



**national treasury**

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National Treasury  
REPUBLIC OF SOUTH AFRICA



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**Portfolio Committee on Finance**  
**Revenue Laws Amendment Bills &**  
**Securities Transfer Tax Bills**  
**Response Document**  
**9 November 2007**

**1. BACKGROUND**

**1.1 Process**

The Revenue Laws Amendment Bills, 2007, represent the second part of this year's tax proposals as announced in the 2007 Budget Review. The main issue is the broadening of the base for the Secondary Tax on Companies ("STC"). This base broadening comes with a rate reduction from 12,5 per cent down to 10 per cent.

These Bills are also accompanied by the Securities Transfer Tax Bills, 2007. The Securities Transfer Tax is not a new tax but simply a combination of two pre-existing taxes. Stamp Duties on unlisted shares and Uncertificated Securities Tax on listed shares will be combined into a single transfer tax on securities. The Uncertificated Securities Tax Act was the template for the newly combined tax, with adjustments to accommodate unlisted shares.

National Treasury and SARS presented both sets of bills before the Portfolio Committee on Finance at an informal hearing held on 26 September 2007. Public hearings were held before the Committee on 16 October 2007 and 19 October 2007. National Treasury and SARS' responses (which are the subject of this document) were presented in draft form on 24 October 2007. Both sets of bills were tabled on 30 October 2007, as scheduled.

## 1.2 Public comments

A request for public comments was announced by website-media release giving taxpayers approximately a month to submit comments. The Portfolio Committee on Finance and National Treasury/SARS received most of these comments during the week of 7 October 2007. Total comments received amounted to approximately 60 submissions (see **Annexure**).

## 2. RESPONSES

Provided below are responses to the policy issues raised by the comments received. This response section is outlined as follows:

- (i) STC base broadening;
- (ii) Group of companies relief;
- (iii) Company reorganisations;
- (iv) Capital versus ordinary shares;
- (v) Intellectual cross-border payments;
- (vi) Long-term insurers and controlled foreign companies (CFCs);
- (vii) Depreciation;
- (viii) Exemption of occupational death benefits;
- (ix) Oil and gas fiscal stability;
- (x) Securities Transfer Tax;
- (xi) Miscellaneous – Income Tax; and
- (xii) Miscellaneous – Other taxes;

### 2.1 STC: base broadening

Background (pre-2001 capital profits/pre-1993 profits; section 1 “dividend” definition and section 64B(5)(c)): Under current law, distributions out of capital and ordinary profits equally give rise to dividends subject to STC unless those distributions are part of a liquidation (or similar winding up or termination). In the latter circumstance, distributions out of all pre-1993 profits and pre-2001 capital profits are exempt. The proposed legislation repeals both exemptions.

(ABASA; Association of Trust Companies in SA; Advocate Meyerowitz; Edward Nathan Sonnenbergs; Ernst and Young; KPMG; Mallinicks; Old Mutual; SAICA; The Banking Association SA; Werksmans)

Comment #1: The effective date of the proposed legislation is unclear. The rules relating to section 1 appear to indicate that the proposed legislation will be effective for all distributions as of 1 January 2009, but the section 64B amendments indicate a 1 October 2007 effective date. The 1 January 2009 effective date is obviously preferred to give taxpayers time to adjust.

Response: *Accepted*. The proposed date for the repeal is 1 January 2009.

Comment #2: The proposed legislation repealing the exemption for pre-1993 profits and pre-2001 capital profits is retrospective regardless of whether the effective date is of 1 October 2007 or 1 January 2009. Many taxpayers will not be in a practical position to utilise the exemption in either time-frame.

Response: *Not accepted.* The proposed repeal only impacts future liquidations. Dual profit systems cannot be maintained into the indefinite future. Simplification requires eventual hard cut-offs.

Background (unrealised profits; section 1 “dividend” definition): The proposed legislation clarifies that distributions will qualify as dividends irrespective of whether those distributions come out of realised or unrealised profits. Unrealised profits within this ambit are taken into account even if not recognised in the financial accounts of the company.

(PWC)

Comment: The proposed legislative inclusion of “unrealised” profits will be administratively burdensome, requiring asset valuations for many actual and deemed distributions. The proposed legislation should accordingly limit “unrealised” profits solely to those assets distributed *in specie*.

Response: *Not accepted.* The compliance concern is overstated. Valuations will only be required for extraordinary dividends (or where distributions test the boundaries of available profits). Most operating dividends typically do not approach any profit boundaries. Distributions out of unrealised profits would typically involve a borrowing against assets or the distribution of an asset *in specie*, which would require a separate valuation in any event.

Background (allocation of share capital and premium; section 1 “dividend” definition): Distributions out of (ordinary and capital) profits are subject to STC; whereas, distributions out of share capital and share premium are outside the ambit of STC. The distinction between profits versus share capital/share premium is essentially based on company law and accounting concepts. The allocation of share capital and share premium to specific distributions is largely unrestricted, subject solely to isolated limits imposed by company law or by virtue of a company’s articles of incorporation. In order to restrict this free allocation, the proposed legislation limits the amount of share capital/share premium that can be allocated to redeemed / cancelled shares. Under this proposed system, the share capital/share premium allocated to specific shares is limited to a formula based on the relevant market value of the shares as compared to the total shares of the company.

