REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

REVENUE LAWS AMENDMENT BILL, 2004

[W.P. 3 —'04]

CONTENTS

DESCRIPTION	PAGE
Introduction	6
Taxation of amounts derived from broad-based employee share plan	6
Taxation of directors and employees on vesting of equity instruments	10
Hybrid financial instruments	19
Incurral and accrual of amounts in respect of assets acquired or disposed of for contingent or unquantified amounts	26
Relief for interest-bearing investments held by Namibian, Swaziland and Lesotho investors	40
Public private partnerships	42
Eliminating tax preferences for the JSE Securities and Bond Exchanges	43
Stamp duty interest, penalties and additional duty	44
Industrial development zones	45
VAT treatment of grants paid by public authorities and local authorities	46

CLAUSE	SECTION / PARAGRAPH	PAGE
Transfer Duty Act, 1949		
Clause 1	Section 4	49
Clause 2	Section 9	49
Income Tax Act, 1962		
Clause 3	Section 1	49
Clause 4	Section 6*quat*	50
Clause 5	Section 7	50
Clause 6	Section 8	51
Clause 7	Section 8A	52
Clause 8	Section 8B	52
	Section 8C	
Clause 9	Section 8E	52
Clause 10	Section 8F	52
Clause 11	Section 9	52
Clause 12	Section 9B	52
Clause 13	Section 9D	53
Clause 14	Section 10	53
Clause 15	Section 10A	53
Clause 16	Section 11	53
Clause 17	Section 11B	54
Clause 18	Section 11C	54

Clause 19	Section 13*quat*	55
Clause 20	Section 20B	56
Clause 21	Section 23F	56
Clause 22	Section 24B	56
Clause 23	Section 24I	60
Clause 24	Section 24J	60
Clause 25	Section 24M	60
Clause 26	Section 24N	60
Clause 27	Section 25B	63
Clause 28	Section 30	63
Clause 29	Section 31A	63
Clause 30	Section 35A	63
Clause 31	Section 36	68
Clause 32	Section 41	68
Clause 33	Section 42	69
Clause 34	Section 43	69
Clause 35	Section 45	69
Clause 36	Section 46	71
Clause 37	Section 47	72

Donations Tax

Clause 38	Section 56	72
Clause 39	Section 58	72

Income Tax Act, 1962

Clause 40	Section 64B	73
Clause 41	Section 64C	76
Clause 42	Section 103	77

Second Schedule to the Income Tax Act, 1962

Clause 43	Paragraph 1	77
Clause 44	Paragraph 2A	77
Clause 45	Paragraph 2B	78

Fourth Schedule to the Income Tax Act, 1962

Clause 46	Paragraph 1	78
Clause 47	Paragraph 18	78
Clause 48	Paragraph 27	78
Clause 49	Paragraph 28	78

Seventh Schedule to the Income Tax Act, 1962

Clause 50	Paragraph 2	79

Eighth Schedule to the Income Tax Act, 1962

Clause 51	Paragraph 1	79
Clause 52	Paragraph 2	79
Clause 53	Paragraph 3	79
Clause 54	Paragraph 4	79
Clause 55	Paragraph 11	79
Clause 56	Paragraph 12	80
Clause 57	Paragraph 13	80
Clause 58	Paragraph 20	80
Clause 59	Paragraph 20A	80
Clause 60	Paragraph 25	81
Clause 61	Paragraph 33	81

Clause 62	Paragraph 35A	81
Clause 63	Paragraph 38	81
Clause 64	Paragraph 39A	82
Clause 65	Paragraph 56	82

Customs and Excise Act, 1964

Clause 66	Section 1	83
Clause 67	Section 44	83
Clause 68	Section 47	83
Clause 69	Section 55	84
Clause 70	Section 65	84
Clause 71	Section 69	84
Clause 72	Long title	84

Stamp Duties Act, 1968

Clause 73	Section 1	84
Clause 74	Section 5	85
Clause 75	Section 6	85
Clause 76	Section 7	86
Clause 77	Section 8	86
Clause 78	Section 9	86
Clause 79	Section 9A	87
Clause 80	Section 9B	87
Clause 81	Section 10	87
Clause 82	Section 11	87
Clause 83	Section 12	87
Clause 84	Section 12A	87
Clause 85	Section 13	88
Clause 86	Section 15	88
Clause 87	Section 19	88
Clause 88	Section 22	88
Clause 89	Section 23	88

Schedule 1 to the Stamp Duties Act, 1968

Clause 90	Item 14	89
Clause 91	Item 15	89

Value-Added Tax, 1991

Clause 92	Section 1	90
Clause 93	Section 2	91
Clause 94	Section 7	91
Clause 95	Section 8	91
Clause 96	Section 9	92
Clause 97	Section 10	92
Clause 98	Section 11	92
Clause 99	Section 12	93
Clause 100	Section 13	94
Clause 101	Section 14	94
Clause 102	Section 17	94
Clause 103	Section 18	95
Clause 104	Section 20	96
Clause 105	Section 39	96
Clause 106	Section 48	96
Clause 107	Section 68	97
Clause 108	Schedule 1	97

Uncertificated Securities Tax Act, 1998
Clause 109 Section 1 97
Clause 110 Section 5 98
Clause 111 Section 6 98

Second Revenue Laws Amendment Act, 2001
Clause 112 Section 121 98
Clause 113 Section 153 98

Revenue Laws Amendment Act, 2002
Clause 114 Section 103 99

Taxation Laws Amendment Act, 2004
Clause 115 Section 46 99

Revenue Laws Amendment Act, 2003
Clause 116 Section 59 99
Clause 117 Section 163 99
Clause 118 Section 164 100
Clause 119 Section 165 100
Clause 120 Section 166 100
Clause 121 Section 169 100
Clause 122 Section 170 100
Clause 123 Section 173 101

Short title
Clause 124 101

EXPLANATORY MEMORANDUM ON THE REVENUE LAWS AMENDMENT BILL, 2004

INTRODUCTION

The Revenue Laws Amendment Bill, 2004, introduces amendments to the Transfer Duty Act, 1949, the Income Tax Act, 1962, the Customs and Excise Act, 1964, the Stamp Duties Act, 1968, the Value-Added Tax Act, 1991, the Uncertificated Securities Tax Act, 1998, the Second Revenue Laws Amendment Act, 2001, the Revenue Laws Amendment Act, 2002, the Revenue Laws Amendment Act, 2003, and the Taxation Laws Amendment Act, 2004.

TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN

Current Law

An employee that acquires shares from an employer (or from certain other parties) for consideration at less than the market value is treated as having received a fringe benefit to the extent of the shortfall, all of which is taxable in the hands of the employee. This taxable fringe benefit comes in the form of ordinary income and is subject to Pay-As-You-Earn withholding by the employer. An employer that directly issues shares to employees is not entitled to any tax deduction for the shares issued because the issue of shares is not viewed as a cost "actually incurred".

Reasons for change

Current fringe benefit taxation of employer-provided shares at less than market value to employees protects the tax base against the tax avoidance of disguised salary benefits. This protection is especially important because top management is usually the main recipient of these schemes; whereas, rank-and-file employees are fully subject to tax on salary as ordinary income. Indeed, the proposed legislation enhances the taxation of equity instrument fringe benefits in order to eliminate current tax advantageous schemes (see proposed section 8C).

However, situations do exist that justify a preference for the issue of employer-provided shares over a standard salary package. The acquisition of shares by employees (over standard salary) can motivate productivity because employees obtain a stake in future growth. Moreover, this acquisition does not come at the expense of corporate governance if shares are transferred to most employees on a broad basis (unlike recent history with top heavy plans that have benefited executives and directors at the expense of shareholders).

Unfortunately, current tax treatment does not encourage the transfer of free or discounted shares within the confines of broad-based plans. This treatment is especially problematic for low-income employees who cannot afford to pay tax on free or discounted shares without selling their stake. Special tax rules are accordingly required to promote long-term, broad-based employee empowerment by allowing employees to participate in the success of their employer with minimal tax cost.

Proposal

1. General terms for tax-free treatment

The proposed rules allow for the tax-free treatment of "qualifying shares" acquired by employees, even though the shares may be acquired without cost or at a discount (proposed paragraph 2*(a)* of the Seventh Schedule). In order for a share to be a "qualifying share," that share must satisfy two requirements (proposed section 8B(2)("qualifying equity share" definition). First, the employee must receive the shares in terms of a "broad-based employee share plan." Second, the total shares received under the plan by the employee may not exceed R9 000 in value during any 3-year period.

In order to ensure broad-based "real" participation, the following conditions must be satisfied in terms of the "broad-based employee share plan" requirement:

(a) Equity shares for minimum consideration (proposed section 8B(2)(paragraph (a) of the "broad-based employee share plan" definition)

The employer must offer the shares to employees for no (or minimal consideration to the extent required by the Companies Act, 1973 (Act No. 61 of 1973), e.g. par value if par value shares are issued). This free or minimal cost provision of shares is essential if low-income employees are to fully participate. Employee plans of this kind can consist of shares in the employer or of another company within the same group. Loans can also be offered without interest or below the prescribed rate to subsidise the employee's purchase (paragraph 2(*f*) of the 7th Schedule).

(b) Widespread participation (proposed section 8B(2)(paragraphs (a) and (b) of the "broad-based employee share plan" definition)

The employer must offer the plan to at least 90 per cent of its employees who have been permanently employed on a full-time basis for at least 1 year. This 90 per cent requirement ensures that the plan is fully broad-based, but provides the employer with some flexibility (i.e., thereby allowing exclusions for under-performing employees or other special circumstances). This provision also allows the employer to exclude persons working at reduced hours or filling temporary positions because of the related administrative burden entailed (and because these persons are not fully associated with the employer). Employees may not participate in the broad-based employee share plan if they participate in another equity share plan.

(c) No dividend or voting restrictions (proposed section 8B(2)(paragraph (c) of the "broad-based employee share plan" definition)

The employees must receive full voting and dividend rights in the shares offered under the plan. This requirement ensures that the employees acquire a "real" ongoing equity interest.

(d) Limitation on other restrictions (proposed section 8B(2)(paragraphs (d) of the "broad-based employee share plan" definition)

Lastly, the plan limits the number of disposal restrictions that can be imposed on the shares offered. These limitations ensure that the employee's "real" ongoing equity interest is not indirectly undermined while providing the employer with some flexibility. Hence, no plan may contain any disposal restrictions other than one or more of the following:

- Disposal restrictions imposed by legislation (as opposed to, for example, those created by contract) do not run afoul of section 8B. These types of restrictions are completely outside of the parties' control.

- Another person may retain the right to acquire the shares at fair market. This form of buy-out clause is fairly common in the case of unlisted companies with the buy-out clause preventing dilution of the company's shares for the benefit of parties outside the company's ongoing active management and employees.

- The employer may restrict the employee's right to dispose of the equity share, but this restriction on disposal may not extend beyond five years from the date that the employee is granted the shares. Hence, the employer has some power to ensure the provision of shares leads to a long-term benefit for both employer and employee, without undermining the employee's "real" ongoing equity interest in the employer. The terms of this restriction are likely to be a subject of employer-employee bargaining.

2. Subsequent Sales

Special rules apply when an employee sells qualifying shares. Ordinary income provisions will apply if the employee sells those shares within five years from the date the shares are granted (proposed section 8B(1)). The sale within this period effectively amounts to a salary-substitute for tax purposes. If the employee sells the shares after this five-year period, the employee's gains will generally be capital in nature. This differential treatment creates another incentive for employees to retain their shares for more than five years.

The employer is subject to special PAYE and reporting requirements in terms of qualifying shares in order to ensure that both the taxation of ordinary income and capital gains, within 5 years from date of grant, are fully enforceable. This special enforcement is required because the shares will be issued to many middle- and lower- income employees who are unlikely to have any other forms of passive investments (outside a bank account or a pension fund). Many of these employees may even fall below the SITE threshold, thereby being unaware of their tax obligations upon disposal. Under these special rules, the employer must withhold PAYE from the ordinary income generated on sales of qualifying shares occurring within five years (proposed paragraphs 1 (paragraph (d) of the "remuneration" definition)) and paragraph 11A of the Fourth Schedule).

3. Deductibility for the employer

Under current law, an employer generally cannot deduct the issue or transfer of a share to an employee, even if that issue or transfer acts as compensation for salary. The proposal accordingly overturns this result in the case of broad-based employee

share plans in order to further encourage their use. The proposal will allow for the deduction of the share at market value (proposed section 11(IA), but not beyond R3 000 per year.

Example 1

Facts: Company grants 2 500 of its shares to each and every one of its permanent employees on 5 January 2005. The shares are trading at R1 each on the date on which the grants are approved. No restrictions apply to these shares, except that these shares may not be sold before 5 January 2009 unless an employee is retrenched or resigns. If an employee leaves the employ of Company before 5 January 2009, the employee must sell all the 2,500 shares back to Company for the market value of the shares on the date of departure. Company appoints a trust to administer all the shares administered under the plan.

Mr A, an employee of Company, resigns from employment on 21 December 2006. Under the terms of the plan, he sells his shares back to Company (through the trust) on 21 December 2006 for market value of R3 750 (i.e., at R1,50 per share).

Result: All the shares constitute qualifying equity shares under section 8B(2). Company can deduct all the shares granted at R1 per share for its 2005 tax year, including the shares issued to Mr. A. All the employees receive the shares free of immediate tax. However, Mr. A has R3 750 of ordinary income in 2006 when selling the shares back to Company with Company withholding the appropriate level of tax pursuant to PAYE (as well as reporting the sale).

Example 2

Facts: The facts are the same as *Example (1)*, except that Mr. A leaves Company in 2012 and subsequently sells the shares in the open market for R 4 500.

Result: The result is the same as *Example (1),* except for the disposal. The disposal in 2012 results in a capital gain of R4 500.

Example 3

Facts: Company has 10 executives and 100 rank-and-file employees. Company A grants 3 000 of its shares to all of its executives employed on 15 June 2006. The shares are trading at R1 each on the date on which the grants are approved. No restrictions apply to these shares, except that these shares may not be sold before 15 June 2011 unless the recipient executive is retrenched or resigns. If an executive leaves the employ of Company before 5 January 2009, the employee must sell all the 3 000 shares back to Company for the market value of the shares on the date of departure. Company appoints a trust to administer all the shares administered under the plan.

Result: The shares do not constitute qualifying shares under section 8B(2) because the non-discrimination requirements are not satisfied. All of the executives are taxed on the shares according to section 8A. Employer is not

entitled to deduct the cost of any of the shares issued in the light of existing case law.

TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS

Current Law

Over the years, a number of equity-based incentives have been developed for top management (e.g., directors and executives) that allow top management to receive various forms of equity with minimal tax cost. These equity-based incentives include, among others, share options, deferred delivery shares, restricted shares and convertible debentures.

The existing section 8A of the Income Tax Act attempts to address many of these equity-based incentives. Under these provisions, any gain triggered on the exercise, cession or release of any right to acquire any marketable security (such as share options) will be included as ordinary income if that right was obtained in exchange for services. This section essentially focuses on the intrinsic value of the right on the date of conversion. The employee also has the election to defer the ordinary gain stemming from this intrinsic value if the converted share cannot be freely transferred.

Reasons for Change

The existing section 8A, enacted in 1969, has failed to keep pace with the myriad of equity-based incentives developed for top management. While these provisions cover any right to acquire a marketable security, the nature of the regime is such that its application is often unclear once top management enters into schemes that involve share rights beyond simple share options.

The regime also fails to fully capture all the appreciation associated with the marketable security as ordinary income. The regime only triggers ordinary treatment for the amount of appreciation arising until exercise, cession or release of that right, even if the right is converted to a restricted share. This ordinary amount can then be deferred until the restriction on the share is lifted or the share is sold (with the appreciation on the share after conversion left as capital gain). Many of these schemes also seek to manipulate values so that gain is triggered when values are low (or can be artificially depressed).

Any advantage associated with these schemes conflicts with the concept of vertical equity. Employees (especially top management) should not be allowed to obtain tax advantaged fringe benefits when rank and file employees are fully subject to tax at ordinary rates on their cash salaries. In terms of recent history, share options and other special equity incentives have additionally given rise to corporate governance problems at the expense of corporate shareholders.

Proposal

The proposed law seeks to treat the receipt of all restricted equity instruments on par with "share appreciation rights." In the case of "share appreciation rights," an

employee/director receives cash at certain intervals as the corresponding equity values of the employer company rises. Ordinary income exists for the employee/director as cash is received. Under the proposed law, comparable equity ordinary income treatment will be deferred for various equity schemes so that all the appreciation on the schemes is fully captured.

1. General rule

A. Interaction with the Seventh Schedule

Proposed law clarifies the relationship between the Seventh Schedule and the rules relating to equity-based incentives. Under the proposed paragraph 2(a) of the Seventh Schedule, an employee/director is subject to fringe benefit tax during any year of assessment in which that employee/director acquires a financial instrument (e.g., debt) from his or her employer (or an associated institution or from any person by arrangement with the employer). One exception to this rule is the acquisition of "equity instruments" under section 8A or 8C (or qualifying (i.e., broad-based) equity shares under section 8B).

The term "equity instrument" is comprehensive (proposed section 8C(7) ("equity instrument" definition). The term covers any share (or part thereof) in the equity share capital of a company (or a comparable member's interest in a close corporation). The term also includes share options and any other financial instrument convertible into a share (such as a convertible debenture).

B. Basic system of taxation under section 8C

1. Vesting as the tax event

Employees/directors that acquire equity instruments "by virtue of" their employment (or office) generate ordinary income (or ordinary loss) during the year in which that equity instrument "vests." (Proposed section 8C(1)*(a)*; see also proposed section 10(1)*(n*D*)*). This rule overrides the 5-year capital gain rule for listed shares under section 9B and the limitation of deductions of employees under section 23*(m)*. The date of vesting depends on whether the equity instrument is restricted or unrestricted, as follows:

(a) in the case of an unrestricted equity instrument, the date of vesting occurs when the employee/director acquires the unrestricted instrument (proposed section 8C(3)(a)).

(b) in the case of a restricted equity instrument, the date of vesting occurs on the earliest of the following four events:
   - (i) when all restrictions causing "restricted equity instrument" status are lifted;
   - (ii) immediately before the employee/director disposes of the restricted equity instrument (unless that disposal falls within the equity instrument swap rules of proposed subsection (4) or the connected person/non-arm's length rules of proposed subsection (5));
   - (iii) when an option (qualifying as a restricted equity instrument) terminates; or
   - (iv) immediately before the employee/director dies.

2. Restricted versus unrestricted instruments

As just discussed, the date of vesting greatly depends on whether the equity instrument involved is an unrestricted or restricted instrument. Unrestricted equity instruments trigger a taxable event when acquired; whereas, restricted equity instruments generally trigger a taxable event at a later date. The delayed trigger for restricted equity instruments essentially lies at the core of the proposal. Current equity incentive schemes typically contain employer-imposed restrictions (or special benefits) not generally utilised when a party purchases equity on the open market at arm's length.

The restrictions (or special benefits) associated with these schemes presently offer two advantages. First, these restrictions (or special benefits) generally tie the employee/director to the company for purposes of employment similar to a share appreciation right. Second, these schemes are designed so that the value of the equity instrument is taxable at an early stage when its value is low (thereby avoiding ordinary tax treatment on much of the appreciation).

The term "restricted" equity instrument is broadly defined to cover the full spectrum of schemes currently in practice (proposed section 8C(7) ("restricted equity instrument" definition). The list of instruments falling within proposed "restricted" status is as follows:

(a) *Disposal restrictions:* An equity instrument falls within the restricted list if the employee/director cannot freely dispose of that instrument at fair market value (other than a restriction imposed by legislation as opposed by contract). For instance, an equity instrument would be restricted if an employee (or director) cannot sell the instrument until employment terminates or for several years. Another situation may involve deferred delivery shares, whereby the employee acquires the shares at a future date (much like a forward contract) for an amount due at that later date.

(b) *Forfeiture restrictions:* An equity instrument falls within the restricted list if the restriction could result in forfeiture at less than market value. For instance, a restricted equity instrument may arise if an employee/director must sell the instrument back at cost (or surrender the instrument for nothing) if employment terminates before a specified date.

(c) *Right to impose disposal or forfeiture restrictions:* A restricted instrument similarly falls within the restricted list if any person has a right to impose a restriction described in (a) or (b) above. This situation may arise if a shareholder of the employer company has an option to purchase the shares at cost if an employee leaves employment within a specified period.

(d) *Options on restricted equity instruments:* A freely disposable option will be viewed as a restricted instrument if that option can only be converted into a restricted share. Hence, an option is restricted if the underlying share is restricted (regardless of whether the option itself is subject to any restrictions).

(e) *Financial instruments convertible into restricted equity instruments:* Financial instruments (qualifying as equity instruments) that are convertible into a share (part thereof or a member's interest in a close corporation) will be restricted if convertible only into a restricted share (part thereof or a member's interest). For instance, a convertible debenture qualifies as a restricted equity

instrument if that convertible debenture can only be converted into a restricted share. The principle contained herein is essentially the same as the principle for options described in (d) above.

(f) *Employee escape clauses:* On the flip side of the above, equity instruments can give rise to "restricted" treatment if the equity instrument contains one-sided benefits for the employee/director (as opposed to the employer). This form of restricted equity instrument exists if the employer company (or associated institution) undertakes to:
   (i) cancel the instrument; or
   (ii) repurchase the instrument at a price exceeding market value on the repurchase date,

   if the equity instrument declines in value after the employee/director initially acquired the instrument. In terms of economic substance, these provisions essentially convert the equity instrument into a share appreciation right with the employee receiving the benefit of appreciation while unilaterally being able to ignore any potential loss. This form of one-sided arrangement would never arise outside the context of an employer-employee/director relationship.

Equity instruments free of all the above restrictions fall within unrestricted status. Hence, other forms of restrictions can be ignored.

3. Calculation of gain or loss upon vesting

The vesting of an equity instrument will trigger ordinary income or loss as if the vested amount were an adjustment to salary. As a general rule, an employee/director has ordinary gain upon the vesting of an equity instrument to the extent the market value of that instrument on the vesting date exceeds any consideration paid in exchange with respect to that instrument (proposed section 8C(2)(a)). Similarly, an employee/director has ordinary loss upon the vesting of an equity instrument to the extent the same consideration exceeds the market value of that instrument on date of vesting (proposed section 8A(2)(b)).

For purposes of this section, the term "market value" generally means the price at which the instrument could be obtained between a willing buyer and willing seller on the open market at arm's length. However, this market value calculation specifically excludes any existing restriction or condition upon that equity instrument. For instance, any sale or other restriction that triggers restricted classification for the equity instrument would be ignored for purposes of the "market value" calculation.

The term "consideration" also has a specific meaning for purposes of this ordinary gain/loss calculation. As a general matter, an employee/director treats as consideration any amount given or to be given for the acquisition of the equity instrument. However, the services provided by the employee/director will be ignored because the service element is one of the core elements to be taxed under the proposal (because these schemes essentially amount to deferred salary benefits). On the other hand, consideration includes any amount paid for a prior equity instrument that was exchanged for the equity instrument at issue. For instance, if an employee pays R10 for a restricted option that is subsequently converted into a restricted share, the employee treats the R10 paid for the option as consideration when calculating gain or loss upon the vesting of the share.

Example 1

Facts: Employee is employed by Company X. Employee acquires a Company X share from Company X for R100 at a time when the value of that share is R110. The R10 discount exists by virtue of the employment relationship. The share does not contain any restrictions.

Result: The share vests in Employee at acquisition because the share is unrestricted. Employee immediately includes R10 of ordinary income.

Example 2

Facts: Employee is employed by Company X. Employee acquires a Company X share from Company X in exchange for a R100 note when that share has a value of R100. Employee may not sell the share until after leaving the employ of Company X. Employee eventually sells the share to a wholly outside party for R250 when leaving the company (less payment of the R100 note).

Result: The share vests when Employee departs from Company X because this is the date when all restrictions are lifted (and the date of sale). Employee must include R150 of ordinary income on that date (R250 less the R100 payment on the note).

Example 3

Facts: The facts are the same as *Example 2*, except that the share declines in value to R90 on the date Employee leaves employment.

Result: The share again vests on the date that employment ceases. However, Employee has R10 of ordinary loss (R90 less the R100 cost of the share).

Example 4

Facts: In 2005, Employee is employed by Company X. Employee enters into a forward contract for the purchase of the Company X shares in 2008. Company X shares are each currently worth R100 each. Under the forward contract, Employee will purchase a share for R100 in 2008. In 2008, Employee purchases the shares for R100 when the shares are worth R170.

Result: The Company X share vests in 2008. In 2008, Employee has R70 of ordinary income per share (R170 less the R100 payment).

Example 5

Facts: In 2005, Employee is employed by Company X. Employee acquires an option from Company X at a price of R1. The option allows Employee to acquire a Company X share for R100 as long as Employee remains with Company X. The option is freely transferable, but the Company X share

acquired with the option must be redeemed at cost if Employee leaves Company X before the end of 2010. In 2006, Employee converts the option into a Company X share when that share has a value of R510. In 2010, the share has a value of R1 400.

