REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAXATION LAWS AMENDMENT BILL, 2005

NATIONAL
TREASURY

[W.P. 1 —'05]

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INTRODUCTION

The Taxation Laws Amendment Bill, 2005, 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 Regional Services Councils Act, 1985, the Kwazulu and Natal Joint Services Act, 1990, the Value-Added Tax Act, 1991, the Skills Development Levies Act, 1999, and the Revenue Laws Amendment Act, 2004.

CLAUSE 1

Transfer duty: Amendment of section 2 of the Transfer Duty Act, 1949

Transfer duty is levied in terms of section 2 of the Transfer Duty Act on the acquisition of fixed property in South Africa. Currently, the rates for property acquired by natural persons are—

- 0% on the first R150 000 of the value of the property;
- 5% on the value between R150 001 up to R320 000; and
- 8% on the value above 320 000.

Given the steep increases in property prices during the last few years, the Minister of Finance has proposed that the exempt (zero-rated) threshold for transfer duty be increased to R190 000 and that the second threshold up to where the 5% rate applies be increased to R330 000. The new graduated rate structure will be as follows:

- 0% on the first R190 000 of the value of the property;
- 5% on values between R190 001 up to R330 000; and
- 8% on values above R330 000.

The new rate structure will apply in respect of acquisitions of property on or after 1 March 2005.

CLAUSE 2

Fixing of rates of normal tax

Income Tax: Rates of normal tax

Rates of normal tax payable by all persons are enacted by *clause 2* and Schedule 1 to the Bill.

Persons other than companies

The rates for persons (other than companies) apply in respect of the year of assessment ending on 28 February 2006 and are provided for in paragraph 1 of Schedule 1. More specifically, the rates for—

- persons (other than companies) and special trusts are provided for in paragraph 1*(a)* of Schedule 1; and

- trusts (other than special trusts) are provided for in paragraph 1*(b)* of Schedule 1.

The rates for paragraph 1*(a)* persons consist of a progressive rate structure ranging between 18 per cent on the lowest portion of taxable income (amounts up to R80 000) and 40 per cent which is reached on the portion of taxable income above R300 000. The rates for paragraph 1*(b)* persons are fixed at a single rate of 40 per cent on all taxable income.

Companies

The rates for companies apply in respect of years of assessment, i.e. the financial year of the company concerned, ending during the 12-month period from 1 April 2005 to 31 March 2006, and are provided for in paragraphs 2*(a)* to *(h)* inclusive, of Schedule 1.

Those rates are as follows:

(a) Taxable income derived otherwise than—
  (i) by a small business corporation or an employment company;
  (ii) from gold mining;
  (iii) from long-term insurance business;
  (iv) by a non-resident through a branch or agency in the Republic; or
  (v) by a qualifying company enjoying tax holiday status:

  29 cents per R1. However, in the case of a company which mines for gold and which is exempt from secondary tax on companies in terms of an option exercised by it, 37 cents per R1 of its non-gold mining taxable income (paragraph 2*(a)* of Schedule 1).

(b) Taxable income derived by a company which qualifies as a small business corporation as defined in section 12E:
  (i) 0 cents in respect of taxable income up to R35 000
  (ii) 10 cents per R1 of taxable income exceeding R35 000, but up to R250 000, and
  (iii) 29 cents per R1 of taxable income exceeding R250 000

  (paragraph 2*(b)* of Schedule 1).

(c) Taxable income derived by an employment company as defined in section 12E: 34 cents per R1 of taxable income (paragraph 2*(c)* of Schedule 1).

(d) Taxable income derived by a company from gold mining: an amount determined in accordance with one of the following formulae—

  (i) where such company is not exempt from secondary tax on companies:

$$y = 35 - \frac{175}{x} \text{ ; or}$$

(ii) where such company is exempt from secondary tax on companies:

$$y = 45 - \frac{225}{x},$$

as provided for in paragraph 2*(d)* of Schedule 1.

