Dear Sir/Madam

ANNEXURE C PROPOSALS FOR 2010: INCOME TAX
The SAICA National Tax Committee has identified certain issues that require the attention of National Treasury and possible amendments to the Income Tax Act No.58 of 1962 (“the Act”). Please find our proposals below.

1. Interest deduction: Debt push-down structure

(i) The nature of the problem

Income Tax deduction:
Interest incurred on the acquisition of shares of a company is not deductible for income tax purposes as it does not constitute expenditure actually incurred in the production of income (section 11(a) and 23(f) of the Act).

Par 20(g) of the Eighth Schedule:
In terms of paragraph 20(g) of the Eighth Schedule to the Act, the base cost of an asset includes, inter alia:

“the following expenditure actually incurred which is directly related to the cost of ownership of that asset, which is used wholly and exclusively for business purposes or which constitutes a share listed on a recognised exchange.....

i. ...

ii. ....

iii. Interest as contemplated in section 24J on money borrowed to finance directly the expenditure contemplated in items (a) or (e) in respect of that asset.

Provided that if that asset constitutes a share listed on a recognised exchange..., the expenditure contemplated in sub items (i) to (iii) in respect of that asset must for the purposes of this item be reduced by two-third.”
(ii) A detailed factual description of the relevant transaction
Currently if a company acquires control of another company (became part of the same group of companies), to achieve an income tax deduction for the interest incurred on financing the transaction, the transaction has to be structured in a complicated manner, namely:

- First acquiring the shares of the target company;
- Then creating a Newco (also subsidiary of the holding company for example);
- Then transferring all the assets and liabilities for the acquired company to the Newco, financing the transfer with interest bearing loans (using for example section 45 of the Act);
- The proceeds received from the disposal of the assets are used to settle the original un-productive loan;
- Thereafter the interest on the productive loan that remains will be tax deductible as the loan was utilised to acquire income producing assets.

It is therefore possible to currently structure a transaction when a company acquires the shareholding of another company to achieve an income tax deduction for the interest incurred. The methodology is however complicated and it is respectfully requested that specific provision be made for an income tax deduction for the interest incurred on loan funding utilised to acquire shares of companies in such transactions in line with international best practice.

SAICA requests to further engage with National Treasury in this regard to achieve a practical solution to the problem.

(iii) A description of what the transaction seeks to commercially achieve
Corporate restructuring to expand businesses etc, as well as very importantly BEE deals are also impacted by these transactions.

(iv) The nature of the businesses impacted by the problem
Corporate taxpayers involved in restructuring, as well as businesses taking on a BEE partner.

(v) The relevant urgency of the matter at hand
In the next two years as the economy will begin to recover. We anticipate that the number of BEE deals will increase. To make the transaction commercially viable, an interest deduction on the financing side, without going through a whole set of complex section 41 to 47 transactions will greatly assist taxpayers.

2. Increase small business corporation R300 000 threshold for 28% tax rate
(i) **The nature of the problem**
A small business corporation is defined in section 12E of the Act. A small business corporation is taxed according to a separate tax table, and the maximum marginal tax rate of 28% begins at a taxable income of R300 000. The R300 000 maximum marginal rate level according to the table has not been adjusted for inflation etc since the 2007 tax year.

(ii) **A detailed factual description of the relevant transaction**
As the R300 000 maximum marginal tax rate level has not been adjusted since the 2007 tax year, there is a risk that the small business corporation tax benefits might lose their impact and be depleted. At an increase of 8% per annum, it is therefore requested that the maximum marginal tax rate for small business corporations (currently 28%) should start at a minimum level of R400 000 for the 2011 tax year.

(iii) **A description of what the transaction seeks to commercially achieve**
See (i) and (ii) above.

(iv) **The nature of the businesses impacted by the problem**
Small business corporations as defined in section 12E of the Act.

(v) **The relevant urgency of the matter at hand**
Urgent, as this monetary threshold has remained unchanged since 2007.

3. **Section 23(m): expansion of deductions**

(i) **The nature of the problem**
Deductions available to taxpayers earning remuneration are limited by section 23(m) of the Act. Section 23(m) of the Act was introduced on 1 March 2002 (Taxation Laws Amendment Act No. 30 of 2002). The current version of section 23(m) limits the deductions available to employees earning remuneration to:

- contributions to pension and retirement annuity funds as per sections 11(k) and 11(n);
- allowances or expenses in terms of section 11(c) (legal expenses), section 11(e) (wear-and-tear), section 11(i) (bad debts) and section 11(j) (doubtful debts);
- any premium paid on a income protection policy that would qualify as a section 11(a) deduction to the extent that it covers the loss of income caused by illness, injury, disability or unemployment and to the extent that such amounts received in terms of this policy will constitute income as defined in section 1 of the Act; and
the deduction of home study costs to the extent that it is not prohibited by section 23(b) of the Act.