Result: No vesting occurs when the option is acquired because the option is only convertible into a restricted share, and no vesting occurs upon conversion into the share because the share remains restricted until 2010. In 2010, the share vests because all restrictions are lifted. Employee has R1299 of ordinary income on that date (the R1 400 market value in 2010 less the R100 conversion cost less the R1 option cost).

Example 6

Facts: Employee is employed by Company X. In 2005, Employee purchases a Company X share with a R100 loan when the share has a R100 value. Employee may sell the share at anytime. However, Company X may cancel the loan-share contract as long as Employee remains with Company X if market value is less than the cost of the share. In 2007, Employee sells the share to an outside party when the share is worth R550.

Result: The existence of the unilateral option to cancel the share-loan contract results in restricted equity instrument treatment. The share only vests at time of sale in 2007 when Employee has R450 of ordinary income (R550 market value less R100 consideration).

C. Employees' tax

The amount of any gain determined in respect of the vesting of an equity instrument is included in the definition of "remuneration" in the Fourth Schedule and will therefore be subject to employees' tax.

2. Subsequent transfers

A. Restricted equity instrument swaps

Special rules are required when an employee/director enters into a restricted equity instrument swap in order to ensure that the "restricted" taint remains as before. These swaps frequently arise when a company restructures or due to a change of employment from one company to another within the same group.

Under the basic rules, the swap of restricted equity instruments will not give rise to a taxable event. The new restricted instrument will be deemed acquired "by virtue of employment" just like the initial restricted equity instrument surrendered (proposed section 8C(4)(a)). Hence, the new restricted equity instrument will trigger ordinary income or loss only when the new restricted equity instrument vests.

The swap rules also contain provisions for situations in which the surrendering party receives consideration other than restricted equity instruments. In this circumstance, this other consideration may give rise to immediate taxation.

> **Example**
>
> *Facts.* Employee acquires a restricted equity share while being employed by Company X. Company X enters into an amalgamation with Company Y. Employee surrenders the restricted Company X share in exchange for a restricted Company Y share as part of the amalgamation.
>
> *Result.* The restricted equity share swap does not give rise to a tax event by virtue of proposed proviso to the definition of "consideration" in section 8C(7). Employee will be subject to tax on the restricted Company Y share on a subsequent vesting date (i.e., when all restrictions are lifted, immediate before certain disposals or immediately before death).

B. Connected persons/non-arm's length transfers

1. Transfers to connected persons or at non-arm's Length

As stated above, the main purpose of section 8C is to defer the taxation of restricted equity instruments until a later date so that the full level of gain on the instrument (which effectively amounts to disguised salary) is properly taxed at ordinary rates. Amounts falling outside this regime are generally taxable only at capital gains rates. Hence, unlike most situations, taxpayers in these circumstances have a strong incentive to artificially trigger ordinary rates of tax at an early date before the appreciation of the equity instrument is fully realised.

Without special rules, one potential way for triggering early gain is to sell restricted equity instruments at an early date either in a non-arm's length transaction or to connected persons. The sale to connected persons is especially problematic since the full gain will remain within the same economic group. Section 8C accordingly remedies this concern by treating the disposal to connected persons (or at non-arm's length) as a non-event. First, the disposal is not a vesting event (proposed section 8C(3)(b)(ii)). Second, the connected (non-arm's length) person steps in the shoes of the employee/director so that any vesting event in the hands of transferee creates ordinary income for that employee/director (proposed section 8C(5)(a)). (Note: Comparable rules also exist for Donations Tax purposes (proposed section 58(2))).

> **Example**
>
> *Facts:* In 2005, Employee acquires a restricted equity option in Company X while an employee of Company X. The option costs R1 (when Company X shares are worth R100 each) and allows Employee to convert the option into one restricted Company X share for R100. In 2006, Employee sells the option to Domestic Trust that qualifies as a connected person. Domestic Trust pays R3 for the option (when the Company X shares have a R102 value each). In 2007, the option is converted into a share when the Company X shares are worth R150 and all restrictions are lifted.
>
> *Result:* The transfer to the Trust is ignored by virtue of proposed section 8C(3)(b)(ii)). In 2007, the equity instrument vests generating R49 of ordinary income (R150 less the R100 for the share less the R1 cost for the option). This R49 of ordinary income is taxed in the hands of Employee.

Comparable rules apply if any person other than the employee/director directly acquires an equity instrument by virtue of the employee's/director's employment (proposed section 8C(5)(b)). This situation arises when the person (other than the employee/director) obtains the equity instrument without the employee/director actually being involved in the transfer. For instance, this situation may arise if a spouse of an employee directly receives an equity instrument from the employer-company by virtue of the employee's employment. Under this circumstance, the vesting of that instrument to the spouse will be treated as a taxable event generating ordinary income or loss for the employee (as if employee received the instrument and transferred the instrument to the spouse).

2. <u>Subsequent transfers by connected person/non-arm's length transferees</u>

Additional rules apply if a connected person/non-arm's length transferee subsequently disposes of a restricted equity instrument to another person who is connected to the employee/director (or to another non-arm's length transferee). The subsequent transfer is again free of tax and the second transferee is again treated as having stepped into the shoes of the employee/director (proposed section 8C(6)).

Example

Facts: In 2005, Employee acquires a restricted share of Company X while employed by Company X. Employee acquires the share in exchange for a R100 loan, and Company X provides Employee with a unilateral opportunity to cancel the acquisition if the share declines in value as long as Employee remains with Company X. In 2006, Employee sells the share to Spouse for R105. In 2007, Spouse transfers the share to Trust in exchange for a R100 loan with the Trust being a connected person to Employee. In 2008, Employee leaves Company X, thereby forfeiting the right to unilaterally cancel the acquisition if the shares decline in value.

Result: The transfer to Spouse and the subsequent transfer to Trust are ignored because both parties are connected to Employee. The vesting date for the share arises in 2008 when the unilateral right is cancelled. Employee must include R50 of ordinary income on that date (R150 value less the R100 consideration paid by Employee).

3. Collateral Capital Gains Tax changes

A. <u>Elimination of duplicated gains</u>

Equity instruments within section 8C do not trigger a disposal event for Capital Gains Tax purposes before the date of vesting (proposed paragraph 11(2)(*j*) of the Eighth Schedule) nor any deemed disposal for disposing of an asset for a price not reflecting arm's length (proposed paragraph 38(2)) of the Eighth Schedule). This non-event treatment follows the same principles as proposed for ordinary income (proposed section 10(1)(*nD*)). The equity instrument will generally be provided with a base cost equal to market value on the date that instrument vests (proposed paragraph 20(1)(h)).

Example 1

Facts: Employee is employed by Company X and is not a share dealer. In 2005, Employee acquires a restricted Company X share from Company X in exchange for a R100 loan when that restricted share has a value of R100. In 2007, the restrictions on the share are lifted when the share has a R250 value. Employee eventually sells the share for R400.

Result: The share vests in 2007 when the all restrictions are lifted. Employee must include R150 of ordinary income in that year (R250 less the R100 cost of the share). Employee obtains a R250 market value base cost in that share on that date. Employee has R150 of capital gain on the sale (R400 proceeds less R250 base cost).

Example 2

Facts: In 2005, Employee acquires a restricted share of Company X while employed by Company X. The share is provided at no cost to Employee. Under the restriction, Employee must surrender the share to Company X at no cost if Employee leaves before 2008. In 2006, Employee sells the share to Spouse for R55. In 2007, Spouse transfers the share to Trust in exchange for a R110 loan with the Trust being a connected person to Employee. In 2008, the restriction lifts when the share has a R100 value. Trust subsequently sells the share for R150 with all parties paying off their related loans.

Result: The share vests in 2008 when the restriction lifts, triggering R100 of ordinary income for Employee. Trust obtains a R100 base cost in the shares because a vesting occurred (with respect to "any person's income in terms of section 8C"). Trust has R50 of capital gain on the sale (R150 proceeds less the R100 base cost).

B. <u>Expatriates</u>

As a general rule, a person who ceases to be a resident is subject to immediate deemed disposal of all assets for Capital Gains Tax purposes. However, this deemed disposal event does not apply to assets remaining within South African taxing jurisdiction (e.g., South African immovable property and South African permanent establishment assets). The proposed rule additionally exempts unvested section 8C equity instruments (proposed paragraph 12(a)(ii) of the Eighth Schedule) because these instruments will remain subject to ordinary gain or loss treatment until vesting. Hence, the cessation of residence cannot be used to trigger an early taxable event (when values are low). The ordinary income or loss on the instrument should remain in the net as a jurisdictional matter because the instrument relates to South African sourced services.

HYBRID FINANCIAL INSTRUMENTS

Current Law

The South African Income Tax system, as is the norm internationally, has two sets of rules for the taxation of debt and shares. As far as debt is concerned, the debtor potentially deducts the interest from income while the creditor includes the interest as ordinary income. In the case of shares, the company payor distributes non-deductible dividends subject to the 12.5 per cent Secondary Tax on Companies ("STC") while the dividends are exempt in the hands of the shareholder.

Financial instruments are generally taxed according to their legal form. Accordingly, an instrument classified as debt usually qualifies for full debt treatment under the tax law, and an instrument classified as a share is usually subject to the treatment of equity share capital

The only section in the Income Tax Act specifically dealing with hybrid financial instruments is section 8E. The purpose of the section is to counter tax avoidance by ensuring that debt is not disguised as short term redeemable preference shares (or other redeemable shares containing certain dividend preferences). If shares fall within these rules, section 8E tackles the above avoidance by treating tax-free dividends as taxable interest for the holder. Meanwhile, the company payor remains fully subject to STC and cannot claim a deduction for the distribution of the dividend.

Hybrid financial instruments are, therefore, taxed by applying case law, the gross income definition, section 8E, the general deduction formula contained in section 11 (read with section 23) and the general anti-avoidance provisions of section 103.

Reasons for change

The South African tax system draws a distinction between debt and equity and the tax treatment of interest and dividends. A hybrid financial instrument which combines expected time value returns as well as exposure to changes in the value of a company (unexpected gain or loss attributable to a risk element) poses problems in determining whether the instrument should be treated as debt or equity. The purpose of these mixed features is often to obtain the best of both worlds so that the economic substance of the instrument often differs from its tax characterisation.

These hybrid financial instruments have internationally been used for decades in order to benefit from realisation-based recognition of expected gains and losses and also to alter the character of expected gains and losses.

While some general rules exist to prevent this manipulation, hybrid financial instruments are commonly used to exploit the difference between debt and equity. Firstly, the rules contained in section 8E that recharacterise dividends as interest are too narrow. Secondly, the Income Tax Act does not contain rules to recharacterise interest as dividends for the payor of disguised "dividends". Of special concern is debt convertible or exchangeable into shares because the nature of these instruments often means that the obligor need not actually repay principal (a key characteristic of a true debt instrument).

Other forms of debt-equity manipulation are also of concern. Taxpayers are attempting to escape the deemed interest rules of section 24J by designing complex structures with multiple inter-related agreements involving connected persons or third parties, which are facilitated by financial institutions. The purpose of these

arrangements includes the claiming of the principal amount of a loan as disguised interest, although tax policy principles would only allow deductions for the incurral of interest on a real loan.

Lastly, we have become aware of a number of financial institutions that are attempting to manipulate the tax system through various forms of revenue stream swaps. The purpose of these swaps is to convert amounts of taxable interest or taxable dividends into tax-free dividends by utilising trading entities as well as exemption provisions to shield the swapped taxable interest.

Amendments to section 24J

Current law

Section 24J was introduced to regulate the timing of the accrual and incurral of interest in respect of interest-bearing instruments for income tax purposes. For this purpose interest was defined to include the gross amount of interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement. Interest is spread over the term of the instrument by applying a yield to maturity calculation.

Reason for changes

A number of structured finance schemes which are based on convertible loans have been identified. The schemes under investigation were entered into between members of groups of companies (large and smaller companies) and are as a general rule facilitated by financial institutions.

Common characteristics of the structures are the use of compulsory convertible debt, the circular flow of funds through a number of related and unrelated companies and the borrowing of an inflated amount by the party claiming interest for tax purposes. The tax benefit for the group of companies entering into the scheme is the deduction of interest on the principal amount of a loan on an accrual basis and the creation of a deferred capital gain which in essence results in the deduction of interest and capital of the actual financing needs of the borrower.

It is estimated that the total tax avoided by these schemes amounts to many billions of Rand.

Further aspects were identified where the legislation could be interpreted in a way which is not in accordance with the policy intention of the legislation. These aspects consist of-

- The valuation of the issue price or transfer price of an instrument;
- The criteria for qualifying as a holder or an issuer in relation to an instrument;
- Events that trigger a re-determination of the yield to maturity rate used for tax purposes; and
- Whether section 24J operates as a section which quantifies amounts to be included in gross income and deducted from income or whether it should operate as a charging provision and allow for deductions for tax purposes. The application of the provisions to non-residents in this regard needs to be provided for.

These aspects should be addressed and clarified where necessary.

Proposed law

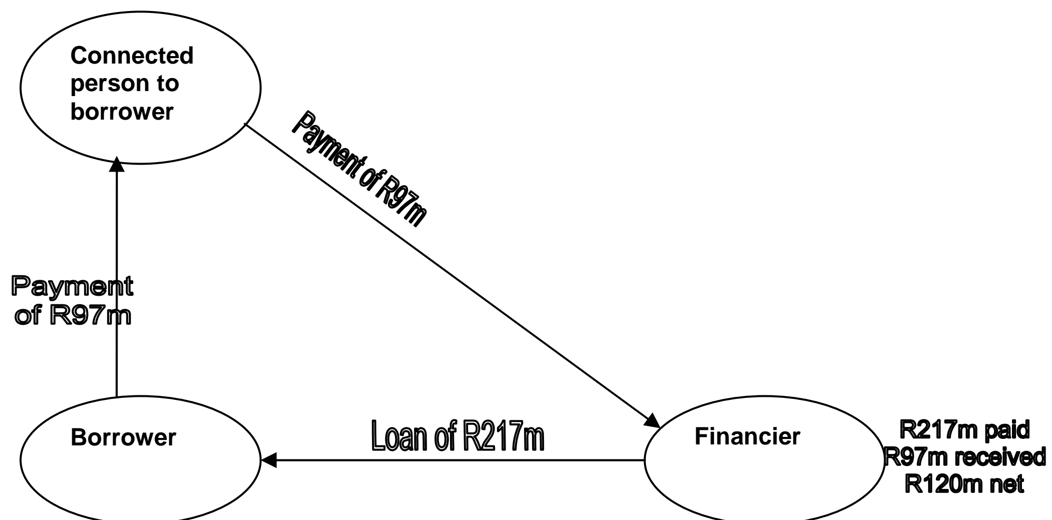
Clause 30(1)(a) and (g): In order to address the tax avoidance element of schemes which are based on the circular flow of funds to which more than one company in a group of companies are party to it is proposed that the interest claimed by a group company be limited to the net amount borrowed in terms of the scheme by the group of companies. It will be required that payments made by the borrower in respect of a financial arrangement or scheme as well as payments made by any connected person in relation to the issuer in respect of a financial arrangement or scheme should be taken into account. A circular flow of funds would then reduce the amount of interest claimed by a group company.

The definitions of "adjusted initial amount" and "yield to maturity" in section 24J(1) are to be amended to provide that where an instrument forms part of any transaction, operation or scheme and, any payments made by the issuer or connected person must be taken into account if made with a purpose or the probable effect of making payment directly or indirectly to the holder (or a connected person to the holder).

See an example of an inflated interest deduction scheme below.

Example

Facts: On 1 January 2005 Borrower borrows R217 million from financier in terms of a financing scheme. On the same day the connected person to the borrower pays an amount of R97 million directly or indirectly to Financier in terms of the same scheme. The actual loan required by Borrower is only R120 million and the net amount advanced by Financier is R120 million. In the absence of the proposed amendments Borrower will claim interest on a loan of R217 million.



Result: For income tax purposes the interest will be calculated on a loan of R120 million as the payment in terms of the scheme by the connected person is deducted from the amount paid directly by the Financier to the Borrower.

A similar result would have been achieved had borrower paid an amount to an unrelated party in terms of a scheme, where Financier indirectly receives the payment.

Clause 30(1)(b) and (d): The definitions of "holder" and "issuer" *inter alia* refer to persons who have become entitled to any interest or have incurred any interest in terms of income instruments or instruments. Technically interest is calculated with reference to amounts payable and receivable. For this reason it would be more appropriate to, in the case of-

- a holder also to refer to any person who has become entitled to any amount in terms of an income instrument; and
- an issuer also to refer to a person who has any obligation to repay any amount in terms of an instrument.

Clause 30(1)(c) and (e): Currently the definitions of "issue price" and "'transfer price" refers to consideration given or received and payable or receivable for the issue or transfer of an instrument. These amounts are used as the starting point to determine the incurral and accrual of interest for tax purposes. It is implied that the consideration should be determined on the date of issue or transfer of the relevant instrument and that the value of the consideration be taken into account. In order to clarify these principles it is proposed that the definitions be amended to refer to the market value of the consideration as determined on the date of which the instrument is issued or transferred.

Clause 30(1)(f): Currently the yield to maturity rate used for tax purposes to determine the interest to be accrued or incurred for tax purposes is redetermined whenever the rights or interest of a holder to receive interest or the obligations of an issuer to pay interest is varied or altered.

In reality the calculation of the yield to maturity rate is based on amounts receivable and payable. It is, therefore, proposed that paragraph *(d)* to the proviso to the definition of "yield to maturity" be amended to refer to a variation or alteration in the amounts receivable by a holder and amounts payable by an issuer instead of to the right to receive interest or the obligation to pay interest.

Clause 30(1)(h) and (i): Currently section 24J does not provide for the inclusion in gross income of a taxpayer of interest accrued or the deduction from the income of a taxpayer of interest incurred. In order to provide certainty as to the tax treatment of interest and to introduce the principle that interest should always be treated on revenue account it is proposed that section 24J be restructured to specifically provide for the inclusion in gross income of interest deemed to have been accrued or the deduction from income of interest deemed to have been incurred in terms of that section. Section 24J(2) and (3) are to be amended to give effect to this principle. This would bring the tax treatment of interest in line with the treatment of exchange differences, which is not subject of the capital nature test. However, the deduction of interest should still be subject to the trade and production of income tests.

It is not recommended that the structure of section 24J relating to the tax treatment of adjusted gains and losses on transfer or redemption of instruments be changed. This means that the capital/revenue test for gains and losses as a result of changes in the value of instruments due to movements in the market interest rates would be retained. Discounts and premiums on the original issue or acquisition of instruments are already defined to be interest and would no longer be subject to the capital/revenue test.

Amendments to section 8E

1. *Expand scope of the section: Section 8E(1): definition of "hybrid equity instrument"*

To address the narrow application of the current section 8E, it was decided to expand the scope of the definition of "hybrid equity instrument" in order to cover additional shares that can be disguised as debt. Under current law, there are two categories of instruments that are regarded as hybrid equity instruments (i.e., subject to section 8E). These are:

(a) redeemable preference shares that are redeemable or disposable within three years from the date of issue, and

(b) any other share (i.e., an ordinary share) which is redeemable or disposable within a three-year period and which contain certain preferences such as:
   (i) ranking above other ordinary shares (in the same class) in dividend participation;
   (ii) ranking above other ordinary shares (in different classes); or
   (iii) dividends payable being calculated directly or indirectly with reference to:
      - a specified rate of interest, or
      - the amount of capital subscribed for the share; or
      - the amount of any loan or advance made directly or indirectly by the shareholder or any connected person in relation to the shareholder.

It is proposed that a new category of affected instruments be introduced. The new category consists of shares of a company where the existence of the company is limited to or is likely to be terminated within a period of three years from the time of issue of shares which contain preferences. The termination feature in this case essentially operates as a redemption or disposal right.

2. *Date of issue of share: Section 8E(1): definition of "date of issue"*

It is proposed that section 8E be amended to cover further situations that are considered to be disguised debt. Importance is placed on the redemption features added after the initial date of issue of the share. For instance, a company originally issued a non-redeemable preference share and subsequent to the original date of issue the terms of the share are altered to make the share redeemable within three years. In this instance section 8E should be applicable to the altered share on or after the alteration. A definition of "date of issue" is to be introduced which takes into account the rights of shareholders as well as obligations placed on the relevant company. It is proposed that the three year period referred to in the section will be determined from of the date-

- of issue of the share;
- subsequent to the issue of the share when the company undertakes to wholly or partially redeem the share at a future date; and
- subsequent to the issue of the share when the holder obtains the right to require the share to be redeemed in whole or in part.

Example

Facts: On 1 November 2004, Company Z issues a non-redeemable preference share to Mr X. On 1 June 2005, the original terms of the issued share are altered. The new terms stipulate that it must be redeemed on or before 31 May 2008 (i.e., within three years from the date of change of the rights and obligations attaching to the share).

Result: As from 1 June 2005 the altered share qualifies as an hybrid equity instrument and the shareholder will be subject to the provisions of section 8E from that date.

Introduction of section 8F

1. *General Rule*

As a further first step in drawing the distinction between debt and equity for tax purposes it is proposed that a new section 8F be introduced which will limit the deductibility of interest by persons other than natural persons in respect of hybrid debt instruments which are debt in legal form but have sufficient equity features that they can clearly be placed at the equity end of the debt/equity spectrum. In other words these instruments are in substance equity and should be treated accordingly. In order to match the current bright-line test contained in section 8E, only instruments which are convertible or exchangeable into shares within a period of three years will be regulated by the proposed provisions.

The purpose of the section is, therefore, to counter tax avoidance by ensuring that equity is not disguised as debt. If shares fall within these rules, section 8F tackles the above avoidance by disallowing the deduction of interest paid or payable in terms of the instruments while still treating amounts payable in terms of the instrument as taxable interest in the hands of the holder.

In the case of a company the interest incurred in respect of the affected instruments is deemed to be a dividend declared for purposes of determining a liability for secondary tax on companies.

The three year period will be determined from either the date on which the instrument is issued or from the date on which that instrument becomes convertible into or exchangeable for a share if these rights are created subsequent to the actual date of issue.

2. *Limitation of deduction: Section 8F(2)*

Section 8F(2) limits the amount of deductible interest allowed for hybrid debt instruments. Section 8F(2) is focused on companies and any person where a connected person which is a company is to issue shares. It, therefore, applies to any issuer that issues debt which is convertible or exchangeable for a share in the issuer or a share of a connected person in relation to the issuer. This would cover the situation where an individual enter into a loan agreement which provides for repayment within 3 years in the form of shares in the individual's wholly owned

company. In terms of this section, interest payments made in terms of affected instruments) made by an issuer are not deductible in respect of certain instruments.

3. *Types of Hybrid instruments covered by section 8F*

Debt that is convertible or exchangeable into equity is debt that gives the holder an equity upside. In a somewhat simplistic fashion, the convertible can be thought of as a straight bond plus an equity option. Since the investor essentially owns the bond, the convertible provides some protection against market declines. On the other hand, the convertibility feature allows the investor to participate in equity. In a sense convertible instruments participate in both fixed income as well as equity markets.

Convertible debt is issued with the aim of having the debt converted into equity rather than being redeemed at the time of maturity. If the issuer can require the holder to convert or exchange the debt into equity, any interest payable on the debt is treated as dividends because the issuer can avoid paying interest by requiring conversion or exchange into equity.

The conversion or exchange can also be exercised at the holder's option. In this instance, the value of the right and the time at which the right can be exercised are relevant. This is because starting life as a debt instrument; convertible debt becomes equity only when converted. Accordingly, if the right can only be exercised at the fair market value of the shares at the date of conversion or exchange, the debt is treated as debt until the conversion or exchange. However, if the value of the right at the date of issue makes it likely or certain that the holder will convert or exchange, then the interest payable on the debt will be treated as dividends.

It is proposed that section 8F applies to the following instruments (as defined in section 24J of the Income Tax Act):

- An instrument which is at the option of the issuer convertible (shares of the same company) into or exchangeable (shares of another company or a separate subscription for shares of the same company) for any share in the issuer or connected person in relation to the issuer within three years from the date of issue of that instrument;
- Where the issuer in relation to an instrument is entitled to repay that instrument in whole or in part within three years from the date of issue of that instrument by the issue of shares by the issuer or connected person in relation to the issuer to the holder of the instrument;
- Where the issuer in relation to an instrument is entitled to repay that instrument in whole or in part within three years from the date of issue of that instrument and is entitled at the time of that repayment to require the holder of that instrument to subscribe for or acquire shares in the issuer or any connected person in relation to the issuer; or
- The instrument is at the option of the holder convertible into or exchangeable for any share in the issuer or any connected person in relation to the issuer within three years from the date of issue and it is determined on the date of issue that the value that share will exceed the value of the instrument by at least 20 per cent (this final requirement will not apply to listed instruments issued by listed companies).

Example

Facts: On 1 April 2005 Company Y issues interest-bearing debentures to investor C. Each debenture is convertible into one company Y ordinary share at

the option of the holder of the debenture at any time from 1 June 2006. The debentures are traded off-market. The debentures were issued at R100 each and the value of each ordinary share of Y is estimated to exceed R150 in June 2006.