(e) Taxable income in the form of "recoupments" of capital expenditure accruing to companies which are or have been gold mining companies: the average rate of tax, determined as provided, or 29 cents per R1, whichever is the higher (paragraph 2*(e)* of Schedule 1).

(f) Taxable income derived from long-term insurance business:
(i) 30 cents per R1 in respect of the insurer's individual policyholder fund; and
(ii) 29 cents per R1 in respect of the insurer's its company policyholder fund and corporate fund
(paragraph 2*(f)* of Schedule 1).

(g) Taxable income (excluding from gold mining, long-term insurance business, or a qualifying project enjoying tax holiday status, or derived by a small business corporation or an employment company) derived by a non-resident which carries on trade through a branch or an agency within the Republic: 34 cents per R1 (paragraph 2*(g)* of Schedule 1).

Example 1:

Facts. Company is incorporated in South Africa but maintains its place of effective management in Foreign Country. Company generates R100 000 of taxable income through a retail sales branch located in South Africa. No treaty for the avoidance of double taxation exists between South Africa and Foreign Country.

Result. Even though Company maintains its effective place of management outside South Africa, the 34 per cent rate described in paragraph 2*(g)* does not apply to the R100 000 of taxable income because Company is a South African resident for income tax purposes by virtue of its South African incorporation.

Example 2:

Facts. The facts are the same as Example 1, except that South Africa and the Foreign Country have entered into a treaty for the avoidance of double taxation. The treaty determines the residence of a company based on the location of that company's place of effective management.

Result. Company does not qualify as a South Africa resident for income tax purposes because the treaty views Company as a resident of Foreign Country. The 34 per cent rate described in paragraph 2*(g)* applies to the R100 000 of taxable income because Company is a non-resident for income tax purposes and that income is derived through a South African branch. STC is not payable by the Company as it is not a resident.

(h) Taxable income derived by a qualifying company which has been granted tax holiday status in terms of section 37H of the Income Tax Act, 1962: zero cents per R1 (paragraph 2*(h)* of Schedule 1).

For purposes of paragraph 2 of Schedule 1, income derived from mining for gold shall include any income derived from silver, osmiridium, uranium, pyrites or other minerals which may be won in the course of mining for gold, and any other income which results directly from mining for gold.

CLAUSE 3

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

This clause increases the primary rebate from R5 800 to R6 300 and the secondary rebate for persons 65 years and older from R3 200 to R4 500. These changes mean that the tax threshold for individuals under age 65 is increased to R35 000 and for individuals at least 65 years of age is increased to R60 000.

CLAUSE 4

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

Section 8 of the Income Tax Act, 1962, determines the taxable portion of an allowance or advance paid by a principal to a recipient. This taxable portion, however, does not include any allowance or advance to the extent that it was actually expended by the recipient on *inter alia* travelling on business. Section 8 contains a deeming provision relating to the distance travelled by a taxpayer to avoid the need to maintain exact details of business travel in the form of a logbook. In terms of this deeming provision the first 14 000 kilometres travelled by a person in a year is deemed to be private travel. The deemed private travel is deducted from the distance travelled in a year (limited to a total of 32 000 kilometres) and the balance is deemed to constitute business travel. The rate per kilometre applied to determine the amount expended on business travel is based on a cost table fixed by the Minister in respect of different categories of vehicles.

The deduction of deemed business expenses against a motor vehicle allowance has increased substantially over the years. As mentioned by the Minister of Finance in his Budget Review this year, this generous allowance in the current formula creates an unfair bias in the structuring of salary packages with undue benefits accruing especially to higher income earners. As part of the package of reform in this area, the Minister proposed that the deemed private kilometres be increased from 14 000 to 16 000 and this amendment gives effect to that proposal.

It is, furthermore, proposed that as the fixed cost table only allows costs in respect of vehicles up to the value of R360 000, a taxpayer claiming actual costs should also be limited to that amount.

