate swaps. The cross currency and interest rate swaps adjustments vary between R100 000 000
and R20 000 000. The entity relies on information provided by third parties to determine the entries required, which information is only available after year-end.

Example 5: Listed entity

The following additional work compared to previous years had to be done:

- Perform an actual calculation for February and roll it forward to March; March month estimate used involved many variables that a position had to be taken on.
- Review previous years to identify the movement in provisions and deferred income; and
- Sit with the different finance departments including the financial director to ensure that the estimates are reasonable.

The above work was a stand alone exercise and did not assist much with the year end work. It took up limited tax resources during the busy period related to year end. We also had to engage senior management from SARS who wanted reasons for variances and requested copies of our latest estimated tax computations well before due date submission of the IRP6. There was indeed a push from SARS management for us to pay in line with first provisional estimate without considering the downturn in the economy.

Companies with year ends other than March:

Example 1: Audit Firm

The firm’s tax year-end is May and they have to make sure that partners make a second provisional payment that is subject to this 80% rule. Firstly a number of their partners rely on calculations that have been produced by the firm. The firm has an investment overseas and also sends its staff on secondments abroad. These two alone depend on the many factors such as exchange rates, the economic conditions aboard, the performance of the investments abroad etc. In order to accurately calculate the second provision they need:

1. To determine the performance of the entities aboard as at the end of May (they may have a different year-end);
2. To determine the relevant exchange rates for the period;
3. Consider double taxation agreements; and
4. Perform tax calculations to be attributable to SA partners.

With regard to secondments, they need to determine:

1. The exchange rate for all countries where they seconded staff;
2. Consider double taxation agreements etc.

Example 2: A group of entities including companies, trusts and individual entities.
The problems created by the amended paragraph 20 of the Fourth Schedule affect all entities in this group and are summarised hereunder.

In the cases of many of the individuals, reliance has to be placed upon overseas service providers to complete financial statements, from which the income taxable in the hands of the individuals in terms of section 9D of the Act, can be extracted. This information is simply not available before, until at the earliest, two months after the February year-end i.e. by 1 May, more realistically, three months, being 1 June.

Furthermore, foreign bank account movements are calculated using an average exchange rate for the year, which SARS only publishes quarterly after the event – in the absence of the rate, the foreign income, gains and losses cannot be translated into Rand’s using approved rates at the February year-end. This would therefore require re-performance of the calculations, once the SARS rates have been published.

The third area of concern relates to the finalisation of capital gains, both local and foreign, by the various banking institutions. These have to be included in the estimate of taxable income under the amended legislation, however, a taxpayer’s estimate of capital trading transactions can be significantly different to what is ultimately filed by the financial institution, especially in the case of roll-up type funds.

Previously, in respect of the first two above practical difficulties, it was convenient and appropriate, in the absence of current year information, to rely on the basic amount i.e. the previous assessed income, when submitting the second provisional tax payment.

In respect of the third difficulty, capital gains were excluded from the basic amount. This was logical, given the non-repetitive nature of capital gains income.

The non-availability of information regarding section 9D income, SARS foreign exchange rates and local and foreign capital gains does not permit an accurate estimation of taxable income to be performed at the year-end itself. The work can therefore only be performed, once this is available, some months after the year-end, and in time for the submission of the actual tax return.

**Example 3: Life Assurance Company**

The following process is followed to complete their tax return, which will be the same process that has to be followed in order to reach an estimate of 80% of taxable income for purposes of the second provisional tax payment.

- The year end is 31 December.
- Because they pay tax based on the four funds tax basis as outlined in section 29A, there are several processes that have to be followed.
The main driver of taxable income is shareholders profit which is the difference between the market value of assets and market value of liabilities at year end. To determine the profit therefore, the assets and liabilities have to be valued, using the market value on 31 December. The starting point to calculate the liabilities is determining the interest rates on 31 December. This can only be done post 31 December. Generally, due to the size of the business, a decent estimate of the actual profit numbers, generally is only available on the 6th working day of January, which is around 10 January. This timeline cannot be brought forward. Unexpected change’s in interest rates materially affects profits and hence any estimate based on an assumption of interest rates is likely to be wrong.