Result: The interest incurred by Company Y on the debentures will not be allowed as a deduction in terms of section 8F as the value of the share will exceed the value of the debenture by at least 20 per cent.

Section 64C(2)*(h)*

Section 64C is amended to deem an amount incurred by a company in terms of an instrument to which section 8F applies to be a deemed dividend. This amendment reinforces the principle that payments in respect of equity disguised as debt should be treated as dividends from the perspective of a company which is an issuer in relation to hybrid debt instruments. The issuer company is subject to secondary tax on companies on the deemed dividend.

Section 103(5)

This section provides for the determination of the tax liability of parties to a transaction, operation or scheme, whereby rights to receive interest has been ceded for an amount of dividends and as a result of the cession the tax liability of the person ceding the interest has been reduced, as if the cession has not been affected.

It is proposed that the ambit of the section be extended to also disregard the cession where the liability for normal tax of any other party to the transaction has been reduced or extinguished. The proposal will extend the ambit of section of 103(5) to include swaps involving dividends and other forms of income subject to tax.

INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR CONTINGENT OR UNQUANTIFIED AMOUNTS

Present law

Under current law, an immediate taxable event arises when a party disposes of an asset for consideration. This immediate taxable event arises even if the liquid cash consideration is deferred over several years (i.e., comes in instalments). Rules of this nature exist both for purposes of ordinary income as well as capital gain. Hence, if a party sells an asset for R40 000, R60 000 and R50 000 in three instalments over three years, that party is treated as having received the full R150 000 immediately upon sale.

On the other hand, the party acquiring the asset for deferred consideration may or may not be viewed as immediately having an expenditure actually incurred. In terms of the Capital Gains Tax, the expenditure incurred is deferred for the buyer until each year in which an amount becomes due and payable. Meanwhile, in terms of ordinary income, the expenditure is generally viewed as incurred immediately upon sale.

Reason for change

Application of current law to the disposal of assets for amounts coming in deferred instalments is generally straight-forward. However, problems arise if future payments do not accrue because they are wholly contingent. In addition, accrued future payments are similarly problematic if these payments cannot be quantified (i.e., cannot be fully known) because these amounts are based on one or more contingencies. These latter situations typically arise if the seller receives consideration based on target levels of revenue/profit.

Contingent and unquantified payments create a number of problems for both the seller and the purchaser with neither party being able to fully predict the future. The seller may under-include gain in the early years, thereby generating excessive early losses followed by a later recapture of the loss as income. Alternatively, the seller may over-include gain in the early years, thereby generating excessive early gains followed by losses to undo these unwarranted gains. The purchaser has similar problems when determining the cost of the asset acquired.

Proposal

A. "Open transaction" method

The proposal seeks to alleviate the above uncertainties by introducing an "open transaction" method for sales arranged with deferred instalments that do not accrue because of contingencies or with deferred instalments containing unquantified amounts. The basic thrust of this method is to account for these instalments as they are received over time. Ordinary income will arise for the seller only once the consideration received exceeds the seller's total expenditure for the property transferred. Losses will arise for the seller only if that loss exists after all instalments are complete. The purchaser of the property will similarly be viewed as incurring expenditures only as payments are made.

The benefit of the "open transaction" method is two-fold. First, this method avoids the administrative complexity of calculating (and possibly valuing) anticipated receipts that are essentially unknown for either party during the initial stages of the transaction. Second, this method avoids the complexity of undoing early calculations based on predictions that ultimately differ from subsequent reality.

Setting aside the special rules required for pre-1 October 2001 assets, the rules for both accrued unquantified and unaccrued contingent deferred instalment sales fall into three major categories, as follows: (i) transfers of non-depreciable capital assets, (ii) transfer of depreciable capital assets, and, (iii) transfers of trading stock assets,

B. Transfers of non-depreciable capital assets

1. Taxation of the transferor – accrued unquantified amounts

If a person disposes of a capital asset for consideration that cannot be quantified in whole or in part, that transferor will be viewed as accruing only the portion of the consideration that can be quantified during the year of disposal (proposed section 24M(1)). Unquantified consideration only accrues in later years as those amounts

become quantifiable (i.e., are fixed). The transferor no longer needs to predict future events to determine current capital gains/losses on disposal.

In mechanical terms, the transferor determines capital gains/losses during the initial year of disposal under normal capital gain rules, except that the proceeds for the initial year are taken into account only to the extent those amounts can be fully quantified. This calculation triggers an initial capital gain or loss. Initial capital gains generate tax just like any other capital gain. However, initial capital losses are disregarded (i.e., suspended) during that year (proposed paragraph 39A(1) of the Eighth Schedule).

The transferor must then account for further consideration in later years as that consideration becomes quantified (fully due and payable). This further consideration generates full capital gain during each year of instalment without any base cost offset (proposed paragraph 3(b)(i) of the Eighth Schedule). However, the transferor reduces this gain to the extent of any remaining disregarded losses stemming from the initial year of transfer (proposed paragraph 39A(2) of the Eighth Schedule). If any disregarded losses still exist once no further proceeds will accrue, these remaining capital losses can be fully accounted for at that time (proposed paragraph 39A(3) of the Eighth Schedule).

2. Taxation of the transferee – accrued unquantified amounts

If a transferee acquires assets for consideration that wholly or partly includes unquantified amounts, that transferee's expenditure incurred (base cost) is accumulated over time (proposed section 24M(2)); whereas, future quantified amounts will be viewed as immediately incurred (with the proposed repeal of paragraph 20(3)(c)). More specifically, the transferee is initially viewed as having incurred expenditures to the extent of the quantified consideration provided on transfer. Further expenditure is added to the transferred asset as further amounts become quantified. If the transferee sells an asset before all amounts are quantified, the gain on the transfer is calculated without reference to the unquantified amounts. However, further quantified amounts incurred by the transferee with respect to the transferred asset will generate capital loss as those are incurred (proposed paragraph 4(b)(ii)) of the Eighth Schedule).

3. Transferor and transferee (unaccrued) contingent payments

As stated above, the proposal additionally clarifies the treatment of unaccrued contingent proceeds. These situations arise if the total price (i.e., proceeds) is contingent on one or more events, thereby preventing accrual as a matter of common law (without reference to section 24M). Proposed law clarifies that all contingent proceeds are treated the same as unquantified proceeds.

Hence, initial capital losses are disregarded (i.e., suspended) during that year (proposed paragraph 39A(1) of the Eighth Schedule). The transferor must then account for further consideration as full capital gain during each year of instalment (without any base cost offset) (proposed paragraph 3(b)(i) of the Eighth Schedule). However, the transferor reduces this gain to the extent of any remaining disregarded losses stemming from the initial year of transfer (proposed paragraph 39A(2) of the Eighth Schedule). If any disregarded losses still exist after all unquantified instalments become due and payable, these remaining capital losses can be fully accounted for at that time (proposed paragraph 39A(3) of the Eighth Schedule).

In terms of the transferee, additional expenditure is added to the base cost of the asset acquired as further amounts are incurred (i.e., accrue to the seller). If the transferee sells an asset before all amounts are incurred, the gain on the transfer is calculated without reference to the unquantified amounts. The transferee has capital losses to the extent further amounts are incurred after the sale (proposed paragraph 4(b)(ii)) of the Eighth Schedule).

Example 1

Straight-forward gain on unquantified amounts

Facts: Individual A acquired retail property in December 2001. In March 2005, Individual A sells all the retail property to Individual B. In terms of the contract, Individual B must pay 10 percent of the profits generated by the retail property to Individual A for 5 years subsequent. Assume the amounts received are eventually R300 000, R200 000, R150 000, R110 000 and R240 000, starting in 2005. Individual A's base cost in the property is R250 000.

Result: The special rules of section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2005 year will trigger a small R50 000 gain for Individual A. Subsequent years will trigger additional capital gains. The net cumulative will amount to R750 000 of capital gain (R1 million proceed less the R250 000 base cost).

Individual B's base cost in the retail property acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a R300 000 base cost in the first year, R500 000 in the second year, etc…).

Year	**2005/6**	**2006/7**	**2007/8**	**2008/9**	**2009/10**
Current receipts	R300 000	R200 000	R150 000	R110 000	R240 000
Base cost	R250 000				
Gain/(loss)	R50 000	R200 000	R150 000	R110 000	R240 000
Suspended loss					
Taxable gain	R50 000	R200 000	R150 000	R110 000	R 240 000

Example 2

Overall gain on unquantified amounts after suspended loss

Facts: Individual A acquired retail property in December 2001. In March 2005, Individual A sells all the retail property to Individual B. In terms of the contract, Individual B must pay 10 percent of the profits generated by the retail property to Individual A for 5 years subsequent. Assume the amounts received are eventually R300 000, R200 000, R150 000, R110 000 and R240 000, starting in 2005. Individual A's base cost in the property is R500 000.

Result: The special rules of section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2005 year will trigger a R200 000 suspended loss for Individual A. Subsequent years will trigger capital gains that will first be used against the suspended loss. The net cumulative will amount to R500 000 of capital gain (aggregated R1 million proceed less the R500 000 base cost).

Individual B's base cost in the retail property acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a R300 000 base cost in the first year, R500 000 in the second year, etc.

Year	**2005/6**	**2006/7**	**2007/8**	**2008/9**	**2009/10**
Current receipts	R300 000	R200 000	R150 000	R110 000	R240 000
Base cost	R500 000				
Gain/(loss)	(R200 000 suspended loss under section 39A)	R200 000	R150 000	R110 000	R240 000
Suspended loss		(R200 000)			
Taxable gain	R0	R0	R150 000	R110 000	R 240 000

Example 3

Overall gain on unquantified amounts with a zero instalment year

Facts: Individual A acquired retail property in December 2001. In June 2005, Individual A sells the retail property to Individual B. In terms of the contract, Individual B must pay 10 percent of the profits generated by the retail property to Individual A for 5 years subsequent. Assume these amounts received are eventually R400 000, R200 000, R150 000, R0 and R240 000, starting in 2005. Individual A's base cost in the property is R500 000.

Result: The special rules of section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2005/6 year will trigger a R100 000 suspended loss for Individual A. Subsequent years will trigger capital gains that will first be used against the suspended loss with the zero instalment year having no net effect. The net cumulative will amount to R500 000 of capital gain (R1 million proceed less the R500 000 base cost).

Individual B's base cost in the retail property acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a 400 000 base cost in the first year, R600 000 in the second year, etc.).

Year	2005/6	2006/7	2007/8	2008/9	2009/10
Current receipts	R400 000	R200 000	R150 000	R0	R250 000
Base cost	R500 000				
Gain/(loss)	(R100 000 suspended loss under section 39A)	R200 000	R150 000	R0	R250 000
Suspended loss		(R100 000)			
Taxable gain	R0	R100 000	R150 000	R0	R 250 000

Example 4

Overall loss on unquantified amounts

Facts: Individual A acquired retail property in December 2001. In December 2005, Individual A sells the retail property to Individual B. In terms of the contract, Individual B must pay 10 percent of the profits generated by the retail property to Individual A for 5 years subsequent. Assume these amounts received are eventually R40 000, R20 000, R15 000, R1 000, R24 000, starting in 2005. Individual A's base cost in the property is R500 000.

Result: The special rules of section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2005/6 year will trigger a R460 000 suspended loss for Individual A. This suspended loss will be partly offset with successive gains. However, the transaction will generate a net R400 000 capital loss in 2009 when all instalment payments are complete.

Individual B's base cost in the retail property acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a 40 000 base cost in the first year, R60 000 in the second year, etc.).

Year	2005/6	2006/7	2007/8	2008/9	2009/10
Current receipts	R40 000	R20 000	R15 000	R1 000	R24 000
Base cost	R500 000				
Gain/(loss)	(R460 000 suspended loss under section 39A)	R20 000	R15 000	R1 000	R24 000
Suspended loss		(R460 000)	(R440 000)	(R425 000)	(R424 000)
Capital loss	R0	R0	R0	R0	(R400 000)

Example 5

Fixed plus unquantified amounts

Facts: Individual A acquired retail property in December 2001. In September 2005, Individual A sells the retail property to Individual B. In terms of the contract, Individual B must pay R20 000 for each of the 5 years subsequent and 15 per cent of the profits of the retail property for each of the 5 years subsequent. Assume the 15 per cent profit receipts received are eventually R90 000, R200 000, R150 000, R1 000, R24 000, starting in 2005. Individual A's base cost in the property is R500 000.

Result: All R100 000 fixed instalments are all included as current receipts in 2005/6. The special rules of section 24M also apply because unquantified payments are involved. Under the open transaction method, the initial 2005/6 year will trigger a R310 000 suspended loss for Individual A after all the fixed instalments and the 2005 contingent instalment are taken into account. Subsequent years will trigger capital gains that will first be used against the suspended loss. The net cumulative will amount to R65 000 of capital gain (R565 000 proceed less the R500 000 base cost).

Individual B's base cost in the retail property acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a R190 000 base cost in the first year, R390 000 in the second year, etc.).

Year	**2005/6**	**2006/7**	**2007/8**	**2008/9**	**2009/10**
Current receipts	R100 000 fixed and R90 000 contingent	R200 000	R150 000	R1 000	R24 000
Base cost	R500 000				
Gain/(loss)	(R310 000 suspended loss under section 39A)	R200 000	R150 000	R1 000	R24 000
Suspended loss		(R310 000)	(R110 000)		
Taxable gain	R0	R0	R40 000	R1 000	R24 000

Example 6

Buyer's sale of property acquired with unquantified amounts before all amounts are incurred

Facts: The facts are the same as **Example 5**, except that Individual B sells the retail property to Individual C after the 2007 instalment payment is made. Individual B's sale of the retail property does not alter the payment relationship with Individual A. Individual B immediately receives R620 000 for the property upon sale to Individual C.

Result: The sale of the retail property by Individual B has no effect on the gain calculations made by Individual A. Individual B has R540 000 base cost in the property (i.e., R190 000 + R200 000 + R150 000) upon sale to Individual C, thereby generating R80 000 of capital gain (R620 000 proceeds less the R540 000 of base cost). Further amounts paid by Individual B to Individual A will generate capital loss during the years those amounts are paid (proposed paragraph 4(b)(ii)) of the Eighth Schedule). Hence, Individual B will have a R1 000 capital loss in 2008 and a R24 000 capital loss in 2009.

Example 7

Unaccrued contingent amounts

Facts: Individual A acquired retail property in December 2001. In September 2005, Individual A sells the retail property to Individual B. In terms of the contract, Individual B must pay 10 per cent of the profits of the retail property for each of the 5 years subsequent if and only if the retail property satisfies certain local zoning standard and only to the extent the property's annual profits exceed R500 000. Assume zoning standard are not satisfied until 2006 and contingent profit receipts received are eventually R150 000, R200 000, R0 and R400 000, starting in 2006. Individual A's base cost in the property is R250 000.

Result: None of the receipts accrue until zoning standards are satisfied in 2006 with all accrued amounts being unquantified after that date. Under the open transaction method, the initial 2005 year will trigger a R250 000 suspended loss. Subsequent years will trigger capital gains that will first be used against the suspended loss. The net cumulative will amount to R300 000 of capital gain (R550 000 proceed less the R250 000 base cost).

Individual B's base cost in the retail property acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a R0 base cost in the first year, R150 000 in the second year, etc.).

Year	**2005**	**2006**	**2007**	**2008**	**2009**
Current receipts*	R0	R150 000	R200 000	R0	R400 000
Base cost	R250 000				
Gain/(loss)	(R250 000 suspended loss under section 39A)	R150 000	R200 000	R0	R400 000
Suspended loss		(R250 000)	(R100 000)		
Taxable gain	R0	R0	R100 000	R0	R400 000

C. Transfers of depreciable capital assets

1. <u>Taxation of the transferor – accrued unquantified amounts</u>

The tax calculations for the transfer of depreciable capital assets received in exchange for consideration containing unquantified amounts are the same as the basic rules for non-depreciable capital asset transfers. However, these rules contain two basic variations. First, these rules must account for potential section 11(o) ordinary losses stemming from the sale of certain depreciable assets with a useful life not exceeding 10 years. Second, these rules must account for potential section 8(4) recoupments.

As described in the case of non-depreciable capital assets, the disposal of a depreciable capital assets for wholly or partly unquantified consideration triggers an initial gain or loss with the transferor including only quantified consideration during the year of disposal (proposed section 24M(1)). Unquantified consideration is taken into account only in later years as those amounts become quantifiable (i.e., are fixed and due).

In more mechanical terms, the transferor again determines gains/losses during the initial year of disposal under the normal disposal rules, except that the proceeds for the initial year relate only to quantified amounts. In the case of certain depreciable assets with useful lives not exceeding 10 years, any losses resulting from the initial year will be classified as an ordinary loss under section 11(o). These initial section 11(o) losses will be suspended (proposed section 20B(1)). Subsequent quantified proceeds will trigger recoupments (see proposed section 24M(3)) that will be offset by the initial, unused suspended losses (proposed section 20B(2)). Suspended section 11(o) losses (if any) existing after all instalments accrue can be fully accounted for at that time (proposed section 20B(3)).

Depreciable assets potentially generate recoupments of prior depreciation (proposed section 24M(3)). Recoupments will arise with respect to consideration accrued in initial and/or subsequent years if the accumulated accrued amount exceeds the base cost transferred, and this excess merely represents a recoupment of prior depreciation. Accrued consideration in excess of this recoupment generally has a capital nature.

2. <u>Taxation of the transferee – accrued unquantified amounts</u>

If a transferee acquires depreciable capital assets for consideration that wholly or partly includes unquantified amounts, that transferee's expenditure incurred accumulates over time (proposed section 24M(2)); whereas, future quantified amounts will be viewed as immediately incurred (with the proposed repeal of paragraph 20(3)(c) of the Eighth Schedule). These rules are essentially the same as the rules for non-depreciable capital assets.

One noted difference is the calculation required for depreciating the asset acquired. In the initial year, the depreciation calculation is fairly straight-forward, being determined solely with reference to quantified accrued amounts (like any other acquisition of depreciable property). However, special calculation is required for subsequent years after adjustment for further payments falling outside the initial year. If the transferee makes a subsequent payment that becomes quantifiable in a later year, that payment is added to the depreciation calculation. The transferee receives additional capital (i.e., depreciation) allowances for a subsequent quantifiable payment equal to all accumulated depreciation that would have arisen with respect to

that payment had the payment been made during the initial year of transfer (proposed section 24M(4).

3. Transferor and transferee – accrued contingent amounts

The proposal again clarifies the treatment of unaccrued contingent proceeds. In these circumstances, wholly contingent proceeds do not accrue to the seller as a matter of common law (without reference to section 24M). Proposed law clarifies that all collateral consequences for depreciable capital assets follow the same paradigm as accrued unquantified proceeds.

Example 1

Undepreciated asset with a suspended ordinary section 11(o) allowance

Facts: Individual A builds a manufacturing plant that is completed in 2004 at a cost of R800 000. Individual A initially planned to conduct a manufacturing operation, but suddenly decides to sell due to the loss of an anticipated key contract. Individual A accordingly sells the plant to Individual B with Individual B agreeing to pay 10 percent of the gross turnover for 5 years subsequent. Assume the amounts eventually received are R190 000, R40 000, R350 000, R180 000, R240 000, starting in 2005.

Result: The special rules of section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2005 year will trigger a R610 000 suspended section 11(o) loss for Individual A (proposed section 20B(1)). This suspended loss will be offset with successive recoupments (proposed sections 20B(2) and 24M(3)). The transaction will ultimately generate a net R200 000 capital gain in 2009.

Individual B's base cost in the manufacturing plant acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a 190 000 base cost in the first year, which will generate a depreciation deduction of 40. 20, 20 and 20 per cent (i.e., R76 000 in 2005 as well as R38 000 in each of 2006 through 2008). The second payment will be added to base cost in the second year, but a special calculation is required for depreciation purposes. Individual B will be entitled to a depreciation deduction on the second instalment equal to 2 years worth of depreciation (proposed section 24M(4)). This second instalment amounts to 60, 20 and 20 per cent depreciation (i.e., R24 000 in 2006, R8 000 in 2007 and R8 000 in 2008). The third instalment similarly amounts to 80 and 20 per cent depreciation (i.e., R280 000 in 2007 and R70 000 in 2008). The fourth and fifth payment amount to 100 immediate depreciation (R180 000 in 2008 and R240 000 in 2009).

Year	2005	2006	2007	2008	2009
Current receipts	R190 000	R40 000	R350 000	R180 000	R240 000
Cost	R800 000				
Offset against section 11*(o)* deduction		R40 000	R350 000	R180 000	R40 000
Gain/(loss)	(R610 000)				

	section 11*(o)*				
Suspended loss (section 11(o))	(R610 000)	(R570 000)	(R220 000)	(R40 000)	R0
Taxable Gain					R200 000 Capital Gain

Example 2

Depreciable asset with recoupment

Facts: Individual A constructs a new hotel within an urban development zone in 2005 at a cost of R800 000. Individual depreciates the asset by R200 000 over a 2-year period (at 20 per cent and again at 5 per cent), leaving the asset with a R600 000 tax value. In 2007, Individual A sells the hotel to Individual B with Individual B agreeing to pay 10 percent of the gross hotel receipts for 5 years subsequent. Assume the amounts eventually received are R190 000, R40 000, R350 000, R180 000, R240 000, starting in 2007.

Result: The special rules of section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2007 year will trigger a R410 000 suspended capital loss for Individual A (proposed paragraph 39A(1)). This suspended loss will be offset with successive capital gain (proposed paragraph 39A(2)). Once all suspended losses have been utilised, further payments will generate recoupment of the full R200 000 prior depreciation (proposed section 24M(3)), followed by payments generating capital gain. The net cumulative will be R200 000 of ordinary recoupment and R200 000 of capital gain.

Individual B's base cost in the hotel acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a 190 000 base cost in the first year, which will generate a depreciation deduction of 40. 20, 20 and 20 per cent (i.e., R76 000 in 2007 as well as R38 000 in each of 2008 through 2010). The second payment will be added to base cost in the second year, but a special calculation is required for depreciation purposes. Individual B will be entitled to a depreciation deduction on the second instalment equal to 2 years worth of depreciation (proposed section 24M(4)). This second instalment amounts to 60, 20 and 20 per cent depreciation (i.e., R24 000 in 2008, R8 000 in 2009 and R8 000 in 2010). The third instalment similarly amounts to 80 and 20 per cent depreciation (i.e., R280 000 in 2009 and R70 000 in 2010). The fourth and fifth payment amount to 100 immediate depreciation (R180 000 in 2010 and R240 000 in 2011).

Year	**2007**	**2008**	**2009**	**2010**	**2011**
Current receipts	R190 000	R40 000	R350 000	R180 000	R240 000
<u>Cost</u>	<u>R600 000</u>				
Gain/(loss)	(R410 000) suspended capital	R40 000 capital	R350 000 capital	R20 000 capital and R160 000 recoupment	R40 000 recoupment R200 000 capital

Suspended loss (capital)	(R410 000)	(R370 000)	(R20 000)	R0	R0
Taxable gain	R0	R0	R0	R160 000 ordinary	R40 000 ordinary and R200 000 capital

Example 3

Depreciable asset with a suspended ordinary section 11(o) allowance and recoupment

Facts: Individual A acquired a manufacturing machine in December 2004 at a cost of R500 000. After depreciating the machine by R200 000 (i.e., at 40 per cent), Individual A sells a machine to Individual B in 2006. Under the terms of the contract, Individual B must pay 10 percent of the value of the products produced by the machine for 5 years subsequent. Assume these amounts eventually received are R190 000, R40 000, R250 000, R280 000, R240 000, starting in 2006.

Result: The special rules of section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2006 year will trigger a R110 000 suspended section 11*(o)* loss for Individual A (proposed section 20B(1)). This suspended loss will be offset with successive income (proposed section 20B(2)). Once all suspended losses have been utilised, further payments will generate recoupment of the full R200 000 prior depreciation (proposed section 24M(3)), followed by payments generating capital gain. The net cumulative will be R200 000 of ordinary recoupment and R500 000 of capital gain.

Individual B's base cost in the manufacturing machine acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a 190 000 base cost in the first year, which will generate a depreciation deduction of 40. 20, 20 and 20 per cent (i.e., R76 000 in 2006 as well as R38 000 in each of 2007 through 2009). The second payment will be added to base cost in the second year, but a special calculation is required for depreciation purposes. Individual B will be entitled to a depreciation deduction on the second instalment equal to 2 years worth of depreciation (proposed section 24M(4)). This second instalment amounts to 60, 20 and 20 per cent depreciation (i.e., R24 000 in 2007, R8 000 in 2008 and R8 000 in 2009). The third instalment similarly amounts to 80 and 20 per cent depreciation (i.e., R200 000 in 2008 and R50 000 in 2009). The fourth and fifth payment amount to 100 immediate depreciation (R180 000 in 2009 and R240 000 in 2010).