Since the introduction of section 23(m), certain taxpayers earning remuneration have suffered hardship due to the fact that they have incurred certain legitimate expenditure in the production of their remuneration (income), which they were obliged to incur, but did not qualify for a deduction in terms of section 23(m). In other words, although these expenditures were a necessary concomitant in earning the remuneration (income) they were nonetheless specifically prohibited from deduction.

(ii) A detailed factual description of the relevant transaction

Examples of expenditure incurred by employees not allowed as a deduction include:

- Membership fees to professional bodies paid by salaried employees for example medical doctors;
- Continuous professional education expenditure incurred by employees and not refunded by employers;
- Professional indemnity insurance premiums paid by salaried employees such as medical doctors;
- Certain employees are in terms of their employment contracts allowed to subcontract the work they need to perform. In certain cases such ‘employees’ have not been seen as independent contractors by SARS, and the salaries paid to the subcontractors were disallowed as deductions, for example:

  - Lecturers at tertiary institutions occasionally make use of assistants in marking papers or performing other administrative tasks and in certain cases remunerate such assistants themselves. Again the ‘salary’ cost of such assistants will not be deductible.
  - Certain government employed teachers, if taken leave outside school holidays are required to obtain a suitable replacement for that period and to remunerate such replacement themselves. The cost of paying such replacement teacher will not be tax deductible.
  - Cellular phone costs of employees that they were obliged to incur in terms of their employment contracts.
  - Fees paid to agents of sportsman.

It is recommended that consideration be given to the amendment of section 23(m) of the Act to include the above examples ‘missing’ from the list and/or alternatively a “general deduction” available to salaried employees, but subject to strict criteria.
(iii) **A description of what the transaction seeks to commercially achieve,**
See (i) and (ii) above.

(iv) **The nature of the businesses impacted by the problem**
Natural persons earning remuneration.

(v) **The relevant urgency of the matter at hand**
Urgent, as natural persons earning remuneration suffer hardship in these circumstances.

4. **Capital gains tax: Capital gain cannot flow through multiple trusts**

(i) **The nature of the problem,**
Paragraph 14.11.6.3 of the SARS CGT Guide (Issue 2) stipulates that a capital gain cannot flow through multiple trusts. This appears to be in accordance with paragraph 80(2) of the Eighth Schedule as amended by the Revenue Laws Amendment Act 2008. There does not appear to be any reason why the “conduit pipe” principle for Capital Gains Tax purposes should be different than the treatment for income tax purposes as indicated by section 25B of the Act (section 25B of the Act does allow normal taxable income to be distributed through multiple trusts).

(ii) **A detailed factual description of the relevant transaction**
The result of paragraph 80(2) of the Eighth Schedule to the Act and the treatment as indicated in paragraph 14.11.6.3 of the SARS CGT Guide is that if for example fixed property is disposed of, and the proceeds are not subject to normal tax, then the capital gain cannot flow through multiple discretionary trusts. If however the fixed property is subject to income tax (in the case of a property dealer) then the profit can flow through multiple discretionary trusts.

(iii) **A description of what the transaction seeks to commercially achieve**
The top level trust might for example be a “business trust” operated for the benefit of two “partners” of the business. The beneficiaries of the “business trusts” are the two family trusts of the “partners”, with the partners being the beneficiaries of the family trusts. These structures have historically been set up in this manner and according to previous versions of the SARS CGT Guide, it was possible to distribute capital gains through multiple discretionary trusts (in line with normal taxable income).

(iv) **The nature of the businesses impacted by the problem**
See (i) and (ii) above.

(v) **The relevant urgency of the matter at hand**
Urgent, as these discretionary trusts distributing capital gains cannot distribute the gains “through” another trust and are therefore incurring additional capital gains in the “second trust”.

5. Section 9C

i) The nature of the problem
If a taxpayer holds a ‘qualifying share’ as defined (in section 9C(1)) any amount other than a dividend received by or accrued to a taxpayer is deemed to be capital in nature.

The above does not take into account taxpayers who acquire shares on trading account and for various reasons do not dispose of these shares within three years of acquiring them.

In the current economic environment, the reasons could include a significant decline in the value of the share which the taxpayer is of the view would reverse in the medium term. The taxpayer would therefore wish to hold the shares until the share price recovers, even if it means holding the shares for more than three years.