CLAUSE 5

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

The interest and dividend exemption is currently fixed at R11 000 for taxpayers under 65 years of age and R16 000 for taxpayers aged 65 years and older. The Minister of Finance proposed in his Budget Review this year that the interest and dividend income exemption be raised with effect from 1 March 2005 to R15 000 for taxpayers under the age of 65 and to R22 000 for taxpayers age 65 and over. Up to R1 000 of this exemption may currently be applied to interest and dividends from foreign sources and the balance applies in respect of domestic interest. The Minister further proposed that this amount be increased to R2 000.

CLAUSE 6

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

An amendment is proposed to exclude assets from the application of section 11*(e)* if those assets qualify for a deduction under section 12E. This amendment is consequential upon the proposal to allow a 50:30:20 depreciation allowance on depreciable assets of a small business corporation.

CLAUSE 7

Income Tax: Amendment of section 12B of the Income Tax Act, 1962

An amendment is proposed to exclude assets from the application of section 12B if those assets qualify for a deduction under section 12E. This amendment is consequential upon the proposal to allow a 50:30:20 depreciation allowance on depreciable assets of a small business corporation.

CLAUSE 8

Income Tax: Amendment of section 12C of the Income Tax Act, 1962

An amendment is proposed to exclude assets from the application of section 12C if those assets qualify for a deduction under section 12E. This amendment is consequential upon the proposal to allow a 50:30:20 depreciation allowance on depreciable assets of a small business corporation.

CLAUSE 9

Income Tax: Amendment of section 12E of the Income Tax Act, 1962

Currently, small business corporations enjoy certain tax benefits, i.e. a beneficial rate structure and an immediate 100 per cent write off in respect of manufacturing assets. A small business corporation is defined in section 12E of the Income Tax Act, 1962, to mean a company or a close corporation where—

- the gross income for the relevant year of assessment does not exceed R5 million;

- the shareholders do not hold any share or interest in another company (with the exception of certain holdings in listed companies, collective investment schemes, etc.); and
- not more than 20 per cent of the total receipts and accruals of the company or close corporation consists of investment income and income from rendering a personal service.

Personal service includes the rendering of certain services listed in section 12E which are performed personally by a person who holds an interest in the company or close corporation (i.e. a shareholder or member).

The Minister of Finance announced in his Budget Review this year that the categories of companies that should qualify for the small business relief will be greatly expanded to also cover the services sector in recognition of their prominence as an engine of growth within the wider small business sector. Small business corporations which are primarily engaged in the provision of personal services will now become eligible for the relief if the company or close corporation maintains at least four full-time employees for the core operations of the business. Furthermore, the turnover limit for small business corporations will also be increased from R5 million to R6 million.

In addition to other tax relief proposed in the 2005 Budget, such as extending the scope of small business corporations and introducing a beneficial rate structure, the Minister also proposed a simplified and enhanced depreciation regime to encourage fixed capital formation. Small business corporations will now be eligible for a deprecation write-off at a 50:30:20 per cent rate over a three-year period for all depreciable assets (other than manufacturing assets, which retain their immediate 100% write-off). This amendment gives effect to this proposal.

Bearing in mind the rate adjustments which apply in respect of years of assessment which end on or after 1 April 2005, the Minister also proposed that the R20 000 double deduction of start up expenses be removed. These amendments give effect to these proposals.

CLAUSE 10

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

In 2004 the definitions of “adjusted initial amount” and “yield to maturity” were amended to address the tax avoidance element of schemes which are based on the circular flow of funds to which connected persons are party. The intention was to limit the interest claimable. In order to achieve the limitation, the “adjusted initial amount” eliminates the circular flow of funds and the “yield to maturity” rate also takes into account the circular flow of funds in order to discourage taxpayers from entering into these schemes. It has been argued that the amendment to the definition of “yield to maturity” has the effect that it also impacts on the taxation of the holder of an instrument (the recipient of interest) and that the calculated interest rate could be increased instead of being limited. In order to provide certainty in this regard, it is proposed that the second proviso to the definition of “yield to maturity” be amended to require that where an instrument forms part of a transaction, operation or scheme, the circular cash flow should be taken into account as a reduction of amounts payable by the issuer (person incurring the interest) in calculating the yield to maturity rate. Furthermore, provision is made for a zero rate of interest to be used where the calculated rate of compound interest results in a negative rate of interest.