Year	**2006**	**2007**	**2008**	**2009**	**2010**
Current receipts	R190 000	R40 000	R250 000	R280 000	R240 000
Cost	R300 000				

Gain/(loss)	(R110 000) section 11*(o)*	R40 000 recoupment (section 11*(o))*	R250 000 recoupment (section 11*(o)* and depreciation)	R20 000 recoupment and R260 000 capital	R240 000 capital
Suspended loss (section (11(o))	(R110 000)	(R70 000)	R0	R0	R0
Taxable gain	R0	R0	R180 000 ordinary	R20 000 ordinary and R260 000 capital	R240 000 capital

D. Transfers of trading stock assets

Present law already contains rules for trading stock assets that are transferred for consideration that does not fully accrue during the initial year of disposal (i.e., that contains unaccrued contingent amounts). These rules require a pro rata allocation of expenditure based on current year consideration as compared to overall consideration. No trading stock rules exist for accrued unquantified amounts. The proposed rules for trading stock will be modified so that all calculations are fully consistent with the newly added rules for nondepreciable and depreciable capital assets.

1. <u>Taxation of the transferor – accrued unquantified amounts</u>

The rules for determining income and loss for unquantified amounts in terms of trading stock assets follow the same paradigm as the rules for nondepreciable and depreciable capital assets. The only deviation stems from inherent differences in the calculation of trading stock versus capital assets. Trading stock assets require a dual deduction/income calculation on an annual basis; whereas, capital assets require only a net calculation upon disposal.

Hence, if a person disposes of trading stock assets for consideration that cannot be quantified in whole or in part, that transferor will again be viewed as accruing only the portion of consideration that can be quantified during the initial year of disposal (proposed section 24M(1)). Unquantified consideration only accrues in later years as amounts become quantifiable (i.e., are fixed). In mechanical terms, the transferor determines trading stock income during the initial year of disposal under normal rules, except the proceeds for the initial year are taken into account only to the extent those amounts can be fully quantified. This calculation triggers initial ordinary income. Initial deductions for that trading stock are then limited to the initial ordinary income. Excess deductions are disregarded (i.e., suspended) during that year (proposed section 23F(2)).

The transferor must then account for further consideration in later years as that consideration becomes quantified. This further consideration generates full ordinary income during each year of instalment. However, the transferor reduces this ordinary income to the extent of any remaining disregarded deductions stemming from the initial year of transfer (proposed section 23F(2A)). If any disregarded deductions still

exist once no further proceeds will accrue, these remaining deductions can be fully accounted for at that time (proposed section 23F(2B)).

2. Taxation of the transferee – accrued unquantified amounts

If a transferee acquires assets for consideration that wholly or partly includes unquantified amounts, that transferee's expenditure incurred is accumulated over time (proposed section 24M(2)); whereas, future quantified amounts will be viewed as immediately incurred. Further expenditure is added to the transferred asset as further amounts become quantified.

3. Transferor and transferee (unaccrued) contingent payments

As stated above, the proposal puts the treatment of unaccrued contingent proceeds on par with the other new rules proposed. As previously discussed, these situations similarly arise if the total price (i.e., proceeds) are contingent based on one or more events, thereby preventing accrual as a matter of common law (without reference to section 24M).

Example

Facts: Individual A acquired commercial property for resale in December 2003. In March 2004, Individual A sells all the commercial property to Individual B, the latter of which will lease the property for profit (i.e., hold the property as a capital asset). In terms of the contract, Individual B must pay 10 percent of the profits generated by the commercial property to Individual A for 5 years subsequent. Assume the amounts received are eventually R300 000, R200 000, R150 000, R110 000 and R240 000, starting in 2005. Individual A's expenditure in terms of the commercial property is R500 000.

Result: The special rules of proposed section 24M apply because unquantified payments are involved. Under the open transaction method, the initial 2005 year will trigger a R300 000 of ordinary income and a R500 000 deduction for Individual A. However, the initial deduction will be limited to R300 000 with the R200 000 suspended until ordinary income is received in later years (proposed section 23F(2)). Subsequent years will trigger ordinary income that will first be used against the suspended loss (proposed section 23F(2A)). The net cumulative will amount to R500 000 of ordinary income (R1 million ordinary income less the R500 000 expenditure).

Individual B's base cost in the commercial property acquired is accumulated over the 5 years as and when Individual B pays Individual A. Hence, Individual B will have a R300 000 base cost in the first year, R500 000 in the second year, etc…).

Year	**2005**	**2006**	**2007**	**2008**	**2009**
Current receipts	R300 000	R200 000	R150 000	R110 000	R240 000
Expenditure	R500 000				
Income	R300 000	R200 000	R150 000	R110 000	R240 000
Deduction	(R500 000)				

Suspended deduction	(R200 000)				
Taxable gain	R0	R0	R150 000	R110 000	R 240 000

RELIEF FOR INTEREST-BEARING INVESTMENTS HELD BY NAMIBIAN, SWAZILAND AND LESOTHO INVESTORS

Present Law

Foreign residents are generally not taxed on South African interest-bearing investments (with certain exceptions for foreign residents conducting business in South Africa or who are physically present in South Africa for extended periods). This interest exemption does not apply to foreign residents from countries within the Common Monetary Area (CMA), i.e., Namibia, Lesotho and Swaziland.

Reasons for change

This exclusion in respect of CMA residents was introduced in order to protect the tax base before the introduction of the worldwide tax system in 2001. During this period, the only protection against tax avoidance shifts offshore were Exchange Controls, but Exchange Controls do not apply to CMA countries. Hence, it was necessary to exclude CMA residents from the interest exemption in order to close this potential tax avoidance opportunity. With South Africa's introduction of a worldwide tax system, the current exclusion in respect of CMA residents is obsolete because straightforward investments routed through CMA countries are fully within the South African tax net.

Proposal

General rule

It is proposed that the exclusion in respect of CMA residents be removed. In addition, the dual provisions exempting interest received or accrued by foreign residents will be streamlined. Generally, all foreign residents will now be exempt from tax on South African interest bearing investments. The purpose of this exemption is to attract portfolio capital. However, this general rule is subject to two exceptions:

- *South African Physical Presence:* Proposed subparagraph (i) provides that foreign individuals will not qualify for exemption if they are present in South Africa for more than six months in a year of assessment. These individuals will most likely open a South African bank account for day-to-day convenience. They do not require a further incentive in order to invest in South African bank accounts.

- *South African Permanent Establishment Presence:* Proposed subparagraph (ii) provides that a foreign person will not qualify for exemption if that person carries on a business through a permanent establishment in South Africa. When a foreign person carries on business in South Africa through a

permanent establishment, that person again utilizes a South African bank as a matter of convenience with no further incentive required. Proposed subparagraph (ii) is a *per se* exclusion of foreign persons carrying on business through a permanent establishment in South Africa, even if the interest bears no relationship to the permanent establishment. Where the foreign person is resident in a country with which South Africa has concluded a Double Taxation Agreement, the agreement will typically permit the taxability of the interest up to a fixed percentage of gross interest received or to interest connected to the permanent establishment. In the second case an exchange of information provision is available to monitor any claim that interest is exempt as it is connected to a permanent establishment.

Proposed subparagraph (ii) focuses on a permanent establishment in South Africa rather than a simple business. A simple business threshold was rejected as too low. The use of a permanent establishment threshold ensures that a solid nexus exists for taxing income in South Africa. In addition, the concept of a permanent establishment is well defined internationally.

Distributions made by collective investment schemes

The proposed amendment mainly preserves current law to the extent a foreign person receives a distribution from a collective investment scheme that represents income (mostly interest). If a collective investment scheme makes a distribution to a foreign person out of profits derived from income, the dividend will be deemed to be interest, thereby mainly being exempt from tax under the general rule.

Example

Facts: A South African collective investment scheme has over a thousand domestic and foreign investors. The scheme is highly invested in bonds. The bonds pay interest to the collective investment scheme. The profits derived from the interest received by a collective investment scheme is distributed to the investors.

Result: In view of the fact that the payments are made out of profits that represent interest, these amounts will be deemed to be interest for purposes of the interest exemption. The distribution will accordingly be exempt from tax in the hands of the foreign investor if the other conditions of this exemption are satisfied.

Effective date

The proposed amendment will generally come into operation during any year of assessment ending on or after 1 January 2005. However, with regard to exempt pension funds, provident funds or retirement annuity funds (hereinafter referred to as retirement funds), the proposed legislation will apply retroactively from 1 January 2001. The retroactive date is linked to the date in which former section 10(1)*(d*A*)* was repealed. Former section 10(1)*(d*A*)* exempted all retirement funds that were managed and controlled in Namibia.

PUBLIC PRIVATE PARTNERSHIPS

Present law

In 2003, certain Government grants to Public Private Partnerships (PPPs) became eligible for tax relief. This tax relief ensured that these grants could be fully used for infrastructure development without any circular reduction back to the fiscus.

Reasons for change

The 2003 changes failed to account for certain tax anomalies created by Roman-Dutch property law. A lessee who builds or constructs improvements on the land of a lessor is faced with a situation that results in ownership of that building or construction affixing to the land. This affixing of ownership means that the lessee no longer owns the buildings/improvements once built, thereby preventing any depreciation deductions. The lessee may be able to deduct the buildings/improvement over the life of the lease, but this deduction applies only if the lessor is a taxable entity (in order to ensure that rental deductions are fully matched by rental inclusions). This latter requirement is problematic for PPPs because PPPs lease from the State, the latter of which is exempt. Hence, PPPs entering into this form of arrangement may find themselves without any deductions for the costs of building/improvement.

Proposal

1. *Deducting building/improvements on leased land over the useful life of the lease*

   Under the proposal, PPPs may deduct buildings/improvements over the useful life of a State lease, despite the fact that the State is exempt from tax (proposed section 11(g)(vi)). Little concern exists that these PPPs will misuse the mismatch (i.e., the existence of deductions without corresponding inclusions) as an opportunity for artificial arbitrage. PPPs are subject to direct control by the National Treasury, the latter of which would oppose the use of a tax mismatch that artificially undermines the tax base.

   The proposed rules also clarify that a lessee may fully write-off any remaining costs of buildings and improvements on leased property if those costs have not been fully taken into account by the lease termination date (and would have otherwise been deductible had the lease continued) (proposed section 11(g)(vi)). This final write-off adjustment will apply to all lessees, not just PPPs. As a theoretical matter, a lessee constructing buildings/improvements should be eligible to write-off costs associated with these items eventually surrendered to the lessor.

Example 1

Facts: PPP constructs a hospital on State land with R10 million of its own funds. The hospital affixes to the State land by virtue of Roman-Dutch law. The PPP arrangement is intended to last 20 years, but the arrangement unexpectedly terminates after 15 years.

Result: The PPP may depreciate R500 000 of the hospital costs for each of the first 15 years (5 per cent of R10 million) by virtue of section 11(g). The remaining R2,5 million can be written off as ordinary loss when the PPP arrangement terminates.

Example 2

Facts: The facts are the same as **Example 1**, except a private company falling wholly outside the PPP regime is involved.

Result: The private company may not write-off the costs over the life of the arrangement because the lessor (i.e., the State) is exempt (section 11(g)). The private company also cannot write-off any of the loss under section 11(g) when the arrangement terminates because the section 11(g) write-off was not available during the life of the lease.

2. *Refining exempt grants*

As stated above, Government grants to PPPs for infrastructure are exempt from tax to prevent inefficient circular cash-flows. These circular cash-flows are especially problematic when the grant will be used for buildings/improvements that eventually revert to Government. The PPPs in this instance are essentially acting as trustees of Government property. Under current law, the exemption is solely limited to South African physical infrastructure. The case for expanding the exemption to all forms of buildings/improvements affixed on State land can easily be made given the Roman-Dutch law reversion to the State (thereby making the PPP only a temporary owner). The proposed law accordingly drops the physical infrastructure limitation and treats all grants as exempt if used for buildings/improvements affixing to State land.

ELIMINATING TAX PREFERENCES FOR THE JSE SECURITIES AND BOND EXCHANGES

Present Law

The JSE Securities Exchange and the Bond Exchange of South Africa are currently formed in terms of the Stock Exchange Control Act of 1985 (to be replaced by the Securities Services Act, 2004). In terms of section 10(1)*(d)*(iii) of the Income Tax Act, both exchanges are currently tax exempt as non-proprietary exchanges. These exemptions require Commissioner approval, subject to regulatory conditions as the Minister of Finance may prescribe.

Reasons for Change

Preferential tax treatment for entities is generally granted only for non-profit organizations (such as public benefit organizations), meaning that the entity cannot distribute profits to its members. Indeed, the current exemption similarly requires non-proprietary status. However, the impact of this "non-proprietary" status under current and proposed law has little economic effect. Section 11A(2) of the Stock Exchanges Control Act and section 17 of the newly proposed Securities Services Bill allows exchanges to distribute surplus assets to its members. The distribution can be made after making provision for any liabilities as long as the distribution occurs with approval of its members in terms of the constitution and with the written consent of the Registrar. Both the Stock Exchanges Control Act and the proposed Securities Services Bill specifically state that these distributions will not have any affect on the non-proprietary status of an exchange.

In addition, the current tax exemption creates unfair competition amongst exchanges, which is directly contrary to the principles of the Securities Services Bill. The tax exemption effectively limits access to new taxable entrants that seek to create rival overall or niche exchanges. No reason exists to provide current exchanges with this unfair competitive advantage.

Lastly, exemptions for exchanges of this kind are becoming increasingly disfavoured internationally. A growing number of international exchanges are moving away from traditional non-proprietary membership to taxable "for profit" status. Hence, the retention of the current South African exemption is increasingly difficult to justify in terms of international competitiveness since the international tax environment is pulling in the opposite direction.

Proposed Changes

The proposed legislation deletes the current exemption for non-proprietary exchanges contained in section 10(1)*(d)*(iii) of the Income Tax Act. The net result is that both the JSE Securities Exchange and the Bond Exchange of South Africa will become taxable entities for on a date to be fixed by the President by proclamation in the Gazette. This date was left open to ensure that proper time was given to allow for a tax-free conversion to proprietary status.

STAMP DUTY INTEREST, PENALTIES AND ADDITIONAL DUTY

Stamp duties are at this stage levied only on fixed property leases, instalment sale agreements, debit entries and the issue and transfer of ownership of marketable securities (other than interest bearing securities).

To bring the Stamp Duties Act more into line with other Acts administered by the Commissioner, it is proposed to introduce interest and penalty provisions for failure to pay duty within the prescribed period as provided in section 8 of the Act, and to introduce additional duty provisions in cases of evasion. The headings change accordingly. The new duty structure phased out penalty stamps.

The Commissioner will now be in a position to impose interest in terms of section 9 of the Act which approximates the potential interest loss to the State. In cases where a client fails to pay the duty within the prescribed period as provided in section 8 of the Act, a penalty of 10 per cent of the said amount of the duty will be payable in terms of section 9A. This penalty may be waived or reduced by the Commissioner. Section 9B will give the Commissioner the power to impose an additional duty of up to 200% of the duty evaded in cases of evasion. Except in the case of evasion, the interest and penalties provisions are less harsh than the present provisions, which impose fixed penalties of up to triple the duty, even where there was no intention to evade duty.

INDUSTRIAL DEVELOPMENT ZONES

An IDZ is a specific geographical area designated by the Minister of Trade and Industry. IDZ's are meant to attract foreign and local investment to a particular area where economic development is required. Within each IDZ, are other designated areas known as Customs Controlled Areas ("CCA") where approved enterprises and business activities will be carried on. These areas will be identified by Customs in concurrence with the Director General: Trade and Industry and controlled by Customs.

Current Law

Legislation was enacted in the 2003 Revenue Laws Amendment Act to make provision for the introduction of the concept of a CCA in the VAT Act and to align the definitions with those of the Customs and Excise Act, 1964. In addition, the VAT Act was amended to ensure that supplies of goods and services, made by a vendor situated outside a CCA to a vendor situated in a CCA, would be zero rated.

The Customs and Excise Act did not regard the direct importation of goods into a CCA from an export country as being an entry for home consumption. Accordingly, VAT would not be levied on the direct importation of goods into the CCA from an export country. The VAT Act was accordingly amended to include the movement of goods from a CCA into the Republic to be regarded as an importation for VAT purposes so as to align it with the provisions of the Customs and Excise Act.

Reason for change / future application

Section 21A of the Customs and Excise Act is being amended to make provision for the importation of goods from an export country into a CCA to be an entry for home consumption under rebate of duty.

In light of the fact that the entry of goods into a CCA from an export country will be recognised as an importation for Customs and VAT purposes, it is proposed that:

- An exemption be provided for in Schedule 1 to the VAT Act in order to exempt goods imported into the Republic from an export country for use in a CCA from the payment of VAT levied on the importation of goods into the Republic; and
- the subsequent supply of the goods from the CCA to a person in the Republic cannot be regarded as an importation into the Republic but rather as a supply of

goods by a vendor situated in a CCA to a person in the Republic which will be subject to VAT at the standard rate in terms of section 7(1)*(a)*.

The proposed amendments to sections 7(1)*(b)*, 13(1)(ii) and 13(2)*(b)* of the VAT Act are therefore required.

In addition, the provisions of section 11(1)*(c)* and 11(1)*(m)* of the VAT Act were amended to zero rate the supply of goods and services to a vendor situated in a CCA.

Due to the possible abuse of VAT levied on the supply of goods or services which would not qualify for an input tax deduction in terms of the provisions of section 17(2) of the VAT Act, being zero-rated in terms of sections 11(1)*(c)* and 11(1)*(m)* of the VAT Act, the proposed amendments will exclude the zero-rating of motor cars when such motor cars are to be used in a CCA. Furthermore, where the vendor would not have been entitled to an input tax deduction in respect of the acquisition of goods and services which would be used for the purpose of supplying entertainment, the vendor will be required to make a change in use adjustment in terms of the new provisions of section 18(10) of the VAT Act. The effect of the adjustment is to ensure that the standard rate of VAT is effectively levied on goods where the provisions of section 17(2) of the VAT Act are applicable.

VAT TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTHORITIES

Amendments were effected in 2003 to the Value-Added Tax Act, 1991 ("the VAT Act") pertaining to the VAT implications of the payment of government grants to national and provincial government, public entities and private business. It was proposed in the 2004 Budget, to further consider the VAT implications of these payments.

The conclusions reached and reasoning behind the decisions made are as follows—

- *General Principle.* The major portion of the supplies made by national and provincial departments are outside the scope of VAT which means that VAT is not charged on the goods and services supplied by Government to the public. Accordingly, Government is not entitled to claim input tax in respect of the VAT incurred on the acquisition of goods and services. In addition, the proposed VAT amendments use the Schedules to the Public Finance Management Act 1999 ("PFM Act") as the source to determine whether these public entities are conducting an enterprise or not as well as the VAT rate applicable to the payments made to such entities. Certain public entities that are conducting an enterprise, as well as welfare organisations and public private partnerships ("PPP's") making taxable supplies, are defined as "designated entities".

  As discussed below, grants by Government will be zero-rated. "Grant" means any appropriation, grant in aid, subsidy or contribution transferred, granted or paid to a vendor by a public or local authority or Constitutional Institution. It however does not include goods or services supplied to a public or local

authority or Constitutional Institution including where goods or services are acquired in accordance with a procurement process.

- *National and Provincial Departments.* It is proposed that the *status quo* with respect to the VAT treatment of appropriations to national and provincial government departments be retained, namely that they be treated as outside the scope of VAT unless the Minister is satisfied that the department, or an activity within the department, is making supplies which are the same or similar as taxable supplies made by other vendors. In this instance, the specific activity will be regarded as falling within the ambit of "enterprise" and will be registered as a vendor.

- *Constitutional Institutions.* It is proposed that all the Constitutional Institutions listed in Schedule 1 to the PFM Act, such as the Public Protector, the Human Rights Commission, the Commission for Gender Equality, etc be excluded from the definition of "enterprise" as their activities are not commercial or in competition with any other vendors.

- *Major Public Entities.* It is proposed that payments to the major public entities listed in Schedule 2 to the PFM Act, such as ESKOM, Transnet Ltd and Telkom S A Ltd, fall within paragraph *(a)* of the definition of "enterprise" and be subject to VAT at the standard rate. The rationale is that these entities conduct commercial activities.

- *National and Provincial Public Entities.* It is proposed that payments to national public entities and provincial public entities listed in Parts A and C of Schedule 3 to the PFM Act respectively be treated on the same basis as government and provincial departments. The supplies of these entities such as the Competitions Board, Judicial Services Board, Legal Aid Board etc, will generally not be the same or similar to taxable supplies made by other vendors and will therefore fall outside the scope of VAT i.e. not subject to VAT. However if it is determined that these entities are supplying goods or services which are the same or similar to taxable supplies made by other vendors, the Commissioner, in pursuance of a decision by the Minister, will notify such entities that these activities fall within the ambit of "enterprise" and a "designated entity". Such activities may result in the re-classification of the entity or part thereof, within the Schedules to the PFM Act. The supplies made by those entities or part thereof, will therefore be subject to VAT.

- *National and Provincial Business Enterprises.* It is proposed that payments to the national government business enterprises and the provincial government business enterprises listed in Parts B and D of Schedule 3 to the PFM Act be subject to VAT at the standard rate. These businesses will fall within paragraph *(a)* of the definition of "enterprise" and "designated entities".

- *Local Authorities.* Supplies by local authorities of goods and services listed in paragraph *(c)* of the definition of "enterprise" such as electricity, water, gas, removal of sewage, drainage and certain businesses designated by the Minister are subject to VAT. Local authorities cannot claim input tax on any VAT paid on goods and services acquired that are directly attributable to its non-enterprise activities. It is proposed that payments received by local authorities from national and provincial departments and other local authorities be zero rated.

- *Private business.* It is proposed that "grants" (other than payments relating to

the supply of goods and services i.e. consideration) by national and provincial departments and local authorities to private business (other than welfare organisations) be zero rated.

- *Welfare Organisations.* It is proposed that "grants" to "welfare organisations" from national and provincial departments and local authorities continue to be zero-rated where such payment is not in respect of the supply of goods or services. These organisations will continue to have the advantage of being able to claim input credits on the tax paid on their purchases.

- *Public Private Partnerships.* It is proposed that payments to PPP's, as defined in Regulation 16 of Treasury Regulations issued in terms of section 76 of the PFM Act, be subject to VAT at the standard rate. However, if the PPP makes exempt supplies as contemplated in section 12 of the VAT Act, the payment will fall outside the scope of VAT to the extent of the exempt activities. VAT incurred in respect of the exempt activities, will not qualify as input tax.

- *Deregistration of Vendors:* The proposals above will result in a number of enterprises of Government and public entities being deregistered. In terms of section 8(2) of the VAT Act, these entities would be required to account for output tax on the lower of the cost on acquisition or the open market value of their assets on the date of deregistration. However, as this will merely result in a circular flow of funds within the Government sphere, it is proposed that the operation of section 8(2) be suspended in these circumstances. It is also proposed that after the introduction of this amendment in the Revenue Laws Amendment Act, 2004, any re-classification of a vendor or part of a vendor's activities within the Schedules to the PFM Act will also enjoy the same dispensation. However, this dispensation will not be allowed to vendors, who are Constitutional Institutions listed in Schedule 1 to the PFM Act or public authorities, and who applied and were registered as vendors during the period 22 December 2003 and 31 March 2005.

- *Adjustments:* It is proposed that where a public entity is re-classified within the Schedules to the PFM Act, which will result in the entity falling within the ambit of "enterprise", such entity, on registration for VAT purposes, will be precluded from claiming a section 18(4) adjustment i.e the entity will not be entitled to claim input tax on goods held on the date of re-classification.

The changes proposed above are on Government's revenue side and corresponding changes will have to be made on the expenditure side to adjust the amount of the transfer payments to ensure that there is little, if any, change to the net position of the different government bodies and the total tax collections of the Government.

Amendments to give effect to the proposals are set out in the different clauses and where necessary a technical explanation is provided. It should be noted that it is proposed the term "transfer payment" be replaced with the term "grant" and it is proposed that the amendments only come into operation on a date fixed by the President by proclamation in the *Gazette*. The reason for not implementing the amendments immediately is that the introduction of the amendments must be coordinated with the Government budget cycle so that the necessary adjustments can be made on the expenditure side of the budget.

CLAUSE 1

Transfer Duty: Amendment of section 4 of the Transfer Duty Act, 1949

Subclauses (a), (b), (c) and (d): This amendment serves to clarify that transactions entered into prior to 1 March 2005, will be subject to the penalty provisions of section 4(1). However, after 1 March 2005, the word "penalty" will be referred to as "interest". The method of calculating the interest or penalty, as the case may be, remains the same.

The amendment to subsection (1) makes provision for the levying of penalty in cases where duty was not paid within the period referred to in section 3 dealing with acquisitions of property which were acquired before 1 March 2005.

The insertion of subsection (1A) makes provision for the levying of interest in cases where duty was not paid within the period referred to in section 3 dealing with acquisitions of property which were acquired on or after 1 March 2005.

The amendment to subsection (3) is intended to change the word "penalty" to "interest" so as to align the Transfer Duty Act with other Acts administered by the Commissioner.