In addition, another driver of taxable income is capital gains tax numbers, which catches all the transactions up to and including 31 December. This practically can also only be run on the CGT software post 31 December and the earliest practical time that this can be available, considering the software engine takes 3-4 days to run the transactions for the year (approximately 840 000 transactions for the year), is at the end of the 3rd working day of January which is generally around 5/6 January.

They also have transactions which are not currently on the CGT system, and these generally take longer to process in order to arrive at the actual CGT for these assets.

Their analysis of expenses take several months to determine deductibility or not of those expenses, and this also delays the submission of the tax return.

Example 4: Automotive Company

There may be some incidental benefits derived from producing estimated tax computations before year end. However, as many variables that affect the tax computation can only be determined after the end of the tax year, it is considered that the work done to provide the estimates of taxable income for provisional tax purposes is not going to reduce the amount of work required to complete the annual tax return, as this will largely be a duplication of processes. Because of the difficulties experienced in estimating some of the adjustments required for the tax computation without complete information, there is a risk that the estimates will not be within 80% of the taxable income as finally assessed. This could result in substantial penalties being imposed on the company despite the level of time and effort that was required to calculate the estimated taxable income and despite the fact that the estimate was based on the best information that was available at the time.

Specific feedback was received from the Automotive and Logistics divisions.

Automotive division

The following areas proved most difficult in calculating the tax estimates:

- Trading income (current economic conditions) - To accurately estimate even one month's earnings in advance is particularly difficult while trading in the current
economic conditions where seasonality, travel patterns, used car sales market etc all move without a clear trend pattern.

- **Bad debt provision** - The provision is calculated in terms of IFRS which requires a credit rating exercise on over 8,000 individual debtor accounts. Each of these accounts needs to be assessed based on the status of the account at 30 September and the calculation applied to the balance outstanding on the same date. To estimate the movement on each account both in value and credit status over a month period is extremely difficult.

- **Fleet & stock Net Book Value** - the fleet and stock NBV is influenced by new purchases, sales, write offs by customers, vehicles stolen, vehicles converted by customers, vehicles returned by manufacturers etc. Each one of these events could apply to any and all of 17,000 vehicles varying in price from R100k - R600k and in age from brand new to 16 months old. To estimate each of these variables is nearly impossible.

- **Fleet & stock Net Tax Value** - Same principle as previous point.

- **Recoupment** - The recoupment is affected by both the previous two points and further complicated by the current year-on-year shrinking of fleet due to the negative trading conditions. As a result they also have to estimate the effect of the deferred recoupment provisions in terms of section 8(4)(e) of the Act.

The extra work required consisted mostly of duplicating the credit ratings of customers both one month before the end of the reporting period and again at the end of the reporting period and using the first rating as a basis for the estimate. This involved at the least 6 staff members full time over a period of 3 days. The same applied to the NBV, NTV & recoupment estimates where a duplication of work needed to be performed both on the August balances (estimated to September) and again on the September actual balances for the final calculation.

*Logistics division*

- Relatively easy to forecast profit before tax from latest plan or forecast;
- Difficulty arose with respect to deductible and taxable timing differences i.e. W&T allowance not forecasted while depreciation and amortisation is – is the W&T to depreciation ratio higher in the estimate due to an increase in the fixed asset base or lower due to less capex and increasing age of fixed assets?
- Latest forecast may not include recent developments and economic impacts for e.g. they used some Plan 2 numbers that had been submitted but Plan 2 is only due in April – there was a significant drop in volumes in some of their business units between Plan 1A and the draft Plan 2 (R22m PBT effect);
- Permanent differences – normally increases taxable income however there may be once off large permanent differences that materially affect the final tax calculation.