CLAUSE 11

Income Tax: Amendment of paragraph 23 of the Fourth Schedule to the Income Tax Act, 1962

Although taxpayers can generally claim foreign tax credits for foreign taxes paid against their final liability for income tax in South Africa, the provisional tax payment system currently only accounts for these credits in the case of individuals and not companies. It is proposed that the provisional tax system for companies be aligned with that of individuals to allow for these foreign tax credits to be taken into account. This amendment gives effect to this proposal.

CLAUSE 12

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

Section 44 of the Customs and Excise Act, 1964, provides that there is no liability for an underpayment of duty, if the underpayment is found during the course of an investigation which commenced more than two years after the date on which underpayment occurred.

It has been argued that the provision is somewhat ambiguous in this regard and it is proposed that it be clarified.

CLAUSE 13

Air Passenger Departure Tax: Amendment of section 47B of the Customs and Excise Act, 1964

The air passenger departure tax was last adjusted for inflation in 2003. The Minister of Finance has therefore proposed an increase in the air passenger departure tax from R55 to R60 in respect of international departing passengers traveling to Botswana, Lesotho, Namibia and Swaziland, and from R110 to R120 for all other international flight destinations.

The rate changes for Botswana, Lesotho, Namibia and Swaziland will be published by way of notice in the *Gazette*, and the rate change from R110 to R120 for other countries is contained in the Bill.

These changes will generally come into operation for flights commencing on or after 1 August 2005. The new rates will however not apply for flight tickets purchased and issued before this Bill is promulgated.

CLAUSE 14

Customs and Excise: Amendment of Schedule No. 1 to Act 91 of 1964

This clause provides for the amendment of Schedule No. 1 to the Customs and Excise Act, 1964. These amendments are reflected in Schedule 2 to this Bill. These amendments give effect to the taxation proposals which were tabled by the Minister of Finance during his Budget Speech this year and contain the rates of duty in respect of alcoholic and tobacco products.

CLAUSE 15

Customs and Excise: Continuation of certain amendments of Schedules Nos. 1 to 6 and 10 to Act 91 of 1964

This clause provides for the continuation of the amendments to the Schedules to the Customs and Excise Act, 1964, which were effected by the Minister of Finance during the 2004 calendar year.

CLAUSE 16

Stamp Duties: Repeal of item 6 of Schedule 1 to the Stamp Duties Act, 1968

As was announced by the Minister of Finance in his Budget Review this year, Government and the public alike have become increasingly concerned about the high cost of banking charges in South Africa. These charges have a disproportionate impact on low-income individuals as well as small businesses. Government has accordingly decided to play its role in reducing these charges by eliminating stamp duties on all debit entries with effect from 1 March 2005 and this amendment gives effect to this proposal.

CLAUSE 17

Stamp Duties: Repeal of item 13A of Schedule 1 to the Stamp Duties Act, 1968

As was announced by the Minister of Finance in his Budget Speech this year, stamp duties on instalment credit agreements are abolished with effect from 1 March 2005. This amendment gives effect to that proposal.

CLAUSE 18

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

Last year legislation was introduced to withdraw the tax exemption for non-proprietary exchanges. This legislation, however, only comes into operation on a date to be determined by the President by Proclamation. It was announced in the Budget Review this year that legislation will be introduced to address the tax consequences of the possible incorporation of these exchanges. As far as the issue of shares by the newly incorporated exchanges is concerned, it is proposed that an exemption from stamp duty be introduced to ensure that no duty will be payable on this issue.