CLAUSE 2

Transfer Duty: Amendment of section 9 of the Transfer Duty Act, 1949

Subclause (a): The proposed amendment clarifies the exemption from transfer duty, regarding the acquisition of "property" by a Public Benefit Organisation (PBO). Subsequent to such acquisition, the property is not used wholly or substantially the whole for public benefit activities. The exemption applies if the whole property, or substantially the whole of such property, is to be used for PBO purposes. In terms of the Income Tax Interpretation Note No. 22, issued on 11 March 2004, the meaning ascribed to "substantially the whole" is that 85% or more of the property must be used for public benefit activities. In instances where a public benefit organisation qualified for an exemption on the acquisition of the property, but subsequently uses the property for other purposes which results in the exemption no longer being applicable, transfer duty will become payable from the date the property was first used for such other purpose.

Subclause (b): The proposed amendment is required as the reference is obsolete.

CLAUSE 3

Income Tax: Amendment of section 1 of the Income Tax Act, 1962

Subclause (a): The reference to financial instrument is contained in a number of provisions in the Income Tax Act, 1962, predominantly for purposes of anti-avoidance provisions. The definition of "financial instrument" includes *inter alia* any contractual right or obligation which derives its value from the value of a debt security, equity, commodity, rate index or a specified index. The concern has been raised that the reference to the value derived from a commodity may be too wide and

may include rights or obligations which were not intended to be included. It is therefore proposed that the definition be amended to clarify this.

Subclause (b): This amendment is consequential upon the introduction of the Securities Services Act, 2004.

Subclause (c): See notes on **PUBLIC PRIVATE PARTNERSHIPS**.

CLAUSE 4

Income Tax: Amendment of section 6quat of the Income Tax Act, 1962

Prior to its repeal section 9E, which dealt with the taxation of foreign dividends, made provision for an election that the withholding taxes on foreign dividends could be claimed as a deduction from the foreign dividends in lieu of claiming the withholding taxes as a foreign tax credit against the tax payable on the foreign dividend. Section 9E also provided for the deduction of interest incurred in the production of income from foreign dividends. When section 9E was repealed by the Revenue Laws Amendment Act, 2003, provision was made for the deduction of the withholding taxes and interest in section 11*(r)* and *(bC)* respectively. Section 11, however, contains a trade test which has the effect that these deductions would not be allowed in instances where the taxpayer receiving the foreign dividends does not carry on a trade. This was not the intention and it is proposed that section 11*(r)* and *(bC)* be deleted and be replaced by a substantive provision on foreign dividends in section 11C.

CLAUSE 5

Income Tax: Amendment of section 7 of the Income Tax Act, 1962

Foreign trusts have been a focus of concern for quite some time. South African taxpayers continue to artificially shift assets offshore via foreign trusts, thereby excluding income from the South African tax net. In 2001 and 2002 (as part of the shift to worldwide taxation), Government enacted further anti-avoidance measures to prevent this form of artificial exclusion from, the South African tax net. Section 7(8) is a key anti-avoidance measures in this regard.

Under current law, section 7(8) provides that income of a non-resident will be deemed to be income of a resident if that income is attributable to the non-resident by reason (or in consequence) of a donation, settlement or other disposition by the resident. However, section 7(8) does not apply to income of a controlled foreign company (because that income may be shifted back to a resident by virtue of section 9D) nor to foreign public benefit organisations. This section can potentially apply when a resident makes a donation, settlement or other disposition to a non-resident trust.

Unfortunately, present law may be argued to contain a technical defect that limits section 7(8) to South African sourced (as opposed to foreign sourced) income. This defect arises from the term *"income."* Under section 1, the term *"income"* means the amount remaining of *"gross income"* after deducting amounts exempt from tax. In turn, *"gross income"* means, in the case on a non-resident, the total amount received by or accrued to or in favour of a non-resident from South African actual or deemed sources. Hence, income outside this ambit (i.e., foreign sourced income) of a non-resident (e.g., trust) technically falls outside the anti-avoidance rules of section 7(8).

On the other hand, existing case law provides that income is used in its ordinary, expansive, meaning and not its defined meaning in previously existing subsections of section 7. In order to pre-empt any possible argument, it is proposed that the word "*income*" in section 7(8) be deleted and replaced to account for any amount which would have constituted income had that amount been received or accrued to a resident.

Example 1

Facts: In 2005, South African resident donates R750 000 to a foreign discretionary trust. The trust is owned by a foreign trustee with oversight from a foreign protector. The foreign trustee has the power to vest the trust assets to a wide range of parties, but an attached letter of wishes requests that the funds be ultimately vested back to the South African resident or a connected family member. The foreign trust places the full R750 000 in a foreign bank account, thereby generating R60 000 in 2005.

Result: The R60 000 amount generated by the foreign trust from the foreign bank account is included as income of the South African resident. Section 7(8) applies because this amount would have been income to the South African resident had this amount been received or accrued directly by the South African resident.

Example 2

Facts: The facts are the same as **Example 1**, except that the foreign trust transfers the R810 000 of accumulated funds to a foreign collective investment scheme in 2006. This scheme generates R40 000 of foreign dividends that are paid to the foreign trust.

Result: The full R40 000 is again included as income of the South African resident under section 7(8). It makes no difference that the foreign collective investment scheme assets stem from the foreign bank account because the full amount is initially attributable to the donation made by the South African resident.

CLAUSE 6

Income Tax: Amendment of section 8 of the Income Tax Act, 1962

Section 8(4)*(a)* provides for the inclusion in the income of a taxpayer of amounts allowed to be deducted or set-off, which were recovered or recouped. This section does not refer specifically to amounts deducted in terms of sections 24I and 24J. Although section 11*(x)* does provide a link to those sections, it is proposed that a specific reference to these sections be inserted.

CLAUSE 7

Income Tax: Amendment of section 8A of the Income Tax Act, 1962

See notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS**.

CLAUSE 8

Income Tax: Insertion of sections 8B and 8C in the Income Tax Act, 1962

Regarding the insertion of section 8B, see notes on **TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN**.

Regarding the insertion of section 8C, see notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS.**

CLAUSE 9

Income Tax: Amendment of section 8E of the Income Tax Act, 1962

See notes on **HYBRID FINANCIAL INSTRUMENTS**.

CLAUSE 10

Income Tax: Insertion of section 8F in the Income Tax Act, 1962

See notes on **HYBRID FINANCIAL INSTRUMENTS**.

CLAUSE 11

Income Tax: Amendment of section 9 of the Income Tax Act, 1962

These amendments are consequential upon the promulgation of the Mineral and Petroleum Resources Development Act, 2002 (Act No. 28 of 2002).

CLAUSE 12

Income Tax: Amendment of section 9B of the Income Tax Act, 1962

This amendment is consequential upon the introduction of the Securities Services Act, 2004.

CLAUSE 13

Income Tax: Amendment of section 9D of the Income Tax Act, 1962

This amendment is consequential upon the deletion of section 10(1)*(h*A*)*. See notes on **RELIEF FOR INTEREST-BEARING INVESTMENTS HELD BY NAMIBIAN, SWAZILAND AND LESOTHO INVESTORS**.

CLAUSE 14

Income Tax: Amendment of section 10 of the Income Tax Act, 1962

Subclause (a): See notes on **ELIMINATING TAX PREFERENCES FOR THE JOHANNESBURG STOCK AND BOND EXCHANGES**.

Subclause (b) and (c): See notes on **RELIEF FOR INTEREST-BEARING INVESTMENTS HELD BY NAMIBIAN, SWAZILAND AND LESOTHO INVESTORS**.

Subclause (d): See notes on **TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN**.

Subclause (e) and (f): See notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS**.

Subclause (g) and (h): See notes on **PUBLIC PRIVATE PARTNERSHIPS**.

CLAUSE 15

Income Tax: Amendment of section 10A of the Income Tax Act, 1962

As a result of recent amendments to apply an annual averaging (rather than spot) basis of calculating currency profits and losses, it is proposed that the purchased-annuity formula be updated to use this basis of calculation.

CLAUSE 16

Income Tax: Amendment of section 11 of the Income Tax Act, 1962

Subclause (a): Prior to its repeal, section 9E which dealt with the taxation of foreign dividends made provision for the deduction of interest incurred in the production of income from foreign dividends. Section 9E also provided for an election that the withholding taxes on foreign dividends could be claimed as a deduction from the foreign dividends in lieu of claiming it as a foreign tax credit against the tax payable on the foreign dividend. When section 9E was repealed by the Revenue Laws Amendment Act, 2003, provision was made for the deduction of interest and the withholding taxes in section 11*(b*C*)* and *(r)* respectively. Section 11, however, contains a trade test which has the effect that these deductions would not be allowed in instances where the taxpayer receiving the foreign dividends does not carry on a trade. This was not the intention and it is proposed that section 11*(b*C*)* and *(r)* be deleted and be replaced by a substantive provision on foreign dividends in section 11C.

Subclause (b) and (c): See notes on **PUBLIC PRIVATE PARTNERSHIPS**.

Subclauses (d) and (e): These amendments are of a textual nature.

Subclause (f): See notes on **TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN**.

CLAUSE 17

Income Tax: Amendment of section 11B of the Income Tax Act, 1962

Subclauses (a) and (b): Section 11B of the Income Tax Act, 1962, provides for a deduction of expenditure incurred in respect of research and development and an allowance in respect of any building, machinery, plant, implement, utensil and article used by a taxpayer for purposes of research and development. This allowance is based on the cost of the relevant asset. It is, however, proposed that anti-avoidance provisions similar to those contained in other provisions in the Act relating to depreciation of assets be incorporated in section 11B. Therefore, if that asset is acquired by the taxpayer from a connected person, the allowance must be determined on the lesser of—

- the actual cost to the taxpayer of that asset;
- the market related cost which the taxpayer would have incurred under a cash transaction concluded at arm's length; or
- the actual cost to the connected person of that asset.

Subclause (c): Section 11B allows for the deduction of expenditure incurred in respect of research and development relating to intangible assets, but excludes trade marks. It is proposed that this exclusion be extended to also refer to assets which are similar to trade marks.

CLAUSE 18

Income Tax: Insertion of section 11C in the Income Tax Act, 1962

Prior to its repeal, section 9E which dealt with the taxation of foreign dividends made provision for the deduction of interest incurred in the production of income from foreign dividends. Section 9E also provided for an election that the withholding taxes on foreign dividends could be claimed as a deduction from the foreign dividends in lieu of claiming it as a foreign tax credit against the tax payable on the foreign dividend. When section 9E was repealed by the Revenue Laws Amendment Act, 2003, provision was made for the deduction of interest and the withholding taxes in section 11*(b*C*)* and *(r)* respectively. Section 11, however, contains a trade test which has the effect that these deductions would not be allowed in instances where the taxpayer receiving the foreign dividends does not carry on a trade. This was not the intention and it is proposed that section 11*(b*C*)* and *(r)* be deleted and be replaced by a substantive provision on foreign dividends in section 11C.

CLAUSE 19

Income Tax: Amendment of section 13quat of the Income Tax Act, 1962

The 2003 tax legislation introduced a tax incentive coming in the form of an accelerated depreciation allowance for investments in the inner cities. The core objectives of the incentive are to promote urban renewal and development by promoting private sector investment in the construction and improvement of buildings. Subsection (6) of the legislation sets out various criteria to be satisfied by the 16 municipalities so certain urban development zones can benefit. It has since been decided that some of the criteria should be softened because they are impractical.

Under current law, each municipality has the task of demarcating one area within its municipal boundaries that will be eligible for the incentive. This demarcation is now adjusted as follows:

- The demarcated area must still be a prioritised area in terms of a municipality's integrated development plan in terms of the Local Government: Municipal Systems Act, 32 of 2000. However, municipalities now have the option to promote investments in either business, industrial or residential areas (rather than requiring all three). This change enables smaller municipalities to meet the criterion because areas within smaller municipalities usually contain only one category of activities (proposed section 13*quat*(6)*(c)*).

- Under current law, the demarcated area must contribute (or must have previously contributed) a significant portion of the municipality's total revenue collections. The contributed proportion must be measured in the form of property rates or assessed property values (whichever the municipality prefers). Under the proposal, the municipality can now show the decline in sustained real or nominal terms (i.e., with or without inflationary adjustments) (proposed section 13*quat*(6)*(d)*).

- Under current law, the municipality must commit to the objective of processing planning approvals within 90 days (section 13*quat*(6)*(f)*). Proposed law deletes this requirement because planning and building approval targets already exist in other legislation (and all of these targets are mandatory).

Each municipality must presently provide annual information to the Commissioner and to the Minister of Finance in terms of the list set out in section 13*quat*(9)*(a)* to *(g)*. In terms of revised subsections (9)*(c)* and (9)*(d)*, only estimated costs incurred and estimated jobs created will be required. This change provides municipalities with flexibility. They are no longer required to provide the actual costs incurred or jobs created, which could prove difficult or impossible. In terms of the newly added subsection (9)*(g)*, every municipality is now required to provide information on the average completion times for planning and building approvals. This information substitutes for the deleted subsection (6)*(f)*.

CLAUSE 20

Income Tax: Insertion of section 20B in the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 21

Income Tax: Amendment of section 23F of the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 22

Income Tax: Insertion of section 24B in the Income Tax Act, 1962

Present Law

One way that companies raise financing is through the issue of shares. While companies can issue their own shares free of tax (paragraph 11(1)(*b*) of the Eighth Schedule), companies that issue shares in exchange for capital assets do not generally receive any base cost in the asset acquired. This zero base cost results from the fact the issue of shares does not technically entail any cost "actually incurred". This same zero principle equally applies to the issue of shares for trading stock. The only exception to this zero principle occurs when a company issues shares as part of a company restructuring rollover (i.e., sections 41 through 47).

Another form of financing is debt. While taxpayers can issue their own debt instruments free of tax (paragraph 11(1)(*d*) of the Eighth Schedule), taxpayers that issue their own debt instruments (e.g., notes, bonds, loans and advances) in exchange for capital assets only receive base cost in the assets acquired as payments are made on the debt (paragraph 20(3)(*c*) of the Eighth Schedule). On the other hand, this pay-as-you-go principle does not apply to trading stock. Taxpayers that issue their own debt instruments for trading stock assets receive a full cost price in the assets acquired during the initial year that the debt instrument is issued (section 11*(a)* of the Income Tax Act).

Reasons for Change

The zero principle for assets acquired in exchange for shares creates a significant hindrance to company formations and other forms of share financing. This zero principle also stands in contrast to widespread international practice, despite support for the principle found in case law. This zero principle is especially problematic if the party transferring assets to the company issuing shares is taxed on the transfer.

The pay-as-you-go principle for capital assets acquired in exchange for the issue of debt instruments creates a significant hindrance to self-debt financing. This pay-as-you-go principle disadvantages self-debt financing vis-à-vis third party (e.g., bank) financing, the latter of which allows for a full base cost in the asset acquired. This uneven playing field for self-debt financing makes certain transactions more difficult

in tax terms when third party financing is unavailable. Lastly, the pay-as-you-go principle for capital assets is inconsistent with the longstanding rules for trading stock.

Proposal

1. General Rules

Shares for Assets

Under the law as modified, a company that issues shares for an asset will now be deemed to have actually incurred amounts to acquire that asset equal to that asset's market value at the time of acquisition (proposed section 24B(1)*(a)*). This market value principle will apply equally to both capital assets and trading stock. The transferor of the asset will similarly be deemed to have disposed of that asset for the shares at market value (proposed section 24B(1)*(b)*). One pre-existing exception to this rule are the company formation rules of section 42 and the share-for-share rules of section 43 (proposed section 24B(4)).

Example 1

Facts: Individual transfers real estate to a newly formed company in exchange for all of that company's shares. The real estate has a R100 000 market value and a R20 000 base cost at the time of the transfer. The real estate is a capital asset in the hands of both Individual and the company.

Result. Individual has R80 000 of capital gain on the real estate as a result of the transfer (the R100 000 market value less the R20 000 base cost of the real estate transferred). The company does not have any taxable gain or loss upon the share issue (paragraph 11(2)(*b*) of the Eighth Schedule), and the company has a R100 000 base cost in the real estate acquired.

Example 2

Facts: The facts are the same as **Example 1**, except that Individual and the company elect the rollover relief of section 42.

Result.: Individual has no capital gain on the real estate transfer (section 42(2)*(a)* of the Income Tax Act), and the company similarly does not have any gain on the share issue (paragraph 11(2)(*c*) of the Eighth Schedule). Individual has a R20 000 base cost in the company shares received (section 42(2)(*a*) of the Income Tax Act), and Company similarly has a R20 000 base cost in the real estate transferred (section 42(2)(*b*) of the Income Tax Act).

Debt for Assets

Under the law as modified, a taxpayer that issues a debt instrument for a capital asset will now fall under the general rule (i.e., paragraph 20(1)(*a*) of the Eighth Schedule as opposed to repealed paragraph 20(3)*(c)*). The net result is that the

debtor will obtain a base cost equal to the expenditure incurred. The rules for trading stock acquired with debt will generally remain the same as before.

2. Exceptions

Shares issued for shares or debt

Shares issued in exchange for the direct cross-issue of shares create special problems. Unlike the standard issue of shares for property, the dual cross-issue of shares is wholly tax-free to both parties in the transaction. This dual tax-free nature of the transaction creates an easy opportunity for artificially inflating the value of both sets of shares issued.

The proposed rules retain the zero principle for the cross-issue of shares and extend the principle to the indirect cross-issue of shares (proposed section 24B(2)) as well as to connected person situations. Similar zero treatment applies when shares are issued in exchange for debt instruments to that company. Shares-for-debt issues create the same potential for avoidance as share-for-share issues because both issues are tax-free, thereby providing an easy opportunity for artificially inflating values.

Example 1

Facts: Parent Company owns all the shares of Sub 1 and Sub 2. Sub 1 issues shares in exchange for the issue by Sub 2 of Sub 2 shares.

Result: Sub 1 and Sub 2 are involved in a direct cross-issue of shares. Sub 1 receives a zero base cost in the Sub 2 shares received, and Sub 2 similarly receives a zero base cost in the Sub 1 shares.

Example 2

Facts: Parent Company owns all the shares of Sub 1 and Sub 2. Sub 1 issues shares to Sub 2 in exchange for cash, and Sub 2 issues shares to Sub 1 in exchange for cash of the same amount.

Result: Sub 1 and Sub 2 are involved in an indirect cross-issue of shares. Sub 1 receives a zero base cost in the Sub 2 shares received, and Sub 2 similarly receives a zero base cost in the Sub 1 shares.

Example 3

Facts: Parent Company owns all the shares of Sub 1 and Sub 2. Sub 1 issues shares to Parent Company in exchange for cash, and Sub 2 issues shares to Parent Company in exchange for Sub 1 shares recently acquired by Parent Company.

Result: Sub 1 and Sub 2 are involved in an indirect cross-issue of shares. Sub 1 receives a zero base cost in the Sub 2 shares received, and Sub 2 similarly receives a zero base cost in the Sub 1 shares.

Example 4

Facts: Parent Company owns all the shares of Sub. Parent issues a promissory note to Sub in exchange for additional Sub shares.

Result: Parent Company are involved in a share-for-debt cross issue. Sub receives a zero base cost in the promissory note acquired in exchange for the issue of Sub's shares.

Debt issued for shares or debt

Debt instruments issued in exchange for the direct cross-issue of shares or debt create the same problems as the cross issue of shares. This cross issue is again wholly tax-free to both parties in the transaction, thereby creating a similar opportunity for artificially inflating value. The proposed rules retain the pay-as-you-go principle for the cross-issue of debt and debt issued for shares. This pay-as-you-go principle is extended to indirect and connected person transactions reaching the same result (proposed section 24B(3)).

Example 1

Facts: Parent Company owns all the shares of Sub 1 and Sub 2. Sub 1 issues a debt instrument in exchange for a debt instrument issued by Sub 2.

Result: Sub 1 and Sub 2 are involved in a direct cross-issue of debt. Sub 1 receives base cost in the debt instrument issued by Sub 2 as Sub 1 makes payments on the debt instrument issued by Sub 1. Sub 2 similarly receives base cost in the debt instrument issued by Sub 1 as Sub 2 makes payments on the debt instrument issued by Sub 2. However, base cost in the Sub 1 debt instrument is reduced as payment is made on that note, and the base cost in Sub 2 is similarly reduced as payment is made on that debt instrument.

Example 2

Facts: Parent Company owns all the shares of Sub. Parent issues a promissory note to Sub in exchange for additional Sub shares.

Result: Sub is involved in a debt-for-share cross issue. Parent Company receives a base cost in the shares acquired as payments are made on the note.

Example 3

Facts: Company X borrows funds to acquire pre-existing debenture of Company Y that are widely traded on a listed market.

Result: Section 24B(3) does not apply because no direct or indirect cross-issue of debt exists. Company Y never issued the debt directly or indirectly to Company X.

CLAUSE 23

Income Tax: Amendment of section 24I of the Income Tax Act, 1962

Section 24I of the Income Tax Act, 1962, applies in respect of—
- companies;
- trusts carrying on any trade;
- natural persons who hold exchange items as trading stock; and
- natural persons and trusts to whom any amount is owed or who owes an amount in respect of a forward exchange contract or who has a right or contingent obligation to buy or sell an amount in terms of a foreign currency option contract.

The application of this section is not limited to residents and it equally applies in respect of controlled foreign companies. It is, however, not the intention that it applies in respect of exchange items of non-residents which are not attributable to any permanent establishment in the Republic and an amendment is therefore proposed to clarify this.

CLAUSE 24

Income Tax: Amendment of section 24J of the Income Tax Act, 1962

See notes on **HYBRID FINANCIAL INSTRUMENTS**.

CLAUSE 25

Income Tax: Insertion of section 24M in the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 26

Income Tax: Insertion of section 24N in the Income Tax Act, 1962

Present Law

Government continues to appreciate the importance of promoting business restructurings that enhance the competitiveness of the economy. In prior years, Government introduced provisions that allowed for the tax-free rollover of company formations, acquisitions, intra-group transfers, unbundlings and liquidations, all of which are consistent with international best practice. These company regimes are based on the notion that no tax should apply if parties are merely shifting their investments to improve economic efficiency rather than cashing out of altogether.

Parties often sell their business interests in a company for amounts based on that company's future profits/receipts (sometimes referred to as "profit participation" clauses). The total proceeds for these sales may often be fixed with only the timing of payment contingent on profits/receipts. All of these arrangements are frequently used for the sale of small business companies because of the high level of uncertainty of the undertaking involved. These forms of sales, however, trigger

immediate taxation because of the cash-out nature of the transaction. Any gain or loss is based on the full value of the anticipated proceeds to be received currently and in future years.

Reasons for Change

The immediate taxable event caused by the above "profit participation" sales creates cash-flow problems, thereby justifying deferral. The seller is being taxed currently for amounts that will be received at an uncertain future date. Many of these transactions are economically equivalent to sales with contingent proceeds (which will also be subject to deferred taxation under proposed law). The only difference may be the fact that the ultimate amounts are fixed with a right of reversion (i.e., a resolutive condition) should the total yield not be fully realised.

It has also come to Government's attention that certain black economic empowerment transactions are being structured in this fashion. The deferred cash element is often crucial for these restructurings needed for economic growth. Many of these deals are predicated on future cash-flows that will be enhanced by the empowerment process, thereby requiring the need for a "profit participation" feature. Continued immediate taxation of all anticipated future proceeds unduly hinders these arrangements.

Proposed Law

The proposal essentially allows taxpayers to sell a meaningful shareholder stake in company shares without being subject to immediate taxation if substantial payment proceeds are deferred until a later year. The proposal essentially promotes the sale of businesses supported by seller self-financing.

A. General Deferral

The proposal essentially adopts an "open transaction" method for the sale of certain equity shares (as defined in section 41) containing deferred consideration. As with proposed section 24M, this method essentially requires both the seller and the purchaser to account for these instalments as they are received over time.

1. <u>Taxation of the seller</u>

In mechanical terms, the seller determines capital gains/losses during the initial year of disposal under normal capital gain rules, except that amounts due and payable in later years are ignored (proposed section 24N(1)*(a)*(i)). This calculation may trigger an initial capital gain or loss. Initial capital gains generate tax just like any other capital gain. However, initial capital losses are disregarded (i.e., suspended) during that year (proposed paragraph 39A(1) of the Eighth Schedule).

The seller must then account for further consideration in later years as that consideration becomes due and payable (proposed section 24N(1)*(b)*(i)). This further consideration generates full capital gain during each year of instalment (without any base cost offset) (proposed paragraph 3*(b)*(i) of the Eighth Schedule). However, the seller reduces this gain to the extent of any remaining disregarded losses stemming from the initial year of transfer (proposed paragraph 39A(2) of the Eighth Schedule). If any disregarded losses still exist after all instalments become

due and payable, these remaining capital losses can be fully accounted for at that time (proposed paragraph 39A(3) of the Eighth Schedule).

2. Taxation of the purchaser

If a purchaser acquires equity shares for consideration that wholly or partly includes amounts within section 24N, that purchaser's expenditure incurred (base cost) is accumulated over time. More specifically, the purchaser is initially viewed as having incurred expenditures to the extent of the consideration provided on transfer (proposed section 24N(1)*(a)*(ii)). Further expenditure is added to the asset acquired as further amounts become due and payable (proposed section 24N(1)*(b)*(ii)). If the transferee sells an equity share before all amounts are due and payable, the gain on the transfer is calculated without reference to these amounts. However, further amounts paid or incurred by the transferee with respect to the transferred asset will generate capital loss as those amounts are quantified (proposed paragraph 4*(b)*(ii)) of the Eighth Schedule).

