Call for comment file

12 March 2007

Mr N Nene
Chairman: Portfolio Committee on Finance
Parliament
P O Box 15
CAPE TOWN
8000

BY E-MAIL: ahermans@parliament.gov.za

Dear Sir


We refer to the call for comment on the above-mentioned documents. Set out below please find SAICA’s National Tax Committee’s submission in this regard.

1. GENERAL

1.1. As with previous submissions, we raise our concerns with the inadequate turnaround time allowed for commenting on the above mentioned Bills. The concerns relate to the fact that the Portfolio Committee on Finance requires comment by 12 March 2007, when the notice by SARS calls for comment only by 23 March 2007. This clearly impacts on the ability to provide meaningful comment on the proposed amendments.

1.2. The budget proposals regarding corporate reorganisations and BEE transactions have not been included in the draft bill.
2. SECTIONS OF THE BILL

2.1. Sub-clause 5(1)(b) - S8(4)(a)(aA)(i)

What would the revenue expenditure recovery be? If one disposes of an intangible, for example, is it envisaged that revenue expenditure be recouped? If one disposes of a building there is no recoupment for the section 11(d) repairs to the building. This principle is supported by decided case law. Clarity needs to be provided in this regard. Revenue expenditure on an intangible may not be reflected in the final product being sold why should this then be recouped?

2.2. Sub-clause 5(1)(b) - S8(4)(a)(aA)(ii)

As far as the building recoupments in respect of section 11D(1) assets are concerned, will these rank for consideration under section 13(1), if so, what amount will qualify for write-off? Furthermore, no amendments have been proposed for section 13. We recommend that the necessary amendments be made to section 13.

2.3. Sub-clause 9(1) - section 10

2.3.1. Annexure C of the detailed Budget Review 2006/2007 indicated that the provisions of section 10(1)(o)(ii) of the Act would be amended to extend the exemption to remuneration for services rendered whilst the South African was abroad but which is only received in a later tax year when the South African no longer qualifies for the exemption. The Bill does not include a provision to extend the exemption as proposed.

2.3.2. It is believed that the amendment in sub-clause 1(g) (of clause 9) should be backdated to the date of the original amendment (1 June 2004). This was clearly an oversight in the original amendment and it has now been confirmed that the intention was that the provisions should apply in the alternative.

2.3.3. Subclause (1)(j) with regard to the exemption of amounts received from a Sector Education Training Authority is long overdue. The problem is that due to the uncertainty created by the “to be” amended provisions, some taxpayers were under the impression that these amounts were still free of tax.

2.4. Sub-clause 10(1)(a) - s11(e)(viii)

The reference to building in this paragraph makes no sense in light of subparagraph (ii) of the section which provides “in no such case shall any allowance be made for the depreciation of buildings ...”. If the above stands then sub-paragraph (ii) needs to be amended or deleted.
2.5. **Sub-clause 10(1)(a) – S11(e)**

The following Budget proposals appear to have been omitted from the draft bill:

- The wear and tear allowance of 5% on Commercial buildings.

2.6. **Sub-clause 10(1)(c) - S11(m)**

It is most surprising to see the removal of the concession for dependants of the employee. SARS is of the view that this concession is not generally used. This is because the quantum of R2 500 was so insignificant, it would have made more sense to increase the amount rather than delete the concession. In practice, employers are more often than not assisting the dependants of employees. Certainly non-corporate employees would benefit from the concession and this would encourage private enterprise to assist where hardship exists.

2.7. **Clause 16 – Amendment of section 18A**

We believe that the 10% should be determined with reference to either taxable income or assessed loss, thereby not prejudicing entities that are in an assessed loss position.

2.8. **Sub-clause 46(1)(a) – paragraph 5(1)**

“by the deletion in subparagraph (5) of item (c)” this should read “by the deletion in subparagraph (1) of item (c)”.

2.9. **Sub-clause 46(2) and clause 47**

The date of 1 January 2006 does not match the date of the inclusion of Second Schedule, section (1)(b) of 1 March 2007. Surely these two dates should coincide.

2.10. **Clause 47 – Amendment of paragraph 6 of the Second Schedule**

The “or” at the end of subparagraph (1) needs to be deleted if subparagraph 2 is deleted.

2.11. **Sub-clause 50(2)**

The date here must tie in with the Second Schedule amendments. The proposed amendments do not in their current form provide for this. Again reference is made to 1 March 2007 whereas sub-clause 46(2) refers to 1 January 2007.
2.12. Sub-clause 84(2)

The date of coming into operation has erroneously been stated as 7 February 2007 and should be 2 November 2006.