CLAUSE 19

Regional Services Councils Levies: Amendment of section 12 of the Regional Services Councils Act, 1985

As was announced by the Minister of Finance in his Budget Review this year, a prescription period will be included in the Regional Services Councils Act, 1985, to limit the retrospective collect of RSC levies to create certainty, especially following a recent court decision which ruled that dividends paid to certain holding companies were subject to RSC levies. This amendment gives effect to this proposal and makes provision for a two year limitation on the collection of RSC levies in all instances, except in the case of fraud or misrepresentation.

CLAUSE 20

Kwazulu and Natal Joint Services Levies: Amendment of section 16 of the Kwazulu and Natal Joint Services Act, 1990

See notes relating to Regional Services Councils Levies in clause 19. The Kwazulu and Natal Joint Services Act, 1990, contains similar provisions as are contained in the Regional Services Councils Act, 1985, and it is proposed that a similar limitation be included in this Act.

CLAUSE 21

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

Prior amendments to the Act in terms of Acts 45 of 2003 and 32 of 2004 respectively had the unintended effect that SETA grants payable to designated entities did not qualify for the application of the zero rate of VAT. The proposed amendment will allow a designated entity to account for output tax at the zero rate where the payment is a training grant which is paid in terms of section 10(1)*(f)* of the Skills Development Act, 1998 by a SETA for the purposes of training the employees of the designated entity.

CLAUSE 22

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

The proposed amendment is to allow for the payment of penalty and interest where a person fails to pay VAT on an environmental levy in terms of section 7(3)*(a).*

CLAUSE 23

Value-Added Tax: Amendment of section 40A of the Value-Added Tax Act, 1991

The proposed amendments are consequential upon other amendments pertaining to public authorities and public entities contained in the Revenue Laws Amendment Act, 2003 (Act No. 45 of 2003) and the Revenue Laws Amendment Act, 2004 (Act No. 32 of 2004) which came into effect from 1 April 2005.

As from 1 April 2005 public entities listed in Schedule 1 or Part A or C of Schedule 3 to the Public Finance Management Act, 1999 (Act No. 1 of 1999)("the PFMA"), which are registered as vendors are to be deregistered and only in very limited circumstances will they be required to register as vendors. As a result of uncertainty in the past as to what constitutes "transfer payments" some public entities applied the zero rate of tax to supplies they made. In some of these cases this incorrect application has been corrected by the Commissioner by the issuing of assessments and the amounts due on these assessments are wholly or partly outstanding. These public entities are largely funded by Government and if the tax due is to be paid additional funds will have to be made available to the entities to pay the tax which will result in a circular flow of funds in the Government.

In order to address this section 40A proposes that upon written application, the Commissioner must issue a reduced assessment in respect of certain amounts of tax, additional tax, penalty and interest which have been assessed and are payable by any public entity listed in Schedule 1 or Part A or C of Schedule 3 to the PFMA, or any public authority (government department). The reduced assessment only applies where and to the extent that the amount payable arose as a result of the incorrect application of the zero-rate in terms of sections 8(5) and 11(2)*(p)* on an actual supply of goods or services made on or before 31 March 2005 and is still outstanding on that date. This is where the public entity or public authority failed to charge VAT at the standard rate in terms of section 7(1) because it assumed that the payment in respect of those supplies qualified as a "transfer payment" as defined in section 1.

The amount of the reduced assessment may not exceed the net balance of VAT which remains payable on 31 March 2005 by the public entity or public authority concerned. Where any refund due to that vendor arose in any tax period subsequent to the tax period in which the assessment was raised and has been set off against the outstanding debt, or if any part of that amount has otherwise been recovered by SARS, that amount will not be reduced. The reduced assessment may therefore not give rise to a refund of any tax, additional tax, penalty or interest paid in respect of the outstanding amount for any period prior to 1 April 2005.

In order to prevent the Commissioner from issuing assessments where no assessments have been raised before 1 April 2005 on the entities and authorities mentioned above, in regard to the incorrect application of the zero rate in terms of sections 8(5) and 11(2)*(p)* for the period prior to 1 April 2005, it is proposed that the Commissioner may not raise any assessment to recover those amounts.