Prior to the introduction of section 9C, in these circumstances the taxpayer would be partially shielded from the economic loss by way of the income tax deduction for which the taxpayer would qualify. With the introduction of section 9C, as soon as taxpayers hold shares for more than three years, the taxpayer would lose the benefit of the income tax deduction.

It is conceivable that, notwithstanding good commercial reasons for holding a share beyond 3 years (albeit with the ultimate intention of resale), taxpayers would be forced to scrutinise portfolios regularly and manage these in light of income tax considerations (that is, to secure income tax losses to set off against gains that may well be fully taxable given that it is sold within 3 years).

ii) The nature of businesses impacted by the problem
Banks, asset managers, insurers, etc. who acquire shares on trading account and for various reasons do not dispose of these shares within three years of acquiring them.

iii) Proposed Solution
We propose that the taxpayer be granted an option to elect out of the provisions of section 9C on a share-basis. In other words, taxpayers should be obliged to elect upfront whether a share is held for capital investment purposes (in which case section 9C would be elected to apply) or on trading account (in which case, section 9C would not apply). A taxpayer
would be bound by this election in respect of all future sales of shares in the same company, until all the shares are disposed of, unless there is a ‘change in intention’ as contemplated by the courts (note, the taxpayer would have to rely on the usual capital versus revenue principles enunciated by the courts to support a change in intention). This to ensure that the taxpayer does not manipulate this election by only electing out of section 9C in respect of shares where the taxpayer would sustain a loss only and having the benefit of section 9C where the taxpayer makes a profit).

As a transitional measure, it is proposed that taxpayers are also allowed to elect, on a share-by-share basis, in the year that election in terms of section 9C becomes effective, in respect of any existing shares owned by the taxpayer at the effective date.

6. **Section 9C**

i) **The nature of the problem**

The Taxation Laws Amendment Act in section 49(1)(a) deletes the definition of “equity share” in section 44 of the principal Act. Section 9C of the Act refers in section 9C(1) to a “qualifying share” as contemplated in section 44 of the Act.

There is thus a problem as to what constitutes an equity share for purposes of section 9C of the Act for years of assessment commencing on or after 1 January 2010.

ii) **The nature of businesses impacted by the problem**

Please refer to point (i) above.

iii) **Proposed Solution**

Section 9C of the Act should be amended for all years of assessment commencing on or after 1 January 2010. The amendment to section 9C of the Act should refer to section 41 as opposed to section 44.

7. **Suggested amendment to section 12I(2)**

i) **Current position**

The current version of section 12I(2) of the Act which deals with additional investment and training allowances in respect of industrial policy projects provides as follows:

"In addition to any other deductions allowable in terms of this Act, a company may, subject to subsection (3), deduct an amount (hereinafter referred to as an additional investment allowance) equal to –
(a) ..., or

(b) ..., in the year of assessment during which that asset is first brought into use by the company as owner thereof for the furtherance of the industrial policy project carried on by that company, if that asset was acquired or contracted for on or after the date of approval and was brought into use within four years from the date of approval" (our emphasis).

ii) The nature of the problem

The requirement that the additional investment allowance would only be applicable to assets which were acquired or contracted for on or after the date of the approval of the industrial policy project is problematic for the following reasons:

- Industrial companies involved in the industrial environment continuously have to consider whether or not to expand or upgrade their current facilities. Equally, these companies or companies seeking to enter the industrial market have to decide whether or not market and/or economical conditions – local or global – are conducive to the setting-up of a new industrial facility.

- There are a number of factors which are taken into account by these companies when the timing of these expansions, upgrades or new facilities are considered. One of the major considerations is the projected after-tax return-on-investment ("ROI") of the specific investment. The sensitivity of the ROI is usually tested against the movements of various variables such as

  - exchange rates in respect of:
    - the acquisition or manufacture of the various components required to erect the expanded, upgraded or new facilities; and/or the export of the end products;
    - other costs such as transport costs in respect of the components and/or raw materials required to manufacture the products and/or the delivery of the end products to the required markets;
    - projected/estimated demand for the product to be produced, taking into account economic cycles;
    - cost to manufacture the product v price at which the product can be sold;
    - tax allowances and investment incentives.
All or any combination of the above and various other factors therefore could significantly impact the timing of any investments in these industrial projects.

The limitation of the application of the additional investment allowance to assets which were acquired or contracted for on or after the date of the approval of the industrial policy project is unrealistic as it ignores the practicalities surrounding the commencement of any industrial project of the nature envisaged. One of the most significant practical issues is the lead times required by suppliers of components or plant for (i.e. assets) which are required for installation. Generally, these components or plant are not of the nature where supplier would keep stock or be able to manufacture the same on demand. Further, the time required in manufacturing these components or plant may be months and in order to ensure that the specific components or plant are available for installation at the time required in terms of the steps identified to complete the project within the specified timeframe.