PART II – INCOME TAX MONETARY THRESHOLDS SUBJECT TO PERIODIC LEGISLATIVE CHANGE

3. General comment

In general, the proposed increases in the monetary thresholds are welcomed. There are however a number of monetary thresholds that have not been reviewed in decades. These, and others, are highlighted below.

4. Retirement savings reform

4.1. We are aware that the National Treasury and the Long-term Insurance industry players are consulting on a continuous basis with the view to reinforce government’s objective of encouraging savings and preserving retirement benefits.

4.2. Several specific reforms are to be implemented without further delay, such as the repeal of the Tax on Retirement Funds Act, No 38 of 1996.

4.3. Against this background, we wish to note the following:

4.3.1. The monetary ceilings set for deductible retirement fund contributions and the exempt lump sum portions have not been amended for a significant number of years. We hope that these ceilings are also subject to review as part of the general overview of the taxation of retirement benefits in the near future.

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4.3.2. One consequence of the not having adjusted these monetary thresholds for such a long time (more 20 (twenty) years have passed since the last amendments) is that higher income earners arranged their affairs in such a way that they are not solely dependant on their retirement savings in the form of retirement funds when they retire. They have invested directly in other vehicles such as the equity markets (directly or via unit trusts), property markets etc. in order to provide for their retirement.

4.3.3. This has had significant consequences for those individuals who have no choice but to be members of retirement funds, generally lower-income earners. The low thresholds after taking inflation and current remuneration levels into account, are in effect causing a larger portion of their retirement savings to be subject to tax if compared to someone in the same situation having retired 20 (twenty) years ago. A review of these monetary thresholds will contribute to the preservation of the retirement capital of these individuals.

SPECIFIC AMENDMENTS

5. Clause 12 – section 11D

5.1. Clause 12 contains proposed amendments to section 11D – Deductions in respect of scientific or technological research and developments – of the Act. The proposed amendments are welcomed as it deletes certain unclear terms such as “novel, practical and non-obvious” (replaced with “new”), and clarifies certain issues such as qualifying designs. In addition, the deductions are extended to also include “know-how of a scientific or technological nature”.

5.2. The comments that follow are made in the context of the preamble to the discussion of the research and development deductions in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006:

“Innovation, research and technological development are key factors for improved productivity (leading to new or improved products, processes or services). This enhanced productivity in turn leads to increased economic growth and international competitiveness. However, R&D is costly, involving high levels of technical risk. Given the high entry costs (and the indirect positive externalities for countries as whole), Governments sometimes provide extra support for local R&D via direct subsidies as well as through tax incentives (the latter of which operate as indirect subsidies). While South Africa offers a variety of direct subsidies for R&D, the South African tax regime for R&D does not provide substantial incentives. South Africa accordingly needs an improved set of R&D tax incentives to ensure that local R&D is not at a global competitive disadvantage”.

5.3. It is unclear why the scientific and technological research and development expenditure (“R&D”) is restricted to “new information of a scientific or technological nature” while other jurisdictions which grant special allowances for

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R&D (such as the United Kingdom (“UK”) or Australia) also include advancements on current or improvements on current materials, products, devises, processes or services. The apparent restriction of R&D expenditure to “new” information of a scientific or technological nature is in our view placing local R&D at a global competitive disadvantage.

5.4. It is interesting that the South African definition of “research and development” contained in section 11B of the Income Tax Act was similar to that of the UK, albeit the fact that the definition contained in the Act was not limited to science and technology and also appear to have been limited to the creation of an “intangible asset”. The UK Act essentially defines research and development as a project that seeks to achieve an advance in science and technology. An “advance in science and technology” means an advance in an overall knowledge or capability in the field of science or technology (not the taxpayer’s own state of knowledge or capability alone). This includes that adaptation of knowledge or capability from another field of science or technology in order to make such an advance where this adaptation was not readily deducible. Further, an advance in science or technology may have tangible consequences (such as a new or more efficient cleaning product or process which generates less waste) or more intangible outcomes (new knowledge or cost improvements). The mere use of science and technology to create a process, material, device, product, service or source of knowledge does not become an advance in science and technology. The Australian Act in essence defines R&D activities as activities which are systematic, investigative and experimental in nature, involve innovation or high levels of technical risk and are carried on for the purpose of either acquiring new knowledge or creating new or improved materials, products, devices, processes or services. The R&D allowances provided for in the Act seem to be most restrictive when compared with the equivalent allowances provided for in some of South Africa’s major competitor jurisdictions.