On the other hand, to prevent the claiming of refunds where the public entity or public authority concerned has incorrectly paid output tax in terms of section 7(1) at the standard rate instead of the zero rate in terms of sections 8(5) and 11(2)*(p)* on a "transfer payment", it is proposed that the Commissioner may not refund any amount of tax, penalty or interest incorrectly paid in respect of any period prior to 1 April 2005.

Example 1

A Schedule 3A PFMA public entity (vendor) supplies management services to a Schedule 3C PFMA public entity. VAT should have been charged at 14% on the services in terms of section 7(1), but both parties were under the mistaken impression that the payment made was a zero-rated "transfer payment." SARS raised an assessment against the Schedule 3A PFMA public entity in the amount of R50 000 in March 2003. Since that date, SARS has recovered R35 000 of that *amount by offsetting VAT refunds which were due to that entity. With effect from 1 April 2005, the entity will be required to deregister, but it still has a VAT liability of R15 000 plus penalty and interest thereon as at 31 March 2005. In terms of section 40A(2), the remaining tax liability of R15 000, plus the penalty and interest thereon must be reduced to nil by the issuing of a reduced assessment by the Commissioner, if written application is made in this regard. This is because the entire liability to tax relates to the incorrect application of the law referred to in that section.*

Example 2:

If in the case of the Schedule 3A PFMA public entity in example 1, SARS had not raised an assessment for the VAT by 31 March 2005 which should have been levied in terms of section 7(1) on the consideration paid for the management services supplied. The Commissioner may not make any assessment to correct the previously incorrect application of the zero rate (section 40A(3)).

CLAUSE 24

Skills Development Levies: Amendment of section 4 of the Skills Development Levies Act, 1999

Currently, a business with a payroll of less than R250 000 per annum and which does not have any employees who are liable for PAYE, is exempt from the payment of skills levy. As part of the initiative to provide relief for small businesses and to reduce their compliance costs, the Minister of Finance proposed in his Budget Review this year that the threshold for the exemption from the skills development levy be increased to R500 000. The requirement of not having any employees liable for PAYE will also be deleted.

CLAUSE 25

Income Tax: Amendment of section 40 of the Revenue Laws Amendment Act, 2004

The provisions relating to secondary tax on companies (STC) were amended in 2004 to *inter alia* deal with the STC credits in respect of foreign dividends received. Prior to this amendment in 2004, foreign dividends from designated countries could still be claimed as an STC credit up to the end of any year of assessment commencing before 1 June 2004. It was not clear to what extent the commencement date for the STC amendments introduced in 2004 affected these designated country dividends. It is, therefore, proposed that the commencement date be amended to clarify that it was not the intention to change the original date of withdrawal of the credit in respect of designated country foreign dividends, i.e. only in respect of dividends received in any year of assessment commencing on or after 1 June 2004.

CLAUSE 26

Tax treatment of share acquired upon conversion of non-proprietary exchange

Last year legislation was introduced to withdraw the tax exemption for non-proprietary exchanges. This legislation, however, only comes into operation on a date to be determined by the President by Proclamation. It was announced in the Budget Review this year that legislation will be introduced to address the tax consequences of the possible incorporation of these exchanges. A specific provision is inserted to ensure that the conversion of rights in the non-proprietary exchanges into shares in the newly incorporated exchanges does not trigger tax consequences in the hands of the holders of the rights.

CLAUSE 27

Taxation proposals on customs and excise duties

Schedule 1 of the Customs and Excise Act, 1964, is amended by clause 14 to give effect to the rates of duty in respect of alcoholic and tobacco products which were tabled by the Minister of Finance during his Budget Speech.

The budget proposals contained incorrect rates of customs and excise duties in respect of cigarettes. The proposals contained the rate of 252.43c per 10 cigarettes instead of 252.22c. These rates have been rectified in the Schedule to the Bill. However, for technical reasons it is also necessary to amend the Taxation Proposals tabled by the Minister.

CLAUSE 28

Short title and commencement

This clause provides the short title and commencement date of the Bill.