The argument that, the mere fact that a company has already acquired or contracted for "assets" which would qualify for the additional investment allowance had the assets not been acquired to or contracted for on or after the date of the approval of the industrial policy project, is an indication that the company intended to invest in the assets at this time, is in our view, unfounded. Not only would these companies at the same time be preparing the application for submission as required in terms of the regulations, but for the reasons noted above, these investments would, in the absence of the additional investment incentives, not produce a ROI which would meet the required hurdle rates of the company in respect of such returns.

### Proposed solution

We propose that the limitation of the additional investment allowance to assets acquired or contracted for on or after the date of the approval be removed. Further, the additional investment allowance should be available in respect of all assets which form part of any industrial policy project which has been approved provided the assets were acquired or contracted for on or after the effective date of the section.

We accordingly propose that the wording of section 12I(2) of the Act be amended as follows:

"In addition to any other deductions allowable in terms of this Act, a company may, subject to subsection (3), deduct an amount (hereinafter referred to as an additional investment allowance) equal to –

(a) ...; or

(b) ...,
in the year of assessment during which that asset is first brought into use by
the company as owner thereof for the furtherance of the industrial policy
project carried on by that company, if that asset was acquired or contracted
for on or after the effective date of this section and was brought into use
within four years from the date of approval”.

8. Amendments to section 9(1)(g)

i) Current position
The expansion to specifically include a "lump sum benefit contemplated in the
Second Schedule" is welcomed. Although we have argued that a lump sum is
nothing more than the upfront payment of any pension or annuity granted to a
person, the inclusion of the lump sum benefit now ensures that there is no
doubt as regards the application of section 9(1)(g) of the Act to these lump
sum benefits.

ii) Problem statement
Clarification is required regarding the determination of "period during which
the services rendered". In this regard we refer to determination of the tax-free
portion of a lump sum in the circumstances provided for in section 9(1)(g) of
the Act in circumstances for example where the taxpayer at some time during
his/her career transferred his/her fund credit from a pension fund to a provident
fund. There are currently two views regarding the determination of the period
during which the services were rendered which should be applied. Supporters
of one view argue that the tax-free portion of the lump sum should be
determined with reference to period of membership of the provident fund and
not with reference to taxpayer's years of service in respect of which he/she is
now receiving the lump sum payment whereas supporters of the other view
argue that in these circumstances the period during which the services rendered
relates to the taxpayers total career and not merely the period related to his/her
membership of the provident fund.

Whilst it is clear from the provisions of section 9(1)(g) of the Act, the
calculation of the non-resident portion is totally dependent on the years of
service rendered in respect of which the pension or annuity is granted and
no reference is made at all to the period of membership of the particular
retirement fund, the jury seems to be out on whether it can be said that the
lump sum to which the taxpayer has become entitled to has been granted "in
respect of services" rendered by him, and if so, whether it is only in relation to
the services rendered by the taxpayer whilst a member of the provident fund,
or the total services rendered by him to his employer.
It is apparent that the present provisions of section 9(1)(g) of the Act, read with paragraph 2(a) of the Second Schedule to the Act, give rise to considerable uncertainty in application. Where previously the tax-free portion of a lump sum derived on retirement was determined by reference to formula A, and formula A was determined by reference to the number of years of employment taken into account for purposes of determining the amount of benefits payable to the taxpayer under the rules of the retirement fund, this is no longer the case. As a consequence of the benefit of taking years of employment (service) into account for purposes of formula A, that the revenue authorities allowed a provident fund in these circumstances to carry over the employee's service period under the pension fund on conversion. Having determined the tax-free portion of the lump sum, section 9(1)(g) of the Act would then have been applied to determine the portion of the taxable amount of the lump sum that was regarded as being derived from a source in South Africa.

Had formula A not been replaced by the graduated tax rate regime (thereby rendering the years of service rendered by the taxpayer redundant for purposes of determining the tax payable in respect of a lump sum), there would have been no doubt that the period of service referred to in formula A and section 9(1)(g) of the Act were the same years of service, namely, in the stated situation, those relating to membership of the pension fund and provident fund. It is only now that years of service rendered under a pension and provident fund in the case of conversion are no longer relevant for purposes of determining the tax-free portion of the lump sum, that an argument that only the period relating to the membership of the last retirement fund, in this instance the provident fund should be used has arisen.