5.5. The UK grants allowances of between 125% and 150% depending on the size of the entity undertaking the research and development. An allowance is granted for those activities that directly contribute to achieving this advance in science and technology. Certain indirect activities also qualify such as:

- Scientific and technical information services insofar as they are conducted for the purpose of research and development support (preparation of reports of findings etc);
- Support activities such as maintenance, security, administration, clerical, finance and personnel activities;
- Leasing of equipment, computer software etc;
- Training required to directly support the project;
- Research to devise new scientific or technological testing to the extent that this research is not research and development in its own right;
- Feasibility studies.

5.6. Australia grants allowances of between 100% and 125% on direct R&D expenditure and considers expenditure similar to those classified as indirect activities by the UK as direct expenditure incurred.
5.7. We are further of the opinion that by limiting the deduction to activities undertaken in the Republic undermines the objective of the incentive that is aimed at increased economic growth and international competitiveness. It is noted that the UK does not place any limitation on the deduction based on the jurisdiction in which the expenditure was incurred. Australia requires “adequate” Australian content, that the R&D be exploited in a manner which is of benefit to the Australian economy, the foreign expenditure be certified expenditure and that the expenditure be incurred “on own behalf”.

5.8. As noted above, R&D is costly and involves high levels of technical risk. The South African taxpayers who can afford to embark on significant R&D projects operate, with a few exceptions, in highly competitive international markets. These taxpayers have access to and use the services of highly qualified non-South African resources to assist them with certain aspects of the R&D undertaken. These resources are not, for various reasons, available in South Africa and cannot be relocated to South Africa. The taxpayers have no option but to incur some or all of the R&D expenditure outside the Republic as the unique skills and/or facilities of the non-South African resources are essential to the project in order to ensure that the South African taxpayers obtain or maintain their competitive edge on their competitors. Competitors are very eager to employ/make use of these unique skills and/or facilities for their benefit and will not hesitate to do so should the South African taxpayers not employ/use the services and/or facilities of these non-South African resources.

5.9. Further, South African taxpayers may be required to extend the R&D in non-South African regions for valid reasons such as:

- The efficacy of the product may be affected by climatic conditions which vary significantly from that in South Africa; or
- Considering an agricultural application, the efficacy of the product needs to be tested on various crop variants, not all of which are suitable for testing in South Africa.

5.10. The inclusion of definitions of “science”, “technology”, “information of a scientific or technological nature” or alternatively a practice note which clarifies the various terms and concepts contained in this section, would be useful.

5.11. Section 11D(11) of the Act requires that the taxpayer must submit certain information to the Minister of Science and Technology, failing which the taxpayer will not be entitled to the allowance provided for in this section. We have not been successful in obtaining any information from the Department of Science and Technology regarding the required information which needs to be submitted.

6. **Clause 20 – Amendment of section 24I**

It is with disappointment that we note that the proposed amendments to section 24I do not extend to clarifying the interpretation of section 24I(11)(a)(iii) and, in particular, its reference to trading stock.
In addition, amendments were previously made to the provisions of section 24I(7A) of the Act. These amendments came into operation on 8 November 2005 and applied to all years of assessment ending on or after that date. Essentially, the provisions of section 24I(7A) provided for the deferral and phasing in at 10% per annum (on a reducing balance basis) of qualifying unrealised foreign exchange gains and losses. The amended wording of section 24I(7A) states that the provisions of section 24I(7A) continues to apply to any loan or advance obtained or granted during any year of assessment ending before 8 November 2005.

What is not clear, however, is that section 24I(10) provides that “no amount shall in terms of this section be included in or deducted from the income...”, thus overriding the provisions of section 24I(7A) and rendering it ineffective.

We recommend that clarification be provided in this regard i.e. that it be made clear that section 24I(10) would apply, subject to section 24I(7A) in scenario’s where the loan or advance was obtained or granted during any year of assessment ending before 8 November 2005. This will ensure that loans and advances obtained or granted in those years would still be subject to the deferral and phasing provisions whilst loans and advances after that date would be subject to the provisions of section 24I(10) i.e. be taxed on a realised basis.

7. **Clause 31 – section 44**

7.1. Clause 31 of the Bill contains amendments to section 44 of the Act which deals with amalgamation transactions. It is proposed that subsection (9) be deleted until such time as a methodology has been devised which will provide for the tax-free distribution of dividends in terms of amalgamation transactions.