B. Conditions for section 24N deferral

In order for section 24N deferral to apply, the sale must satisfy five conditions. These conditions are as follows:

1. Significant deferred and contingent consideration (proposed section 24N(2)(a)): More than 25 per cent of the sales proceeds must be due and payable based on profits after the first year. In other words, the deferred profit participation element must be meaningful (see also section 24(2) for deferred credit agreements).

2. Sale of a meaningful company stake (proposed section 24N(2)*(b)*): One or more sellers must dispose of more than 25 per cent of the total value of the equity shares in the same company during that year, and those sales must fall within section 24N. This rule ensures that the transaction is truly limited to its intended purposes – to assist the sale of a meaningful stake in a company (not to promote deferral for portfolio shares). The "more than 25 per cent" threshold mirrors the percentages found in other company restructuring rules (such as section 41 formations).

3. No connected persons (proposed section 24N(2)*(c)*): The sale must not occur between a seller and purchaser who are connected to each other after the disposal. This limitation prevents section 24N from becoming a home-made system for tax-deferred connected person transfers.

4. Resolutive condition (proposed section 24N(2)*(d)*): The sale must be subject to a performance requirement by the purchaser, which means that the purchaser is obliged to return the equity shares to the seller in the event of failure by the purchaser to pay an amount when due. This resolutive condition means that the contingency "profit participation" element is a core part of the transaction (as opposed to a standard deferred instalment agreement).

5. No cash equivalents (proposed section 24N(2)*(e)*): The claim received by the seller for the equity shares cannot be payable on demand or readily tradable in the open market. In other words, the claim cannot be a cash equivalent (thereby undermining the lack of cash-flow premise for relief).

CLAUSE 27

Income Tax: Amendment of section 25B of the Income Tax Act, 1962

Section 25B of the Income Tax Act, 1962, regulates the taxation of income received by or accrued to a trust and provides for the flow through principle in the case where the income is received by or accrued to or in favour of a vested beneficiary. The question has been raised as to whether income is referred to in its ordinary meaning or as defined in section 1 meaning gross income less exempt income. If it refers to the defined term, section 25B is deprived of much of its force as an anti-avoidance measure in respect of off-shore trusts.

It is proposed that the term "income" be replaced by "amounts" in order to clarify that the more general meaning of income is intended.

CLAUSE 28

Income Tax: Amendment of section 30 of the Income Tax Act, 1962

Subclause (a): This amendment is consequential upon the introduction of the Securities Services Act, 2004.

Subclause (b): The date by which public benefit organisations must reapply for exemption was extended last year to 31 December 2004. Section 30(3B) of the Income Tax Act, 1962, which provides that the Commissioner may grant exemption retroactively if the organisation applies before the deadline, was not amended simultaneously. It is therefore proposed that the date in this subsection also be extended to 31 December 2004.

CLAUSE 29

Income Tax: Repeal of section 31A of the Income Tax Act, 1962

The repeal of section 31A is consequential upon the insertion of section 24B.

CLAUSE 30

Income Tax: Insertion of section 35A in the Income Tax Act, 1962

Present Law

Non-residents are subject to income tax only on their South African source income (actual plus deemed). This tax includes capital gains on the sale of:

(i) the non-resident's immovable property located in South Africa or any interest or right (of whatever nature) in that property; and

(ii) any asset that is attributable to the non-resident's permanent establishment located in South African.

For purposes of these provisions, an interest in immovable property includes shares in a company that mainly consists of immovable property. In order for this treatment to apply, the party at issue must (directly or indirectly) hold at least 20 per cent of the equity share capital of the company. In addition, more than 80 per cent of the net value of that company must be attributable to immovable property (or an interest or right therein).

Reasons for Change

The current system of taxing locally sourced capital gains generated by non-residents is consistent with international best practice and is well-recognised by international income tax treaties. However, this system of source taxation lacks one essential element – proper administrative enforcement through withholding. Many countries that tax capital gains generated by non-residents impose a special withholding regime when the sale involves immovable property. This withholding regime is often critical because the non-resident's connection to the source country is often tenuous, making enforcement impossible once the immovable property is sold. Enforcement is much easier in terms of the purchaser because the purchaser is the party holding the local immovable property upon completion of the transaction.

As a side matter, this form of withholding is not internationally utilised in the case of capital gains generated by non-residents when those gains are associated with a local permanent establishment. No withholding is required in these instances because the non-resident's practical connection to the source country is much more extensive.

Proposal

A. General Rule

1. <u>Withholding Obligation on the buyer</u>

The proposed withholding rules apply to any (resident or non-resident) person that acquires any interest in South African immovable property from a non-resident. More specifically, any person liable for payment to a non-resident (or to any other person for or on behalf that non-resident) in terms of the disposal of immovable property must withhold from the amounts actually paid (proposed section 35A(1)). This withholding amount equals: (i) 5 per cent if the non-resident individual (i.e., natural person), (ii) 7,5 per cent if the non-resident is a company, or (iii) 10 per cent if the non-resident is a trust (proposed section 35A(1)).

The person required to withhold pursuant to these provisions must generally pay the amount withheld to SARS within 14 days after the date the amount was withhold (proposed section 35A(4)*(a)*). This payment to must be made in the form and manner prescribed by SARS (proposed section 35A(6)).

Example 1 *Facts:* Foreign Individual sells a South African residential property to Domestic Individual for a R10 million contract price. The closing date of the sale is 10 June 2006 with the funds flowing at that date. Domestic Individual pays the R10 million by using R800 000 of cash savings and another R9,2 million of bank borrowings.

Result: Domestic Individual must withhold R500 000 of the amount paid to Foreign Individual (i.e., 5 per cent of R10 million). Domestic Individual must pay over this R500 000 to SARS 14 business days later.

Example 2

Facts: Foreign Company sells a South African shopping centre to Domestic Company. The closing date of the sale is 15 September 2006. Under the agreement, Domestic Company must pay R20 million by the closing date, another 20 million on 15 September 2007 and a final R10 million on 15 September 2008. All amounts are paid using bank borrowings.

Result: Even though all the proceeds accrue on 15 September 2006, Domestic Individual must withhold solely based on actual payment. Hence, Domestic Company must withhold R1,5 million on 15 September 2006, R1,5 million on 15 September 2007 and R750 000 on 15 September 2008. Domestic Company must pay over the withheld amounts to SARS 14 days after each withholding date.

Special adjustments are required in two cases. First, if the person acquiring the property is a non-resident, that non-resident will have 28 days (rather than the usual 14) to pay over withheld amounts (proposed section 35A(4)*(b)*). This additional time may be required because the non-resident will often be located overseas. Second, if the amounts withheld are denominated in foreign currency, payment to SARS must be translated on Rands at the spot rate on the date of payment (proposed section 35A(5)).

2. Advance against the seller's income tax liability

Any amounts withheld pursuant these provisions operate as an advance (i.e., a credit) against the non-resident's income tax liability for the year of assessment during which the property is disposed of (proposed section 35A(3)). The withheld amounts can potentially be applied to reduce the total income tax due for the year (or to even claim a refund in terms of section 102). Any withholding under these provisions, however, does not alleviate the non-resident of the general responsibility to submit an income tax return.

B. Exemptions and Directives

1. R2 Million Exemption

The immovable property withholding mechanism does not apply if the total amount payable (e.g., the total contract price) for the immovable property does not exceed R2 million (proposed section 35A(13)*(a)*). This exemption essentially eliminates low- and middle-income buyers who are unlikely to be aware of the immovable property withholding requirements. If the total amount payable exceeds R2 million, the withholding requirements apply in full without regard to the R2 million exemption.

Example 1

Facts: Foreign Individual sells a South African commercial property to Domestic Individual for a R800 000 contract price.

Result: No withholding obligation applies under section 35A because the total amount does not exceed R2 million.

Example 2

Facts: The facts are the same as *Example 1*, except that the contract price amounts to R2,1 million.

Result: The withholding obligation of section 35A applies to the full R2.1 million (i.e., Domestic Individual must withhold R105 000).

2. Deposits

Real estate transactions often involve a deposit to secure the property in advance of the actual contract. These deposits should only trigger a withholding requirement if applied to the purchase price upon acquisition.

The withholding rules accordingly limit this withholding obligation to deposits until agreement for the disposal of the immovable property is reached (proposed section 35A(13)*(b)*). In this instance, the withholding obligation on the deposit is carried over to the first following payment for the disposal.

Example 1

Facts: Foreign Individual enters into a contract for the sale of a South African residential property to Domestic Individual for a R5 million contract price. On 25 June 2006, Domestic Individual must place a R25 000 deposit to secure the property, pending financing approval. The financing is subsequently approved and the remaining R4 975 000 amount is to be paid on the closing date, which is anticipated on12 September 2006.

Result: Domestic Individual has no obligation to pay any withholding for the deposit until the closing date. On that date, Domestic Individual must withhold 5 per cent based on the full R5 million amount (the R25 000 deposit plus the R4 975 000 remainder).

Example 2

Facts: The facts are the same as *Example 1*, except that the deposit is nonrefundable and the transaction is never closed.

Result: No withholding obligation applies because the underlying agreement for disposal never occurs.

3. Directives

The non-resident party disposing of the immovable property may alternatively seek withholding relief through a directive issued by SARS (proposed section 35A(3)).

This relief may come in the form of reduced withholding or no withholding altogether. In order to obtain this relief, one of four conditions must exist:

(a) Adequate security: SARS may issue a directive if the non-resident party disposing of the immovable property provides adequate security. This form of security can be provided through a variety of means including a bank note.

(b) Other assets within South Africa: The South African Service may alternatively issue a directive based on the non-residents other assets within South Africa. The existence of these other assets means that enforcement officials will have recourse to other local assets should the ultimate capital gains tax not be paid.

(c) Person not subject to tax: SARS may issue a directive where the person will not be subject to tax on the disposal due to some other factor, such as the reorganisation rules or as a result of the application of a tax treaty.

(d) Actual liability on disposition: SARS may lastly issue a directive if the ultimate capital gains tax due is less than the standard gross withholding required. For instance,

- o The directive may wholly waive any withholding if the non-resident can demonstrate that the disposition will trigger a capital loss; or

- o The directive may partially waive withholding if the non-resident can demonstrate that the ultimate capital gains tax liability stemming from the gain is less than the withholding amount;

C. Liabilities Stemming from the Withholding Obligation

1. Liability for the person acquiring the property

The person acquiring immovable property is personally liable for the withholding tax due if that person "knows or should reasonably have known" that the transferor is a non-resident (proposed section 35A(7)). One such situation may arise if a purchaser knows that a seller of immovable property lacks a South African identification. In addition, no withholding is required if the purchaser relies on an estate agent or conveyancer subject to these provisions, and these parties fail to provide the purchaser with the required notification. If any withholding is required under these provisions, the due date for this withholding is no later than the required 14/28 days after the payment that triggered the required withholding.

Persons failing to satisfy this withholding obligation are additionally liable for interest on the amounts due starting from the 14/28 day due date (proposed section 35A(8)(a)). These persons will also be subject to a 10 per cent penalty (in addition to any other penalties and charges prescribed by the Income Tax Act) (proposed section 35A(8)*(b)*). However, SARS may wholly waive or reduce the 10 per cent penalty based on the circumstances of the failure (proposed section 35A(8)).

2. Estate agent/conveyancer obligation to notify

Estate agents and conveyancers entitled to compensation with respect to an immovable property transfer are each required to notify the party acquiring the property of the obligation to withhold (proposed section 35A(10)). This notification

must be in writing before payment is made to the seller. The purpose of this liability is to ensure that these professional parties inform the persons acquiring the property of the section 35A withholding obligation. As experts, these professional parties are more likely to be aware of the withholding tax obligation arising from the transfer than the ordinary purchaser.

The above obligation applies only if the estate agent or conveyancer "knows or should reasonably have known" that the party disposing of the property is a non-resident (proposed section 35A(11)). Failure to provide this notification triggers joint and several liability for each estate agent or conveyancer failing to make the required notification. However, this joint and several liability is limited to any commissions/fees generated from the transaction.

3. Recourse to the seller

Any person (e.g., purchaser, estate agent and conveyancer) subject to any personal liability as a result of a failure to withhold has a right of recovery of any amounts paid to SARS against the non-resident disposing of the immovable property (proposed section 35A(12)). This right of recovery exists only for the required withholding, not for any interest or penalties.

D. Commencement Date

Proposed section 35A will come into operation only on a date set by Presidential proclamation in the government *Gazette*. Flexibility was required for this withholding to come into effect so SARS has sufficient time to accept withholding amounts and to establish the procedure for issuing directives. The professional communities affected will also need time to fully inform members and to fully prepare compliance procedures.

CLAUSE 31

Income Tax: Amendment of section 36 of the Income Tax Act, 1962

These amendments are consequential upon the promulgation of the Mineral and Petroleum Resources Development Act, 2002 (Act No. 28 of 2002).

CLAUSE 32

Income Tax: Amendment of section 41 of the Income Tax Act, 1962

Subclause (a): This amendment ensures that trade debt of a foreign controlled group company may be taken into account for purposes of determining whether a company is a domestic financial instrument holding company.

Subclause (b): This amendment is consequential upon the introduction of the Securities Services Act, 2004.

Subclause (c): This amendment ensures that trade debt of a foreign company or controlled group company may be taken into account for purposes of determining whether a company is a foreign financial instrument holding company.

Subclause (d): These amendments are consequential upon the repeal of section 31A and the insertion of section 24B.

CLAUSE 33

Income Tax: Amendment of section 42 of the Income Tax Act, 1962

This amendment is consequential upon the introduction of the Securities Services Act, 2004.

CLAUSE 34

Income Tax: Amendment of section 43 of the Income Tax Act, 1962

This amendment is of a textual nature.

CLAUSE 35

Income Tax: Amendment of section 45 of the Income Tax Act, 1962

Subclause (a): Intra-group transactions: degrouping

Present Law

Gains or losses are not recognized upon the disposal of an asset by a transferor company to a transferee company in terms of an intra-group transaction where those companies jointly elect that section 45 be applied in respect of that disposal. Any gain or loss is in effect rolled over from the transferor company to the transferee company. However, those rolled-over gains or losses are in effect triggered before the disposal of that asset by the transferee company where that transferor company and that transferee company at any time cease to be members of the same group of companies in relation to each other. The transferee company is then deemed to have disposed of and reacquired that asset for an amount equal to its market value as at the date on which the intra-group transaction was effected.

Reasons for Change

A group of companies can dispose of an asset from one member to another in terms of an intra-group transaction without triggering any gain or loss in respect of that disposal. However, the rolled over gain or loss may subsequently be rolled over again in a group of companies consisting of more than two members. The asset can for example be disposed of within the group in terms of another intra-group transaction or in terms of a transaction to which another provision of Part III applies. The gain or loss rolled over from the transferor company to the transferee company in terms of the later disposal will include any gain or loss rolled over as a result of the first intra-group transaction within that group of companies. Any gain or loss so rolled over to a transferee company still holding the asset will in terms of the current wording of subsection (4) be triggered only where that transferee company and its transferor company cease to be members of the same group of companies in relation to each other. The rolled over gain or loss will therefore not be triggered where a

transferee company that has not yet disposed of the asset and the transferor company from which it acquired that asset leave the larger group of companies of which they formed part while remaining members of the same group of companies in relation to each other. This further deferral does not accord with the underlying rationale for intra-group relief, namely that companies within a group operate as parts of a single economic unit. A gain or loss from an intra-group disposal of an asset by a transferor company to a transferee company should therefore be deferred only while that asset is held by that transferee company or by another company forming part of any group of companies in relation to the transferor company that effected the initial intra-group disposal.

Proposal

It is proposed that the de-grouping provisions of subsection (4) be applied where a transferee company holding an asset acquired—

(i) as a result of a disposal by a transferor company by means of an intra-group transaction; or

(ii) as a result of that intra-group transaction as well as one or more disposals subsequent to that intra-group transaction, all of which resulted in a deferred gain or loss as a result of the application of Part III,

ceases to form part of any group of companies in relation to the transferor company that effected the initial intra-group transaction. The transferee company will then be deemed to have disposed of that asset to and to have immediately reacquired it from a connected person on the day immediately before the date on which that transferee company ceased to form part of that group of companies. This deemed sale and repurchase occurs at market value for trading stock, recoupment or capital gains tax purposes. However, for purposes of future depreciation, the allowances will be limited to the lower of cost or market value. This latter limitation is found in other connected person transfers.

Example 1

Facts: Parent Company owns all the shares of Sub 1 and Sub 2. Sub 2 owns all the shares of Sub 3. Sub 1 owns land with a value of R1 million and a base cost of R200 000. In 2005, Sub 1 transfers the land to Sub 2 in exchange for a R1,3 million note, and Sub 2 immediately retransfers the land to Sub 3 in exchange for another R1,3 million note. Both intragroup transfers are made pursuant to the rollover election provisions of section 45. In 2006, Parent Company unbundles all the shares of Sub 2 (along with its holdings in Sub 3) pro rata among the various Parent Company shareholders. The land has a value of R1,5 million at the time of the unbundling.

Result: The unbundling triggers a deemed sale and repurchase pursuant to the degrouping charge of section 45(4). Sub 3 is deemed to sell the land for the full R1,5 million value, thereby resulting in R1,3 million of capital gain for Sub 3. Sub 3 has a R1,5 million base cost in the land upon completion of the deemed sale and repurchase.

Example 2

Facts: The facts are the same as **Example 1**, except that the transfer involves depreciable office equipment. Sub 1 acquired the office equipment for R1 million and claimed a capital allowance of R100 000 for that equipment, leaving a R900 000

base cost at the time of the transfer to Sub 2. Sub 3 claimed a further R100 000 capital allowance before the unbundling, leaving a R800 000 base cost at the time of the unbundling. The office equipment has a value of R1,5 million at the time of the unbundling.

Result: The unbundling triggers a deemed sale and repurchase pursuant to the degrouping charge of section 45(4). Sub 3 is deemed to sell the land for the full R1,5 million value. This deemed sale results in R200 000 of ordinary revenue due to the recoupment and R500 000 of capital gain for Sub 3. For capital gains tax purposes, Sub 3 has a R1,5 million base cost in the land upon completion of the deemed sale and repurchase. However, Sub 3 can only claim up to R800 000 of further capital allowances with respect to that equipment.

Subclause (b): This amendment is consequential upon the introduction of the Securities Services Act, 2004.

CLAUSE 36

Income Tax: Amendment of section 46 of the Income Tax Act, 1962

Subclause (a): **Unbundling transactions: valuation date value of previously held shares**

Present Law

In a tax-free unbundling, the shareholders of the unbundling company start with one set of shares (their shares in the unbundling company) and end with two sets of shares (both the previously held shares, that is the shares previously held in the unbundling company, as well as the newly acquired unbundled subsidiary shares previously held by that unbundling company).

The unbundling rules require that the tax cost of the previously held shares be allocated between those previously held shares and the newly acquired shares. A shareholder who held the previously held shares as capital assets is therefore, as a point of departure, deemed to have acquired both those previously held shares and the newly acquired shares at a cost equal to either the expenditure in respect of those previously held shares allowable in terms of paragraph 20 of the Eighth Schedule, or their market value as at 1 October 2001 as determined by that shareholder in terms of paragraph 29(4) of the Eighth Schedule.

Reasons for Change

The current formulation of paragraph *(a)* of subsection (3) of section 46 allows the market value as at 1 October 2001 of previously held shares that constitute pre-valuation date assets to be used as the combined cost of acquisition of those shares and the newly acquired shares. This in effect means, so is it argued, that this amount can also be used for purposes of determining the time-apportionment base cost of both sets of shares in terms of paragraph 30 of the Eighth Schedule. An amount equal to the market value as at 1 October 2001 of the previously held shares can, in other words, be used as the expenditure allowable in terms of paragraph 20 that is

attributable to the period before 1 October 2001 when determining such time-apportionment base cost as at 1 October 2001, thereby inflating the TAB value of those shares. This result clearly conflicts with the legislative intent underlying both subsection (3) of section 46 and paragraph 30.

Proposal

The new wording proposed in respect of paragraph *(a)* of subsection (3) makes it clear that the cost of acquisition of previously held shares constituting pre-valuation date assets and of newly acquired shares will be equal to the valuation date value of those previously held shares, as contemplated in paragraph 25. The normal rules, for example those regarding the kink tests, expenditure incurred before and after the valuation date and the determination and use of an asset's time-apportionment base cost, must therefore be applied when determining the valuation date value of those previously held shares that is to be apportioned between the two sets of shares.

Subclause (b): It is proposed that the legislation be amended in order to pre-empt any possible argument that the exclusion of certain disposals to a non-resident in terms of an unbundling arrangement is discriminatory for reasons similar to those discussed under subclause (*d*) of the amendments to section 64B to the Income Tax Act, 1962.

CLAUSE 37

Income Tax: Amendment of section 47 of the Income Tax Act, 1962

It is proposed that the legislation be amended in order to pre-empt any possible argument that the requirement that the recipient of certain liquidation distributions is a resident is discriminatory for reasons similar to those discussed under subclause (*d*) of the amendments to section 64B to the Income Tax Act, 1962.

CLAUSE 38

Donations Tax: Amendment of section 56 of the Income Tax Act, 1962

The proposed amendment narrows the scope of the current provision by limiting this specific donations tax exemption to situations only where the group companies are residents of South Africa.

CLAUSE 39

Donations Tax: Amendment of section 58 of the Income Tax Act, 1962

See notes on **TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN**.

CLAUSE 40

Income Tax: Amendment of section 64B of the Income Tax Act, 1962

Subclause (a): This amendment is of a textual nature and is consequential upon the insertion of subsection (3A).

Subclause (b): This subclause begins by capturing the exclusions previously contained in subsection 64B(3) in terms of real property collective investment schemes, liquidations and intra-group dividends. Dividends of this kind do not give rise to STC credits because the initial dividends are wholly exempt from payment of the STC.

This subclause further ensures that dividends paid by portfolio collective investment schemes in securities do not give rise to STC credits to the extent those dividends generate taxable income (e.g., represent a distribution of interest) for the holder. This result is consistent with the general flow-through principle of the tax regime for collective investment schemes.

Lastly, this subclause clarifies the rules for loop structures (i.e., South African amounts paid to foreign intermediary companies, followed by foreign dividends to a South African company). Under current law, foreign dividends generate STC credits if the parties can trace those dividends to underlying South African profits – either from South African income directly generated by the foreign company, or from South African dividends previously subject to the STC. In terms of direct South African income, the law has been revised to ensure that the underlying South African profits were fully subject to taxes comparable to South African dividends. Hence, the underlying South African profits must be subject to tax at the 35 per cent branch rate (or the 46 per cent optional rate for gold mining companies) without reduction by double tax treaty. In terms of South African dividends, the direct tracing regime continues as before, except that the parties can rely on deemed tracing rules in certain instances.

In order for the deemed tracing rules to apply, the South African company receiving the foreign dividends (i.e., the resident company) must satisfy two requirements. First, the resident company must indirectly hold at least 10 per cent of the equity share capital of the lower-tier South African company. This indirect interest can be held through one or more intermediary foreign companies. Second, no other resident company may hold an equal or greater interest in the lower-tier South African company. For purposes of this latter test, indirect interests held through the resident company are ignored. If these deemed tracing rules apply, the foreign dividends received by the resident company generate STC credits to the extent that the lower-tier South African company distributes dividends to a foreign intermediate company (and those dividends have not already been taken into account under these provisions). These deemed tracing rules last as long as the resident company holds at least the same equity interest in the lower-tier South African company.

Example

Facts: South African Holding Company owns all the shares of South African Parent. Parent owns all the shares of Foreign Sub 1, a controlled foreign company under section 9D. Foreign Sub 1 owns 33.33 per cent of Foreign Sub 2, and Foreign Sub 2 owns 33.33 per cent of Foreign Sub 3. The remaining shares of Foreign Sub 2 and Foreign Sub 3 are publicly held by various wholly foreign parties, none of whom own

more than 5 per cent in any of these foreign companies. Foreign Sub 3 owns all the shares of South African Sub.

South African Sub distributes R24 million as dividends to Foreign Sub 3. Foreign Sub 3 generates R48 million profits in addition to the R24 million dividends. Foreign Sub 3 distributes all R72 million profits as dividends to its shareholders with Foreign Sub 2 receiving R24 million as its sole source of profits. Foreign Sub 2 distributes all 24 million in profits as dividends with Foreign Sub 1 receiving R8 million as its sole source of profits. Foreign Sub 1 distributes all R8 million of profits as dividends to South African Parent as its sole source of profits. South African Parent then distributes all R8 million in profits as dividends to its various shareholders.

Result: The tax impact of the dividend chain is as follows assuming no foreign taxes are imposed:

(i) South African Sub is subject to secondary tax on companies (STC) on the full R24 million of profits distributed as dividends. The dividends are not subject to any South African tax in the hands of Foreign Sub 3 (section 10(1)*(k)*(i)).