Unfortunately, in the absence of any authoritative pronouncements concerning this conundrum, whether by text book writers or the revenue authorities, we are of the opinion that this aspect be addressed in the proposed legislation.

iii) Proposed solution
Provisions need to be incorporate into the Act to clarify the position.

9. PART III of the Income Tax Act

i) Current position
Section 41 of the Act defines an ‘allowance asset’ as a capital asset in respect of which a deduction or allowance is allowable in terms of the Act for purposes other than the determination of any capital gain or capital loss.

The use of the words ‘deduction or allowance is allowable’ creates the impression that the specific requirements contained in the deduction and allowance provisions contained in the Act are required to be complied with. So
for example, in the case of section 13quin allowances, a deduction is allowed on the cost of new and unused improvements to any building owned.

ii) **Problem statement**
Sections 42(3)(a); 44(3)(a); 45(3)(a) and 47(3)(a) in essence require the ‘transferee’ to acquire the asset as an allowance asset. In other words, an asset in respect of which a deduction or allowance is allowable (i.e. to which the transferee is entitled) in terms of the Act. Now, in the example of the section 13quin allowance, the ‘transferee’ would not be able to acquire such an asset as an allowance asset as the asset is not new and unused in the hands of the transferee. In other words, this would lead to the absurd result that the ‘roll-over’ provisions would not apply to the transfer of such assets.

The example of section 13quin is but one example of where problems can be encountered in the application of the ‘roll-over’ provisions.

iii) **Proposed solution**
The legislation needs to be amended to make it clear that the transferor and transferee in terms of a section 42, 44, 45 and 47 transaction are deemed to be one and the same in regards to assessing ‘qualifying criteria’ contained in all of the deduction and allowance provisions contained in the Act.

Currently the transferor and transferee are only deemed to be one and the same in regards to the ‘amount’ of any allowance or deduction to which the transferee may be entitled or is to be recovered or recouped.

10. **The Eighth Schedule to the Act**

i) **Current position**
Currently where a lessee effects improvements to the property of a lessor (where the improvements are not obligatory), the effecting of the improvements and the resultant disposal (through the common law principle of accession) do not give rise to a part disposal for CGT purposes. Rather, on termination of the lease, the expenditure incurred in terms of paragraph 20 of the Eighth Schedule is treated as a capital loss on termination or expiry of the lease.

iii) **Problem statement**
In certain instances, the lessor agrees to reimburse the lessee for the non-obligatory costs incurred. In such an instance, paragraph 35(3)(b) deems such amounts to be proceeds received or accrued and are then subjected to tax. An added problem is that paragraph 20(3)(b) of the Eighth Schedule reduced the expenditure incurred to nil as a result of the reimbursement or recovery. Thus, potential double taxation arises in the sense that there is no base cost to create a loss on termination or expiry of the lease and paragraph 35 requires proceeds to
be taken into account, arguably, on the initial disposal of the bare dominium (through the common law principle of accession).

iii) Proposed solution

It is proposed that paragraph 35(3) of the Eighth Schedule be amended to exclude from proceeds any amount taken into account in terms of paragraph 20(3)(b) of the Eight Schedule to the Act. This will have the effect that any recovery or re-imbursement goes toward reducing the expenditure incurred to nil in terms of paragraph 20(3)(b) i.e. thus resulting in no loss on termination or expiry of the lease. In addition, there is no proceeds on disposal where the amounts constitute a recovery or reimbursement. Viewed in its entirety, the transaction should result in no gain and no loss which mirrors the commercial reality of the transaction.

It is important to note that paragraph 35(3)(a) is currently not wide enough to include such arrangements as the recovery or reimbursements would not be and would not have been taken into account when determining the taxable income of the lessee before the inclusion of any taxable capital gain as the expenditure was never claimed as a tax deduction.

11. Section 28(8)(b)

i) Problem statement

It seems equitable that, should a foreign short-term insurer wish to avail itself of the similar deductions to those available to resident insurers, it should be required to be able to demonstrate that the deductions it seeks to make are similar to those which a local insurer could deduct. Thus it would be reasonable that these insurers are required to provide financial statements which are consistent with the requirements of the Short-Term Insurance Act. However, the requirement of section 28(8)(b) that the law of the foreign country require that the claims estimates and unearned premium provision be established seems both superfluous and discriminatory.

ii) Proposed solution

The requirement of section 28(8)(c) that the claims estimate and the provision comply with the provisions of the SA Act could be bolstered by requiring these amounts to be audited on this basis.

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

Yours faithfully
M Hassan CA(SA)
PROJECT DIRECTOR: TAX
The South African Institute of Chartered Accountants

cc: Keith.Engel@treasury.gov.za
greg.smith@treasury.gov.za