7.2. The deletion of subsection (9) has significant consequences for transactions that are not specifically aimed at exploiting certain secondary tax on companies (“STC”) deferral gaps. Section 44 of the Act is often applied in order to facilitate Black Economic Empowerment (“BEE”) transactions. These usually involve the creation of a new company that acquires the business operations (or part thereof) of another company and the distribution of assets or shares as a dividend *in specie*.

7.3. The fact that section 44(9) of the Act is specifically limited to an “*in specie*” distribution of shares for a specific purpose, in our view, makes it inherently more robust against attempts at abuse.

7.4. Further, we do not understand the need to delete this subsection in order to prevent taxpayers from undertaking avoidance transactions that are specifically aimed at exploiting this gap considering the any transaction entered into in terms of section 44 of the Act is subject to the General Anti-Avoidance Rule contained in sections 80A to 80L of the Act. SARS is therefore able to address such avoidance transactions in terms of GAAR and in the process will not jeopardize valid transactions which qualify for the deferral of the STC on dividends *in specie* as provided.
8. **Clause 33 – Amendment of section 46**

8.1. Subsection 1(a) now refers to section 46(4)(a) as follows:

   “in the year of assessment during which that shareholder becomes entitled to dispose of those shares, which portion, which portion shall be an amount which bears to such gain the same ratio as that contemplated in subsection (3)(a); and”

8.2. The words “which portion” have inadvertently been repeated.

9. **Clause 48 – Amendment of paragraph 1 of the Fourth Schedule**

9.1. Presently the definition of personal service companies provides exemption where a person who is not a connected person to the company performs the services personally. Similar treatment should be accorded to independent contractors under Clause 48(1)(c) whereby should the staff that are unconnected to the independent contractor perform the services, there should be similar exemption from PAYE.

9.2. The change in respect of independent persons, i.e. the regular payment requirement and supervision, is only effective from 7 February 2007. Should it not be retrospective from the date the change in personal service companies and trusts have been made as SARS admitted that it was an omission.

9.3. Surely the “any person” should be the person making the payment and not any person. If the person is truly independent, but does not enjoy the more than three benefit (the person may only employ two employees), the two employees will be subject to control of the independent contractor. As the two requirements of the new clause is separated by an “and” it would mean that payments to the independent person will then be subject to PAYE. This is what we do not want. The payment should only be subject to PAYE if the “employer” exercises control.

9.4. The deletion of the regular payment requirement is welcomed and the backdating thereof as it brings this in line with the previous amendments.

10. **Clause 50 – Amendment of paragraph 9 of the Fourth Schedule**

It is believed that the R43 000 is the new tax threshold amount and we suggest that it is replaced by the wording “tax threshold”. This would then ensure that this provision does not have to be changed from year to year. If the amount is to remain at R43 000 then the proposal is correct.

11. **Clause 73 – VAT: Amendment of section 17**

11.1. The proposed amendment to section 17(1) of the VAT Act provides that vendors may not rely on a “general written ruling” for their apportionment method, but must only rely on a ruling as contemplated in sections 41A or 41B of the VAT Act.
11.2. Previously, vendors could use the general turnover method as set out in the VAT 404 Guide for Vendors.

11.3. The proposal means that vendors will each individually have to apply for a private binding or non-binding ruling.

11.4. It is submitted that this will be administratively cumbersome for both SARS and taxpayers and that SARS should, accordingly, issue a binding general ruling on apportionment methods.

12. Clause 76 – Amendment of section 30 of the Revenue Laws Amendment Act, 2004

12.1. The incorrect wording of the relevant section in the original Act is quoted. The wording was as follows:

(2) Subsection (1) shall come into operation on [a date to be determined by the President by proclamation in the Gazette].

12.2. If the intention is to change the requirement that the Act will replace the announcement by the President this should be stated. As taxpayers would expect an announcement in the Gazette and may not necessarily be aware that reference should be made to the Taxation Laws Amendment Act. In addition, SARS should publicly communicate this change as it affect estate agents and other parties.

EXPLANATORY MEMORANDUM ON THE TAXATION LAWS AMENDMENT BILL, 2007

13. Clause 2 - Rates

13.1. We welcome the fact that tables XII to XVIII have been included in the Explanatory Memorandum of the monetary limits of the various provisions of the Income Tax Act (as provided to National Treasury by SAICA). This in itself shows how many of these limits have not been addressed or amended for many years. At present these thresholds often become futile over time due to inflation.