(ii) The R24 million of dividends distributed by Foreign Sub 3 to Foreign Sub 2 are wholly free from South African tax because the companies involved are wholly outside South African taxing jurisdiction (neither being controlled foreign companies).

(iii) The R8 million of dividends distributed by Foreign Sub 2 to Foreign Sub 1 are exempt from tax because Foreign Sub 1 owns more than 25 percent of the participation rights in Foreign Sub 2 (sections 9D(2A) and 10(1)*(k)*(ii)(*dd*)).

(iv) The R8 million of dividends distributed by Foreign Sub 1 to South African Parent are exempt from tax because South African Parent owns more than 25 percent of the participation rights in Foreign Sub 1 (section 10(1)*(k)*(ii)(*dd*)).

(v) South African Parent receives STC credits for the full R8 million of foreign dividends received. First, the dividends indirectly arose from South African Subsidiary. Second, South African Parent indirectly owns at least 10 per cent (i.e., 11.11 per cent) of South African Sub through its various foreign subsidiaries. Third, no other single resident has an equal or greater interest in the equity share capital of South African Sub (except for the South African Holding company which owns an indirect interest through the South African Parent company). Hence, the R8 million dividends declared by Foreign Sub 1 are deemed to come out of profits from the R24 million of dividends declared by South African Sub, thereby generating R8 million of STC credits.

Subclause (c): Currently section 64B(5)*(d)* provides for an exemption from secondary tax on companies (STC) of a dividend declared by a portfolio of a collective scheme referred to in paragraph *(e)*(i) of the definition of “company, to the extent that the dividend represents a distribution of dividends received by or accrued to that portfolio which are deductible under section 11*(s)*. On the other hand, section 64B(5)*(j)* is much wider and grants an exemption from STC of any dividend declared by a company contemplated in paragraph *(e)*(i) of the definition of “company”. It is, therefore, proposed that the more limited provision contained in section 64B(5)*(d)* be deleted.

Subclause (d): STC is triggered by the declaration of a dividend by a resident company and is imposed on the net amount of dividends declared and domestic

dividends received. A difficulty with any tax imposed on a dividend is that groups of companies are often arranged in multiple tiers. The tax may then be duplicated as a dividend is received and on-declared to individual shareholders. The STC system addresses this cascading effect.

From its inception in 1993 STC has been levied on the net amount of dividends declared and dividends received. STC is thus only levied on dividends declared by companies in the intermediate tiers out of their own profits. This, however, means that lower tier companies will have to pay STC up front, which may result in temporary cash flow difficulties should there be a delay between intermediate companies receiving a dividend and on-declaring it. In order to relieve these cash flow difficulties, the legislation was amended in 1994 to provide that a company declaring a dividend may elect not to pay STC on a dividend paid to a group company. The group company receiving the dividend will then not be permitted to deduct the dividend received when calculating its net amount on declaring a dividend. STC will effectively be levied both on the dividends which it has received and on-declared and those dividends that arise from its own operations.

An important requirement for this arrangement is that the dividend recipient is a resident. In other words, it is not available to companies that declare dividends to an offshore recipient. Since STC is only levied on resident companies the offshore recipient would not be subject to STC and permitting the election would result in a complete and permanent exemption from STC.

It has recently been discovered that some multinationals have taken the view that the equivalent of Article 24(5) of the OECD Model Tax Convention in the applicable double taxation agreements (DTA's) has the effect that the election set out above is available in respect of dividends distributed to their offshore shareholders. They therefore wish to exploit this election to obtain the complete and permanent exemption from STC referred to above.

Article 24(5), in essence, states that:

> "Enterprises of [South Africa], the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of [a Treaty Partner], shall not be subjected in [South Africa] to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of [South Africa] are or may be subjected."

The multinationals' argument is that the requirement that the dividend recipient be resident conflicts with the article. Accordingly it should be overridden by the DTA and, since the rest of the requirements of the election are met, their dividends should be exempt from STC.

SARS does not accept this argument and is of the view that no discrimination, as contemplated in article 24(5) or the South African Constitution, exists. The multinationals' argument is clearly untenable since it places the multinationals concerned at an advantage compared to their domestic competitors. There is, furthermore, no question of double taxation should the STC be levied. South Africa has reached agreement with all its treaty partners that STC is a creditable corporate tax for double taxation relief purposes. However, in order to address any uncertainty in this regard, it is proposed that section 64B(5)*(f)* be amended to make it clear that STC is leviable in these cases.

Subclause (e): In terms of section 64B(5)*(f)* dividends declared by a company within a group of companies will be exempt from STC only to the extent that the profits from which it is declared were derived during the period that it formed part of that group. Certain practical difficulties have been identified in the application of the group companies exemption from secondary tax on companies, where a new company is formed within the group or an existing company is included in a group company. It is, therefore, proposed that section 64B(5)*(f)* be amended to provide that where a new company is formed within the group, it will be deemed to have formed part of the group from the date that its controlling company was formed. Any controlling company in relation to the new company will also be deemed to have formed part of that group from the date that the controlling company formed part of the same group of companies as the controlling company in relation to the new company.

Subclause (f): This amendment is of a textual nature.

Subclause (g): A number of administrative provisions exist with regard to secondary tax on companies and more specifically the imposition of additional tax in the event of default or omission. It is, therefore, proposed that a provision be inserted to provide that the additional tax provisions apply for purposes of STC.

CLAUSE 41

Income Tax: Amendment of section 64C of the Income Tax Act, 1962

Subclause (a): Section 64C(2)*(g)* deems an amount to be a dividend declared by a company for purposes of STC if any loan or advance is granted and made available to the shareholder or connected person in relation to the shareholder.

Section 64C(2)*(b)* furthermore deems an amount to be a dividend where the shareholder or connected person Is released or relieved from an obligation which is owed to the company. In order to ensure that the same amount is not deemed as a dividend under both provisions, section 64C(2)*(b)* is amended that it does not apply to the extent that thte amount was already deemed to be dividend under section 64C(2)*(g)*.

Subclause (b) and (c): See notes on **HYBRID FINANCIAL INSTRUMENTS**.

Subclause (d): Section 64C(2)*(a)* deems an amount to be a dividend declared by a company for purposes of STC if any cash or asset is distributed or transferred by the company to or for the benefit of that shareholder or any connected person in relation to the shareholder. It is, however, not the intention that transfers of cash or assets in terms of an arm's length transaction be included in this provisions and an exclusion is specifically provided for amounts which constitute cash or assets which are transferred by the company in terms of a disposal or acquisition of an asset for arm's length consideration.

Subclause (e): Section 64C(4)*(f)* excludes from the provisions deeming certain amounts to be dividends for STC purposes certain loans that are granted to a shareholder during a year of assessment in certain circumstances. This amendment is proposed to clarify that the provision refers to the year of assessment of the company which grants the loan.

Subclause (f): The exclusions from the deeming provisions of section 64C(2) contained in section 64C(4)(*g*) and (*j*) are not consistent with the group concept that

was introduced into section 64B and 64C in 2002 and have been superseded by the exclusions in section 64C(4)(*k*)and (*l*) that were introduced in 2003. It is, accordingly, proposed that section 64C(4)(*g*) and (*j*) be deleted.

Subclause (g): It has been drawn to SARS' attention that section 64C(4)(*i*) is not aligned with the provisions of section 38(2)(*b*) of the Companies Act, 61 of 1973. It is proposed that that this misalignment be corrected.

Subclause (h): It is proposed that the language of section 64C(4)(*k*) be clarified and that a proviso be introduced to ensure that the same reserves are not counted more than once when this provision is applied for more than one deemed dividend.

Subclause (i): This amendment is of a textual nature.

CLAUSE 42

Income Tax: Amendment of section 103 of the Income Tax Act, 1962

See notes on **HYBRID FINANCIAL INSTRUMENTS**.

CLAUSE 43

Income Tax: Amendment of paragraph 1 of the Second Schedule to the Income Tax Act, 1962

This amendment is of a textual nature and is consequential upon the amendment of the definition of a "former member of a non-statutory force or service" in the Government Employees' Pension Law, 1996.

CLAUSE 44

Income Tax: Amendment of paragraph 2A of the Second Schedule to the Income Tax Act, 1962

In terms of paragraph 2A of the Second Schedule to the Income Tax Act, 1962, the amount from a public sector retirement fund that is to be included in the "gross income" of the member is deemed to be the amount calculated according to formula C in paragraph 1 of the same schedule. Formula C effectively ensures that the retirement benefit relating to pre-1998 public sector service is exempt from tax.

Paragraph 2B of the Second Schedule to the Income Tax Act, 1962 provides that where any portion of a benefit in a pension fund, provident fund, or retirement annuity fund becomes payable to the former spouse of the member, it shall be deemed to be an amount which accrues to the member.

Since the amount that is paid to the former spouse will be taxable in the hands of the member, it is necessary to ensure that formula C is also applied to this amount where it is from a public sector retirement fund. It is therefore proposed that paragraph 2A of the Second Schedule to the Income Tax Act, 1962 be amended accordingly.

CLAUSE 45

Income Tax: Amendment of paragraph 2B of the Second Schedule to the Income Tax Act, 1962

The proposed amendment is of a textual nature and ensures that the full range of orders granted by a Court in terms of the Divorce Act, 1979, is catered for.

CLAUSE 46

Income Tax: Amendment of paragraph 1 of the Fourth Schedule to the Income Tax Act, 1962

Subclause (a): This amendment deletes a reference to an obsolete provision.

Subclause (b): See notes on **TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN** and notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS.**

CLAUSE 47

Income Tax: Amendment of paragraph 18 of the Fourth Schedule to the Income Tax Act, 1962

The current provisions of paragraph 18(1) give rise to inconsistencies by making reference to a "period" instead of a year of assessment. It is proposed that "period" be changed to "year of assessment" to bring this subparagraph in line with other provisions in the Act.

CLAUSE 48

Income Tax: Amendment of paragraph 27 of the Fourth Schedule to the Income Tax Act, 1962

These amendments are of a textual nature and also delete a reference to an obsolete provision.

CLAUSE 49

Income Tax: Amendment of paragraph 28 of the Fourth Schedule to the Income Tax Act, 1962

This amendment deletes a reference to an obsolete provision.

CLAUSE 50

Income Tax: Amendment of paragraph 2 of the Seventh Schedule to the Income Tax Act, 1962

See notes on **TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN** and notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS**.

CLAUSE 51

Income Tax: Amendment of paragraph 1 of the Eighth Schedule to the Income Tax Act, 1962

These amendments are consequential upon the introduction of the Securities Services Act, 2004.

CLAUSE 52

Income Tax: Amendment of paragraph 2 of the Eighth Schedule to the Income Tax Act, 1962

The proposed amendment is of a textual nature.

CLAUSE 53

Income Tax: Amendment of paragraph 3 of the Eighth Schedule to the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 54

Income Tax: Amendment of paragraph 4 of the Eighth Schedule to the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 55

Income Tax: Amendment of paragraph 11 of the Eighth Schedule to the Income Tax Act, 1962

See notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS**.

CLAUSE 56

Income Tax: Amendment of paragraph 12 of the Eighth Schedule to the Income Tax Act, 1962

See notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS**.

CLAUSE 57

Income Tax: Amendment of paragraph 13 of the Eighth Schedule to the Income Tax Act, 1962

This amendment is consequential upon the promulgation of the Collective Investment Schemes Control Act, 2002.

CLAUSE 58

Income Tax: Amendment of paragraph 20 of the Eighth Schedule to the Income Tax Act, 1962

Subclause (a): The proposed amendment is of a textual nature.

Subclause (b): The proposed amendment seeks to clarify that it is only the expenditure contemplated in subitems (i) to (iii) of the item which is dealt with in the proviso and not the cost of the listed share or participatory interest.

Subclause (c): See notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS**.

Subclauses (d) and (e): See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 59

Income Tax: Amendment of paragraph 20A of the Eighth Schedule to the Income Tax Act, 1962

The proposed amendment is to clarify that it is the amounts of base cost allowable in terms of paragraph 20 that must be deducted from the proceeds from the sale of the immovable property, to determine the amount of the capital expenditure in respect of which an election may be made.

CLAUSE 60

Income Tax: Amendment of paragraph 25 of the Eighth Schedule to the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 61

Income Tax: Amendment of paragraph 33 of the Eighth Schedule to the Income Tax Act, 1962

See notes on **PUBLIC PRIVATE PARTNERSHIPS.**

CLAUSE 62

Income Tax: Insertion of paragraph 35A in the Eighth Schedule to the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 63

Income Tax: Amendment of paragraph 38 of the Eighth Schedule to the Income Tax Act, 1962

Subclause (a): Paragraph 38 deals with the situation where assets are disposed of by way of donation, consideration not measurable in money, or to a connected person at a non arm's length price.

In terms of paragraph 38(1)*(a)* a person who disposes of an asset in the above circumstances is treated as having disposed of it for 'proceeds' equal to the market value of the asset. In terms of paragraph 35(3)*(a)*, amounts that have already been taxed under the principal Act must be excluded from proceeds. However, by deeming the consideration to be proceeds, paragraph 35(3)*(a)* is bypassed resulting in double taxation. It is proposed that the word 'proceeds' be replaced with the words 'amount received or accrued'. This will ensure that the provisions of paragraph 35(3)*(a)* can be applied, thereby preventing double taxation.

Example

Facts: Company A and Company B are connected persons in relation to each other. Company A sells a fully depreciated asset that it had acquired at a cost of R100 after valuation date to Company B for R100.

Result: The market value of the asset at the date of disposal was R120. In terms of paragraph 38(1)*(a)* Company A would have proceeds of R120 and a base cost of zero, giving a capital gain of R120. The proposed amendment ensures that the

proceeds are R20 (i.e. R120 less the recoupment of R100). This gives the correct capital gain of R20.

Subclause (b): See notes on **TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS** and notes on **TAXATION OF AMOUNTS DERIVED FROM BROAD-BASED EMPLOYEE SHARE PLAN** and notes to insertion of section 24B in the Income Tax Act, 1962.

CLAUSE 64

Income Tax: Insertion of paragraph 39A in the Eighth Schedule to the Income Tax Act, 1962

See notes on **INCURRAL AND ACCRUAL OF AMOUNTS IN RESPECT OF ASSETS ACQUIRED OR DISPOSED OF FOR UNQUANTIFIED AMOUNTS**.

CLAUSE 65

Income Tax: Amendment of paragraph 56 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 56 provides that where a creditor disposes of a claim owed by a connected person in relation to the creditor, that creditor must disregard any capital loss arising as a consequence of that disposal unless the capital gain arising in the connected person's hands is taxed. An unintended consequence of the paragraph is that should the creditor dispose of a claim against a connected person in relation to that creditor to another person at a loss and in that other persons hand's a capital gain arises which is included in his or her aggregate capital gain or loss, the creditor may not claim the capital loss that he has suffered.

Example

Facts: A and B are connected persons in relation to each other and B owes A R10 000. A needs the cash and discounts the claim with C for R8 000.

Result: The capital gain of R2 000 is taxed in the hand's of C but A cannot claim the capital loss.

It is proposed that where the creditor can prove that the capital gain was brought into account in the determination of the other person's aggregate capital gain or loss then the creditor can claim the capital loss.

CLAUSE 66

Customs and Excise: Amendment of section 1 of the Customs and Excise Act, 1964

The definitions of “common customs area” and “customs duty” are amended and new definitions for “SACU” and “SACU Agreement” are inserted as a result of the entering into force of the new SACU agreement with effect from 15 July 2004.

The definition of “customs duty” is amended to **also** include a reference to the environmental levy leviable under Part 3 of Schedule No. 1.

Subsection 3 is amended to exclude the environmental levy from the common customs pool and it also provides for consequential amendments as a result of the new SACU Agreement. It inserts the name of the agreement and amends references to articles contained in the old agreement to reflect those contained in the new agreement.

CLAUSE 67

Customs and Excise: Amendment of section 44 of the Customs and Excise Act, 1964

Section 44(11)*(a)* deals with the limitation of liability for an underpayment of duty. Liability generally ceases after two years from the date of entry of the goods, except where a false declaration has been made or where the underpayment has been discovered as a result of any inspection, in which case the liability may be further extended.

The current provisions contained in the Customs and Excise Act are not in line with similar provisions already contained in other tax legislation such as the Income Tax Act, 1962, which extends liability also on grounds of fraud, misrepresentation or non-disclosure of any material facts.

The proposed amendment aims to achieve uniformity with the provisions contained in the Income Tax Act by including the aforementioned as grounds that will lead to an extension of liability in the Customs and Excise Act also.

CLAUSE 68

Customs and Excise: Amendment of section 47 of the Customs and Excise Act, 1964

Section 47(10) deals with the limitation of liability for any underpayment of duty where such underpayment is due to the acceptance of any declaration bearing an incorrect tariff heading or item of any schedule to the Act.

This amendment is consequential to the amendment of section 44(11) and inserts a reference to the circumstances that will lead to an extension of liability as contemplated in section 44(11)*(a)*.

CLAUSE 69

Customs and Excise: Amendment of section 55 of the Customs and Excise Act, 1964

The International Trade Administration Act, 2002 (Act No. 71 of 2002) recently replaced the Board of Tariffs and Trade Act, 1986 (Act No.107 of 1986) necessitating consequential amendments to replace references in the Customs and Excise Act to the Board of Tariffs and Trade Act, 1986, with references to the International Trade Administration Act, 2002.

Section 55(2)*(a)* is amended accordingly.

CLAUSE 70

Customs and Excise: Amendment of section 65 of the Customs and Excise Act, 1964

Section 65(7) deals with the limitation of liability for any underpayment of duty where such an underpayment is due to the acceptance of any declaration bearing an incorrect customs value.

This amendment is consequential to the amendment of section 44(11) and inserts a reference to the circumstances that will lead to an extension of liability as contemplated in section 44(11)*(a)*.

CLAUSE 71

Customs and Excise: Amendment of section 69 of the Customs and Excise Act, 1964

Section 69(6) deals with the limitation of liability for any underpayment of duty where such an underpayment is due to the acceptance of any declaration bearing an incorrect value for excise purposes.

This amendment is consequential to the amendment of section 44(11) and inserts a reference to the circumstances that will lead to an extension of liability as contemplated in section 44(11)*(a)*.

CLAUSE 72

Customs and Excise: Substitution of the long title of the Customs and Excise Act, 1964

This clause amends the long title to the Customs and Excise Act, to include a reference to the levying of an environmental levy.

CLAUSE 73

Stamp Duties: Amendment of section 1 of the Stamp Duties Act, 1968

Subclause (a): See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

Subclause (b): The proposed amendment is as a result of the amendment pertaining to the introduction of e-stamping. It is proposed to reduce the use of adhesive stamps and franking machines by allowing the payment of stamp duty by electronic means. The introduction of e-stamping is in line with SARS' e-strategy. It is proposed to expand the definition of "stamp" to include stamping by electronic means.

CLAUSE 74

Stamp Duties: Amendment of section 5 of the Stamp Duties Act, 1968

Subclause (a): See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**. As a result of the proposed amendment, the use of penalty stamps has become obsolete.

Subclause (b): The proposed amendment is as a result of the amendment pertaining to the introduction of e-stamping. It is proposed to reduce the use of adhesive stamps and franking machines in order to allow the payment of stamp duty by electronic means. It is proposed to include a provision whereby the words "duty paid" can appear on the face of the document – in this instance, the requirement of affixing revenue stamps will be met.

The proposed amendment is to limit the amount of adhesive stamps which must be affixed to documents. Where the applicable duty exceeds that amount a special receipt or electronic receipt as contemplated in subparagraph (iii) and (iv) of the definition of 'stamp' in section 1 must be issued. The amendment is aimed at reducing the current abuse of adhesive stamps.

CLAUSE 75

Stamp Duties: Amendment of section 6 of the Stamp Duties Act, 1968

Subclause (a): The proposed amendment is consequential upon the earlier deletion of stamp duty on the following items:

- Item 2 – agreements;
- Item 3 - antinuptual contracts,
- Item 5 - promissory notes and bills of exchange;
- Item 7 - bonds;
- Item 11 - custom documents;
- Item 12 - duplicates;
- Item 13 - fixed deposit receipts;
- Item 17 - partnership agreements.
- Item 18 - policy of insurance;
- Item 19 - power of attorney; and
- Item 20 – securities.

Subclause (b): The proposed amendment is to delete an administrative penalty.

CLAUSE 76

Stamp Duties: Amendment of section 7 of the Stamp Duties Act, 1968

The proposed amendment is consequential upon the deletion on 1 April 1993 of Item 2 (dealing with agreements). The provision has accordingly become obsolete.

CLAUSE 77

Stamp Duties: Amendment of section 8 of the Stamp Duties Act, 1968

Subclause (a): The proposed amendment is to extend the time period in which a document must be stamped from 21 days to 30 days.

Due to the deletion of various items (see subclause *(a)* of the notes to the amendment of section 6 of the Stamp Duties Act, 1968), certain documents do not have to be presented for stamping, either to a banker, or to an authorised revenue officer.

Subclause (b): The proposed amendment provides for specific time periods within which a marketable security must be stamped:

- within six months from the date of execution of the relevant document of transfer;
- within 3 months from the date of execution of the relevant document of transfer in the name of the broker or the nominee of the broker; and
- within 6 months from the date of acquisition as contemplated in item 15(5)*(a)*, *(b)* or *(c)* of Schedule 1. In this instance, the deed or declaration referred to in section 23(15) must be stamped.

Where a lease agreement is concluded, the document must be stamped within 30 days from the date of execution of the document. Where such lease agreement provides for "other consideration" or rental that is not determinable at the time of execution, the additional "other consideration" or rental (excluding VAT) must be stamped as follows:

- where the lessor is a taxpayer, annually by the lessor within six months after the end of the lessor's year of assessment; or
- where the lessor is not a taxpayer, on or before 31 of August each year.

Subclause (c): The proposed amendment is to extend the time period in which a document must be stamped from 21 days to 30 days.

CLAUSE 78

Stamp Duties: Amendment of section 9 of the Stamp Duties Act, 1968

Subclauses (a) and (b): See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

Subclause (c): Due to the deletion of various items as listed in notes on amendment to section 6, certain documents do not have to be presented for stamping, either to a banker, or to an authorised revenue officer.

CLAUSE 79

Stamp Duties: Insertion of section 9A in the Stamp Duties Act, 1968

See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 80

Stamp Duties: Insertion of section 9B in the Stamp Duties Act, 1968

See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 81

Stamp Duties: Amendment of section 10 of the Stamp Duties Act, 1968

Subclauses (a), (c) and (e): Due to the deletion of various items (see notes on amendment of section 6), certain documents do not have to be presented for stamping, either to a banker, or to an authorised revenue officer.

Subclause (b): See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**. Due to the deletion of various items (see notes on amendment to section 6), certain documents do not have to be presented for stamping, either to a banker, or to an authorised revenue officer.

Subclause (d): See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 82

Stamp Duties: Substitution of section 11 of the Stamp Duties Act, 1968

See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 83

Stamp Duties: Amendment of section 12 of the Stamp Duties Act, 1968

See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 84

Stamp Duties: Amendment of section 12A of the Stamp Duties Act, 1968

See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 85

Stamp Duties: Amendment of section 13 of the Stamp Duties Act, 1968

See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 86

Stamp Duties: Amendment of section 15 of the Stamp Duties Act, 1968

See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**. The proposed amendment is to replace penalty stamps with a special receipt.

CLAUSE 87

Stamp Duties: Substitution of section 19 of the Stamp Duties Act, 1968

The proposed amendment aligns section 19 with the provisions of sections 9, 9A and 9B. See notes on **STAMP DUTIES, INTEREST, PENALTIES AND ADDITIONAL DUTY**.

CLAUSE 88

Stamp Duties: Amendment of section 22 of the Stamp Duties Act, 1968

The proposed amendment is to clarify the term "other consideration". It is proposed to include the consideration payable in respect of a lease, the value of the improvements on land or to the building by the lessee, and any acceptance by the lessee of any liability of payments for which the lessor would be liable in the definition of "other consideration. Charges which relate to public services rendered to the lessee, e.g water and lights are excluded from the term "other consideration". In addition, where the lessee is liable to the lessor for the duty in respect of the lease or agreement of lease, such duty will not form part of "other consideration".

CLAUSE 89

Stamp Duties: Amendment of section 23 of the Stamp Duties Act, 1968

Subclause (a): The proposed amendment is to delete the administrative penalty.

Subclause (b): See notes on **STAMP DUTIES INTEREST, PENALTIES AND ADDITIONAL DUTY**. The proposed amendment will result in sections 8 and 9, 9A and 9B now also being applicable to marketable securities.

Subclause (c): The proposed amendment is consequential upon the deletion of "policy of insurance" from the Act on 1 April 2001.

Subclause (d): The proposed amendment is to delete the administrative penalty. This proposed amendment is also consequential upon the introduction of "Offences in respect of duty relating to marketable securities.

Subclauses (e), (f) and (g): The amendment is of a textual nature. The amendment also extends the record keeping period from three to five years.

CLAUSE 90

Stamp Duties: Amendment of item 14 of Schedule 1 to the Stamp Duties Act, 1968

Subclause (a): Refer to the notes on "other consideration" in *subclause (b)* of the amendments to section 8 of the Stamp Duties Act, 1968. The current practice when calculating the total amount on which stamp duty is payable, includes VAT unless the lease agreement provides separately for VAT. The proposed amendment is introduced to eliminate double tax, i.e duty payable on a VAT inclusive amount).

Subclause (b): The proposed amendment makes provision for the deletion of sub paragraphs *(a)*, *(b)*, *(c)* and *(d)* of Item 14(1). As a result, only 1 rate of duty will be applicable for leases, notwithstanding the period of leases. A rate of 50c in respect of every R100 or part thereof will be payable for every period of twelve months.

Subclause (c): Transfer duty applies when real property rights are transferred, and stamp duty applies when real property rights are leased. When using the proviso to Item 14, the long-term lease of real property was taxed at vastly lower amounts than the transfer of real property. The proposed amendment seeks to close this arbitrage opportunity in respect of long-term leases. Accordingly, stamp duty will not be limited to the full selling value where the value of the rentals for the period of the lease, exceeds the full selling value.

Subclause (d): Item 14(3) of the Schedule provides for stamp duty of R2 payable on the cession of a lease. This provision is deleted as it is uneconomical to collect such small amounts of duty.

Subclause (e): The proposed amendment is intended to assist lower income groups by exempting the payment of stamp duty on lease agreements where such duty does not exceed R200.

CLAUSE 91

Stamp Duties: Amendment of item 15 of Schedule 1 to the Stamp Duties Act, 1968

Subclauses (a) and (g): The proposed amendment is consequential upon the deletion of the payment of stamp duty on interest-bearing debentures. Furthermore, the exemption will only apply where the securities fall within the ambit of "instruments" as contemplated in section 24J of the Income Tax Act, 1962.

Subclauses (d) and (h): See notes on **STAMP DUTIES INTEREST, PENALTIES AND ADDITIONAL DUTY**.

Subclause (e): The proposed amendment is consequential upon the deletion of the payment of stamp duty on interest-bearing debentures.

Subclause (f): The proposed amendment is consequential upon the abolishment of the Exchequer and Audit Act, 1975 (Act No. 66 of 1975).

CLAUSE 92

Value-Added Tax: Amendment of section 1 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment to the definition of “consideration” is consequential upon the replacement of the defintion of “unconditional gift” with the definition of “donation”.

Subclauses (b) and (c): An amendment is introduced for the provision of laundry and nursing services supplied to be included in the definition of “domestic goods and services”. The amendment will result in the value of the services, which will now include laundry and nursing services, falling within the ambit of section 10(10) of the Act. The value of these services will be taxable at 60% where the person stays for longer than 28 days.

Subclause (d): The term “donation” will replace the words “unconditional gift”. The proposed amendment is merely to replace the current term with a more appropriate one. The meaning however remains the same.

Subclause (e): The Act provides that supplies made by a branch or main business of an enterprise situated outside South Africa shall not be regarded as supplies made by the South African enterprise. It is proposed that the non-South African enterprise be regarded as a separate person for VAT purposes to ensure that the normal rules relating to exports and imports as well as of the supply of services will apply to the foreign branches or main businesses.

Subclause (f): The Act currently requires an enterprise conducting “commercial accommodation” to make, or reasonably be expected to make taxable supplies in excess of R60 000 in a 12 month period. However, these entities have voluntarily registered as vendors in terms of section 23(3)*(b)* or *(d)* where its taxable turnover exceeded or was likely to exceed R20 000 in a 12 month period.

A new proviso has been inserted to specifically exclude those accommodation enterprises who do not fall within the ambit of “commercial accommodation” from being regarded as conducting an enterprise as the turnover is less than or cannot reasonably be expected to exceed R60 000 in a 12 month period. Accordingly, these businesses will not be allowed to register on a voluntary basis for VAT purposes.

Subclause (g): See notes on **VALUE-ADDED TAX TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTORITIES**. The proposed amendment is to exclude from the definition of “grant” payments for any goods or services supplied in terms of a procurement process.

Subclauses (h) and (i): This amendment is of a textual nature.

Subclause (j): It is proposed that “game viewing vehicle” and “hearse” be added to the exclusions in the definition of “motor car”. The original reason for denying input tax claims on motor cars was to eliminate the possibility of vendors claiming input tax on vehicles purchased for private use. The proposed amendment takes into account the fact that hearses and game viewing vehicles will not generally be used for private purposes.

Subclause (k): See notes on **VALUE-ADDED TAX TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTORITIES**. The proposed amendment widens the definition to include entities listed in Part A or C of Schedule

3 to the Public Finance Management Act, 1999 (PFMA), as well as any other public entity, which is not listed in one of the Schedules to the PFMA, which the Minister for the purposes of the VAT Act has designated to be a public authority.

Subclause (l): The definition of “unconditional gift” is replaced by the definition of “donation” in section 1.

Subclause (m): A textual amendment is proposed to the definition of “welfare organisation”. The proposed amendment intends to delete the words “which is registered under the Non Profit Organisations Act, 1997 (Act No 17 of 1997)” which have become superflous.

CLAUSE 93

Value-Added Tax: Amendment of section 2 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment intends to incorporate all derivatives (as defined in section 2) into the ambit of “financial services”.

Subclause (b): A new definition of a “cheque” is proposed as the previous reference has become obsolete.

Subclause (c): This amendment is consequential upon the amendment to section 2(1)*(k)* and defines what “derivative” means.

CLAUSE 94

Value-Added Tax: Amendment of section 7 of the Value-Added Tax Act, 1991

Subclauses (a) and (b): The proposed amendment is consequential upon the introduction of the environmental levy levied in terms of Part 3 of Schedule No.1 to the Customs and Excise Act, 1964.

CLAUSE 95

Value-Added Tax: Amendment of section 8 of the Value-Added Tax Act, 1991

Subclause (a): See notes on **VALUE-ADDED TAX TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTORITIES**. The proposed amendment is to ensure that public entities which no longer carry on an enterprise and who ceases to be a vendor will not be required to account for output tax upon de-registration. It is proposed that this dispensation will also be available to public entities which has as a result of re-classification within the Schedules to the Public Finance Management Act, 1999 (PFMA), have to deregister after the introduction of the Revenue Laws Amendment Act, 2004. However, this dispensation will not be allowed for vendors, who are Constitutional Institutions listed in Schedule 1 to the PFMA or public authorities, who applied and were registered as vendors during the period 22 December 2003 and 31 March 2005.

Subclause (b): The amendment is consequential upon the amendment to the definition of “enterprise” in section 1. Where a vendor supplies commercial accommodation and its turnover is less or not expected to exceed R60 000 in a 12

month period, that vendor will be required to deregister for VAT purposes. In terms of section 8(2), the vendor is required to effect an output tax adjustment on deregistration. The proposed amendment is intended to assist these vendors by allowing them to make arrangements to pay the output tax due where the amount is in excess of R3000, provided that these vendors cease to be vendors on or before 30 June 2005 as a result of this amendment.

Subclause (c): See notes on **VALUE-ADDED TAX TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTORITIES**. The proposed amendment is to deem a vendor (not being a designated entity) to supply services to a public authority, local authority or public entity listed in Schedule 1 to the Public Finance Management Act, 1999, to the extent of any grant paid to or on behalf of that vendor by these respective authorities or entity.

Subclause (d): The amendment is consequential upon the amendment to the definition of "motor car" in section 1, and the input tax deduction that has subsequently been allowed in terms of section 18(9) of the Act. The vendor is liable to declare output tax on the subsequent supply of the goods, as it will be deemed to be a supply in the course or furtherance of the vendor's enterprise.

Subclause (e): An amendment is introduced to ensure that where the game viewing vehicle or hearse is subsequently applied for a purpose other than the purpose for which an input tax deduction was allowed, a supply at the standard rate of these assets is deemed to take place.

Subclause (f): Fixed property is defined as including land and any improvements thereto. As a result, the words have been replaced with a defined term.

CLAUSE 96

Value-Added Tax: Amendment of section 9 of the Value-Added Tax Act, 1991

The proposed amendment is consequential upon the amendment to sections 8(14)*(b)* and 8(14A).

CLAUSE 97

Value-Added Tax: Amendment of section 10 of the Value-Added Tax Act, 1991

The proposed amendment is consequential upon the amendment to sections 8(14)*(b)* and 8(14A).

CLAUSE 98

Value-Added Tax: Amendment of section 11 of the Value-Added Tax Act, 1991

Subclause (a): The current legislation intended for the zero rate to be applicable only to movable goods which are exclusively used in an export country. However, in sections 11(1)*(c)* and *(d)*, the reference is made to "goods" which includes fixed property. The supply of fixed property was never intended in this instance to be zero-rated. The proposed amendment is to ensure that the zero rate only applies to movable goods. Where immovable goods (i.e. fixed property) are leased to a lessee

in an export country, such supply is exempt in terms of section 12*(e)*. In respect of the inclusion of a customs controlled area, see the notes on **VALUE-ADDED TAX TREATMENT OF INDUSTRIAL DEVELOPMENT ZONES**.

Subclause (b): See the notes on **THE VAT TREATMENT OF INDUSTRIAL DEVELOPMENT ZONES**.

Subclause (c): It is proposed to include the words "wholly or partly" in section 11(1)*(n)*(ii) after the words "Resource Development Act 2002 (Act number 28 of 2002) so as to align it with the provisions of section 11(1)*(n)*(i).

Subclause (d): Section 11(1)*(e)* allows for the zero rating of the disposal of an enterprise as a going concern. It is proposed to insert a new sub-section 11(1)*(p)* to allow for the zero rating of the disposal of enterprises or part of an enterprise, which are separately registered for VAT purposes, but which fall within the same legal entity.

Subclause (e): The proposed amendment is intended to rectify an incorrect reference.

Subclause (f): See notes on **VALUE-ADDED TAX TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTORITIES**. The proposed amendment is to zero rate all grants received by a vendor (other than a designated entity) in respect of services deemed in terms of section 8(5A) of the Act to be supplied to a public authority, local authority or public entity listed in Schedule 1 to the Public Finance Management Act, 1999.

CLAUSE 99

Value-Added Tax: Amendment of section 12 of the Value-Added Tax Act, 1991

Subclause (a): This amendment is to clarify the policy that the right of occupation as defined in section 1 of the Housing Development Schemes for Retired Persons Act, 1988, is exempt from VAT.

Subclause (b): The original intention of section 12*(g)* was to exempt commuter transport to provide tax relief to the less affluent consumers who would be utilising these services. The relief afforded in terms of this provision was never intended to exempt the service of transporting passengers in a game viewing vehicle. Accordingly, the proposed amendment will clarify that section 12*(g)* excludes the transport of passengers in a game viewing vehicle. The supply of the game viewing service therefore remains subject to VAT at the standard rate.

Subclause (c): This amendment is to bring the educational services supplied by a person, which is exempt from income tax in terms of section 10(1)*(c*N*)* of the Income Tax Act, 1962, in line with the list of welfare activities determined by the Minister for purposes of this Act and which are set out in the Regulation to this Act. Accordingly, these services will be subject to VAT at the standard rate.

Subclause (d): This amendment is proposed to exempt the activities of the Joint Joint Matriculation Board referred to in section 15 of the University Act, 1955, as the services are incidental to educational services, e.g. issue Senior certificates. The Joint Matriculation Board will therefore not be conducting an enterprise and cannot be registered for VAT purposes.

CLAUSE 100

Value-Added Tax: Amendment of section 13 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment is intended to align the VAT Act to the provisions of the Customs and Excise Act, 1964, with regard to the importation of goods.

Subclause (b): See the notes on **VALUE-ADDED TAX TREATMENT OF INDUSTRIAL DEVELOPMENT ZONES**.

Subclause (c): Section 13(4) was originally inserted to make provision for the payment of import VAT to be made at any SARS office as the border posts were not sufficiently staffed to deal with the payment of VAT due in respect of the importation of goods. This provision has however become obsolete as payment of VAT on importation on goods must now be made at the point of entry into South Africa. This amendment therefore aligns the provisions of the VAT Act with those of the Customs and Excise Act in respect of the time of payment of VAT due on importation.

CLAUSE 101

Value-Added Tax: Amendment of section 14 of the Value-Added Tax Act, 1991

Subclauses (a) and (b). These amendments are of a textual nature.

Subclause (c): The amendment is intended to align the VAT implications of foreign and local directors with regard to the remuneration received. The proposed amendment is to exclude the supply of certain services by a non-resident, e.g. director from falling within the ambit of “imported services”.

CLAUSE 102

Value-Added Tax: Amendment of section 17 of the Value-Added Tax Act, 1991

Subclause (a): This amendment is of a textual nature.

Subclause (b): The proposed amendment to subparagraph (vii) is to ensure that the payment of ward fees be allowed as an input tax deduction, even where the items are separately reflected on the invoice. Therefore, where meals and beverages are separately indicated on the tax invoice, the employer will be entitled to an input tax deduction provided all other relevant requirements are met.

Subclause (c): Input tax is currently prohibited on meals and refreshments supplied by the employer to its crew on board its ship or vessel. The abuse that the provision intended to prevent was the claiming of an input credit where “entertainment” was provided in lieu of a salary. Clearly meals provided to cabin crew on board a ship or vessel is not the abuse that the provision intended to target. The amendment to subparagraph (viii) allows vendors operating any ship or vessel in the course of making taxable supplies to deduct an input tax deduction in respect of meals and refreshments supplied to crew on board the ship or vessel. It is proposed that a new section 17(2)*(a)*(viii) be inserted to make provision for the permissible deduction of

input tax on meals or refreshments supplied to the crew on vessels conducting business offshore, e.g. fishing vessels, oil rigs, etc where the vendor is making taxable supplies.

CLAUSE 103

Value-Added Tax: Amendment of section 18 of the Value-Added Tax Act, 1991

Subclause (a): It is proposed that the heading “Adjustments” be amended to ”Change in Use Adjustments”.

Subclauses (b) and (c): See notes on **VALUE-ADDED TAX TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTORITIES**. The proposed amendment will not allow a public entity listed in Part A or C of Schedule 3 to the Public Finance Management Act, 1999 (PFMA), to claim a change in use adjustment for assets on hand when they are re-classified by the Minister within the Schedules to the PFMA which may result in the entity conducting an enterprise. Such entity would therefore have to register for VAT purposes.

Subclause (d): The amendment is intended to allow an input tax deduction on the acquisition or importation of a “motor car” on or after the date of promulgation of this Bill that has subsequently been converted into a game viewing vehicle or hearse. Should the proposed amendment not be included, an input tax deduction will be denied in terms of section 17(2)*(c)* on the acquisition of a motor car which is subsequently converted into a game viewing vehicle or hearse.

Example

Facts: A station wagon is purchased for R114 000 inclusive of VAT. An input tax deduction is denied in terms of section 17(2)*(c)* as the station wagon falls within the ambit of the definition of “motor car”. The station wagon is subsequently converted into a hearse.

Result: Input tax is allowed on the conversion costs. An adjustment will be allowed in terms of section 18(9) which will result in input tax being claimed on the acquisition of the station wagon.

Where the hearse is subsequently sold to another undertaker, the supply will be subject to VAT at the standard rate in terms of section 8(14). Alternatively, where the hearse is converted back into a station wagon or it is not used for the transport of deceased persons, a supply of the hearse is deemed to be made in terms of section 8(14A) in respect of the insertion of section 18(1).

In respect of the insertion of subsection (10) to section 18 - See notes on **VALUE-ADDED TAX TREATMENT OF INDUSTRIAL DEVELOPMENT ZONES**.

CLAUSE 104

Value-Added Tax: Amendment of section 20 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment requires a vendor to issue a tax invoice, whether requested to do so or not, within 21 days of the date of the supply.

Subclause (b): Section 20(1A) is deleted as a consequence of the amendment to section 20(1).

Subclause (c): The purpose of this amendment is to increase the requirements with regard to the description of the goods sold. It is important to know when goods are second-hand goods, especially when the goods are exported as the zero rate of VAT cannot be applied.

Subclause (d): The amendment proposes that a full tax invoice need only be issued where supplies exceed R3 000. An abridged tax invoice need therefore be issued for supplies of less than R3 000.

Subclause (e): The purpose of this amendment is to increase the requirements with regard to the description of the goods sold. It is important to know when goods are second-hand goods, especially when the goods are exported as the zero rate of VAT cannot be applied.

Subclause (f): The proposed amendment makes provision for a vendor to obtain and maintain a declaration by the supplier on a form to be prescribed by the Commissioner, confirming that the supply is a non-taxable supply or a supply in terms of section 8(10). The proposed amendment is intended to eliminate abusive practices. The current prescribed form, the VAT 264 form, can be obtained from the SARS website: www.sars.gov.za.

CLAUSE 105

Value-Added Tax: Amendment of section 39 of the Value-Added Tax Act, 1991

Subclause (a): This amendment is consequential upon the deletion of section 13(4).

Subclause (b): This amendment is consequential upon the deletion of subsection (3).

Subclauses (c) and (d): If the Commissioner is satisfied that the provisions of section 39*(a)* or *(b)* are complied with, he or she may remit in whole or in part the penalty and/or interest.

CLAUSE 106

Value-Added Tax: Amendment of section 48 of the Value-Added Tax Act, 1991

A textual amendment is proposed to replace the word "liability" in section 48(9)*(a)* with the word "liable". It is also proposed to include a member of a Close Corporation, as a member is not currently included as a shareholder in the definition of a "company" in the Income Tax Act. As a result, a member of a close corporation, could not be held liable in terms of section 48 of the VAT Act.

CLAUSE 107

Value-Added Tax: Amendment of section 68 of the Value-Added Tax Act, 1991

The proposed amendment is consequential upon the repeal of the "Diplomatic Immunities and Privileges Act, 1989 (Act No. 74 of 1989) and the introduction of the Diplomatic Immunities and Privileges Act, 2001 (Act No.37 of 2001).

CLAUSE 108

Value-Added Tax: Amendment of Schedule 1 to the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment is intended to align the VAT exemption provided for in paragraph 5 to Schedule 1 with the provisions of the Customs and Excise Act. As a result of the Customs and Excise Act as well as the International Trade Administration Commission not allowing the importation of foodstuff and second hand clothing as a donation, the VAT Act had to be amended.

Subclauses (b),(c) and (d): It is proposed that the VAT exemption on importation be limited to those supplies which were originally supplied at the zero rate in terms of 11(1)*(a)*. Any other supply of goods at the zero rate will therefore remain exempt from VAT on importation.

CLAUSE 109

Uncertificated Securities Tax: Amendment of section 1 of the Uncertificated Securities Tax Act, 1998

Subclauses (a), (c) and (f): The proposed amendments are consequential upon the amendment to section 5.

Subclause (b): The proposed amendment is to define the term "exchange" and which is aligned with the Securities Service Act, 2004. This amendment is consequential upon the deletion of the Stock Exchange Control Act, 1985.

Subclause (d): The proposed amendment is to substitute the term "member" to align it with the Securities Services Act, 2004.

Subclause (e): The proposed amendment is to align the definition of a "participant" to that of the Securities Service Act, 2004.

Subclause (g): The proposed amendment is to define the term "securities" and which is aligned with the Securities Services Act, 2004. This amendment is consequential upon the deletion of the Stock Exchange Control Act, 1985.

Subclause (h): The proposed amendment is consequential upon the definitions of "stock exchange" and "stock broker" being replaced by the definitions of "exchange" and "member". These amendments are consequential upon the introduction of the Securities Services Act, 2004.

CLAUSE 110

Uncertificated Securities Tax: Amendment of section 5 of the Uncertificated Securities Tax Act, 1998

The UST Act provides that the change of beneficial ownership of a security is subject to duty. Where no consideration, or a consideration which is less than the fair market value, is paid for the security, it is provided that the consideration shall be deemed to be the ruling price on the JSE Securities Exchange on the business day immediately preceding the day on which the transfer of such securities is effected by the participant. The proposed amendment provides that the closing price of the security shall be used where no consideration is given, or the consideration given is lower than the lowest trading price of the security on the date of the relevant transaction or other manner of acquisition. This ensures that a more accurate value will be applied in these circumstances.

CLAUSE 111

Uncertificated Securities Tax: Amendment of section 6 of the Uncertificated Securities Tax Act, 1998

Subclauses (a) and (c): Securities, issued or where there is a change in beneficial ownership, which are instruments as contemplated in section 24J of the Income Tax Act, 1962, will be exempt from the payment of UST.

Subclause (b): The proposed amendment is consequential upon the deletion of the definition of the "stock broker".

Subclause (d): The proposed amendment is of a textual nature.

CLAUSE 112

Customs and Excise: Amendment of section 121 of the Second Revenue Laws Amendment Act, 2001

A revised set of enabling legislation for Industrial Development Zones was introduced in 2003. The implementation of Industrial Development Zones and specifically the alignment of the Customs and Excise Act and the VAT Act necessitate minor changes to section 21A. References to 'deemed importation' in section 21A will be removed to ensure that goods removed from a customs controlled area situated in an IDZ are not regarded as an import for VAT purposes.

CLAUSE 113

Value-Added Tax: Amendment of section 153 of the Second Revenue Laws Amendment Act, 2001

This amendment deletes a provision in the Second Revenue Laws Amendment Act, 2001, which has not come into operation yet and which has been dealt with in this Bill

CLAUSE 114

Customs and Excise: Amendment of section 103 of the Revenue Laws Amendment Act, 2002

Section 103(10) of the Revenue Laws Amendment Act, 2002 inserted section 37B of the Customs and Excise Act, 1964 which provides for the administration of the manufacture, storage, disposal and use of biofuel (biodiesel and bioethanol).

It has been decided to introduce the legislation as soon as possible on biodiesel.

The rate of duty on biodiesel will be 70% of the rate applicable to distillate fuel (diesel). Refunds of duty and Road Accident Levy payable in respect of biodiesel will be refunded to certain users in accordance with the provisions applicable to distillate fuel.

Farmers producing for own consumption will be exempted from payment of duty and amended provisions will enable the Commissioner to prescribe exemptions by rule.

The provisions in section 37B had to be adapted with regard to the exemption and to clarify, particularly for purposes of refund, that references to distillate fuel will include a reference to biofuel.

Section 103(2) is amended to enable proclamations to be enacted separately for boidiesel and bioethanol.

CLAUSE 115

Value-Added Tax: Repeal of section 46 of the Taxation Laws Amendment Act, 2004

This amendment deletes a provision in the Taxation Laws Amendment Act, 2004, which has not come into operation yet and which is being dealt with in this Bill.

CLAUSE 116

Income Tax: Amendment of section 59 of the Revenue Laws Amendment Act, 2003

STC relief for jntra-group transactions is currently provided by s 64C(4)*(k)* and *(l)* of the Act. These provisions came into operation on 22 December 2003 and replaced the relief measures previously contained in s 44(9). However, s 44 was repealed with effect from 6 November 2003 with the result that no STC relief applies in respect of disposals during the intervening period. The proposed amendment is aimed at correcting this oversight.

CLAUSE 117

Stamp Duties: Amendment of section 163 of the Revenue Laws Amendment Act, 2003

This provides for the continuation in force of certain provisions which have been repealed and which should still be applicable in respect of instruments executed before the date of repeal.

CLAUSE 118

Value-Added Tax: Amendment of section 164 of the Revenue Laws Amendment Act, 2003

This amendment is consequential upon the proposed amendments dealing with public entities and grants.

To the extent that paragraph *(e)* of the section 164(1) is deleted - see notes on **VALUE-ADDED TAX TREATMENT OF GRANTS PAID BY PUBLIC AUTHORITIES AND LOCAL AUTORITIES**. Paragraph *(b)*(i) of the definition of "enterprise" was previously amended to extend its ambit to include entities listed in Part A and C of Schedule 3 to the Public Finance Management Act, 1999. The proposed amendment is, however, consequential upon the amendment to the definition of "public authority", which brings within its ambit the abovementioned public entities.

CLAUSE 119

Value-Added Tax: Repeal of section 165 of the Revenue Laws Amendment Act, 2003

This amendment which has not yet come into operation is being deleted. See notes on Value-Added Tax treatment of Industrial Development Zones.

CLAUSE 120

Value-Added Tax: Amendment of section 166 of the Revenue Laws Amendment Act, 2003

This amendment which has not yet come into operation is being deleted and replaced by a new amendment to section 8 of the Value-Added Tax Act, 1991.

CLAUSE 121

Value-Added Tax: Amendment of section 169 of the Revenue Laws Amendment Act, 2003

This amendment which has not yet come into operation is being deleted and replaced by a new amendment to section 11 of the Value-Added Tax Act, 1991.

CLAUSE 122

Value-Added Tax: Amendment of section 170 of the Revenue Laws Amendment Act, 2003

This amendment which has not yet come into operation is being deleted. See notes on **VALUE-ADDED TAX TREATMENT OF INDUSTRIAL DEVELOPMENT ZONES**.

CLAUSE 123

Value-Added Tax: Amendment of section 173 of the Revenue Laws Amendment Act, 2003

The proposed amendment is to delete the provision relating to the denied portion of input tax incurred as a result of a grant received which grant is now regarded as a deemed supply.

CLAUSE 124

Short title and commencement date

This clause provides for the short title of the Bill.