13.2. Table XII: General savings thresholds - consideration should be given to include the tax threshold, estate duty - R3,5 million exemption, transfer duty exemption – first R500 000.

13.3. Table XV – employment related fringe benefits - consideration should be given to include subsistence allowances tax free rate (section 8(1)(c)(ii) as per the Budget proposals.

14. Clause 7 – Amendment of section 9B

14.1. It is with disappointment that we note that the proposed amendment to section 9B does not extend to including provisions referring to shares that have been held for a period of at least three years, as mentioned by the Minister in his Annual Budget
Speech. We also find it surprising that these amendments have not been included in the draft legislation and that SARS have only covered this matter in a draft interpretation note.

15. **Clauses 10 and 12 – Amendments of sections 11 and 11A**

15.1. The Explanatory Memorandum refers to the “scrapping allowance” in sub-clause (1)(d), but the word scrapping has been removed from the Act since December 2003. Since then, the subsection does not at all apply where the asset is scrapped.

15.2. Section 11(o) (before the proposed amendment) did not apply to assets used for the purposes envisaged in section 11D (scientific research) and section 11D(10) confirmed this. This amendment now brings these assets into the ambit of section 11(o). The remarks that it could lead to artificially inflated allowances in respect of these assets were therefore wrong.

15.3. It is assumed that section 11(o) would apply to buildings used for section 11D purposes, but we are unsure that they have a useful life exceeding 10 years - the section 11D allowance is granted over three years.

15.4. The problem that we envisage is that section 11D will grant the allowance in respect of items other than buildings over a period of 3 years, even where the research is stopped before the end of that period. It would then imply that the full costs of these assets were allowed for tax purposes and the deduction in terms of section 11(o) would then be zero (even where an amount is received on the alienation of the asset).

15.5. The amendment limiting the recoupment to the actual receipt is welcomed.

16. **Clause 12 – Amendments of section 11D**

16.1. Section 11D(9) provides that where a taxpayer during any year of assessment ceases to use an asset for purposes contemplated in subsection (1), there shall be included in the income of the taxpayer all deductions allowed in terms of subsection (2) in respect of that asset limited to etc.

16.2. It is unclear as to what exactly is meant by “ceases to use an asset for purposes contemplated in subsection (1)”. The question has been asked as to whether the provisions of section 11D(9) would also apply, where an asset that has been used by the taxpayer “as contemplated in subsection (1)” for less than ten years, is sold or becomes obsolete. This needs to be clarified. Further, if the provisions of section 11D(9) do apply in these circumstances, it is submitted that section 11D(9) will serve as a disincentive to taxpayers wishing to use assets for research and development.
17. **Clause 31 – Amendment of section 44**

17.1. The removal of the STC rollover provision has a penal effect on an amalgamation transaction as envisaged by section 44. The Explanatory Memorandum states that such transactions will again be free of dividends once the problem of subsequent tax-free distributions to shareholders can be solved.

17.2. Surely, this is relatively simple and can be achieved by including within the dividend definition any distribution to shareholders (including out of share capital or share premium) to any shareholder within, say, 2 years of an amalgamation transaction.

17.3. Clause 31(c) refers to:

> “Given the above anomaly, the proposed amendment deletes section 44(9) and (10), thereby subjecting amalgamations to immediate STC. It is envisioned that amalgamations will again be free of dividend tax once the above problem can be solved.”

As dividend tax is not defined anywhere, clarity should be provided as to whether this refers to the proposed STC amendments.

Also the reference to “SCT” should be corrected to read “STC”.

18. **Clause 49 – Amendment of paragraph 2 of the Fourth Schedule**

18.1. Explanatory Memorandum page 33 – sub clause (1)(a) “employee” must be replaced with “employer”.

18.2. This clause provides that an affidavit should only be obtained where 80% of a company or trust’s income is not derived from a single client. Par 2(1A) of the 4th Schedule however provides that an affidavit should be obtained where the company is not a personal service company or trust as defined in par 1 of the 4th Schedule. The affidavit should also be provided to the “person” to whom the services are rendered and not to the “employee”.

19. **Clause 71 – VAT: Amendment of section 10**

In the Explanatory Memorandum Clause 71 should refer to section 10(3) of the VAT Act and not section 103(3) of the VAT Act.

Please do not hesitate to contact me should you require further information.

Yours faithfully

M Kendall CA(SA)
TECHNICAL ASSISTANT: TAX
*The South African Institute of Chartered Accountants*