(KPMG; LSSA; PWC; SAICA; Werksmans)

Comment: The market value allocation of shares is unrealistic. The share capital/share premium created with the initial issue of shares bears no relationship to the relative market values of those shares

as those values evolve. The pro rata allocation of share capital/share premium is especially problematic for preference shares whose value changes little over time; whereas, ordinary shares typically rise in value over time. If the proposed amendment were to proceed, the net result will be an unsubstantiated shift of share capital/share premium away from preference shares to ordinary shares.

Response: *Accepted.* The market value method was initially chosen due to concerns that companies might not have sufficient records to classify share capital/share premium per class of share. The comments received suggest otherwise and allocation per class of shares, based on contributions for the issue of those shares, represents a better policy approach.

Background (impact of capital distributions; paragraph 76 and 76A of the 8<sup>th</sup> Schedule): Even though capital distributions are exempt from STC, these distributions have a deferred impact under the capital gains tax system. Instead of being treated as an immediate dividend, capital distributions are currently deferred “proceeds” and are only triggered upon subsequent disposal of the underlying shares giving rise to the capital distribution. Stated differently, capital distributions are outside the scope of STC and the capital gains tax is postponed until disposal of the underlying shares. The proposed legislation alters the capital gains tax impact by triggering an immediate part-disposal for capital distributions *in lieu* of the current deferral system.

(BHP Billiton; Deloitte & Touche; Ernst & Young; Gold Fields; Jan. S De Villiers; KPMG; Mallinicks; New Clicks; PKF; PWC; SAICA; The Banking Association SA; Webber Wenzel Bowens; Werksmans)

Comment #1: While the need for the amendment is generally accepted, at issue is the proposed deemed disposal for capital distributions occurring prior to the September 2007 release of the proposed legislation. More specifically, the proposed legislation creates a deemed 1 July 2008 deemed disposal date for all of these prior capital distributions. The 1 July 2008 deemed disposal of all shares involved in pre-existing capital distribution is retrospective.

Response: *Partially accepted.* The initial legislation envisioned that capital distributions represented deferral of capital gains tax, not an outright exemption (i.e. not permanent deferral). The proposed amendment merely ensures eventual recognition of this pre-existing liability as initially intended. However, given the large number of parties and sums involved, some accommodations will be made. Therefore, the deemed disposal date will be moved from 1 July 2008 to 1 July 2011. This change will mean that many shareholders will trigger gain in the ordinary course as intended (i.e. given the fact that many shareholders sell their shares within a few years). On the other hand, taxpayers who engaged in share

capital distributions with the expectation of never disposing of their shares in the normal course (i.e. who have completely stripped the underlying company of value, thereby leaving that company as permanently dormant) will be faced with an eventual deemed disposal as the legislation initially intended. Even these taxpayers will, however, have a substantial period to ensure that they have adequate resources on hand to meet the tax liability. Given the large sums that many of these deals have involved, National Treasury and SARS are reluctant to grant permanent shelter to this potential loss in revenue.

Comment #2: The proposed part-sale regime for capital distributions is problematic in respect of foreign shares. Dividends are exempt if paid to a South African shareholder (and certain of their controlled foreign companies) owning at least 20 per cent of the foreign shares giving rise to the dividend. However, the same exemption does not apply to capital distributions of the same nature. The need for an incentive to repatriate capital distributions back to South Africa is the same, thereby justifying an equivalent exemption.

Response: *Accepted.* The repatriation of share capital distributions back to South Africa should receive the same level of encouragement (i.e. exemption) as dividend repatriations. The law will accordingly be amended to provide an exemption for share capital repatriations that matches dividend repatriations.

Comment #3: The proposed part-sale regime for capital distributions should contain an escape clause for listed shares. An escape clause is needed for listed shares because part-sale treatment (though correct theoretically) will create an added administrative burden for many smaller (innocent) shareholders.

Response: *Not accepted.* The avoidance of concern can equally arise in a listed as well as unlisted context. Private equity deals have often been a culprit in this area, some of which seek to convert listed companies into unlisted companies.

Background (dividend stripping; paragraph 19 of the 8<sup>th</sup> Schedule): Judicial precedent prevents artificial losses stemming from dividend stripping in the case of shares held as trading stock, and specific legislation exists that prevents dividend stripping in the case of shares of a capital nature. The current legislative regime preventing dividend stripping in the case of shares held as capital is triggered if the shareholder at issue receives an extraordinary dividend within two years of purchase. These rules essentially deny any capital loss to the extent of the extraordinary dividend. The proposed legislation strengthens the scope of this rule. First, the trigger is now an extraordinary dividend that occurs two years before sale (as opposed to two years after acquisition). Second, all extraordinary dividends within this two year period add to proceeds (i.e. both to reduce loss or to increase gain) upon subsequent sale.

(Deloitte & Touche; KPMG; PKF; PWC; SAICA; Werksmans)

Comment #1: The proposed anti-dividend stripping rule creates a double tax charge. Taxpayers could be subject to both the STC as a result of that distribution while also being subject to additional capital gains tax due to the extraordinary nature of the distribution. Therefore, the proposed change should either be dropped, be limited to situations where the dividend at issue is exempt from STC or the rule should be limited solely to prevent artificial loss.

Response: *Accepted.* The potential for both STC and CGT to apply to the same distribution has been noted. The rule has accordingly been amended to only disallow capital losses.

Comment #2: The proposed anti-dividend stripping rule should not apply in listed situations because small listed parties would not seek to benefit from these transactions.

Response: *Not accepted.* The avoidance of concern could happen equally in a listed and unlisted context. It should be remembered though that the proposed anti-avoidance rule applies only to “extra-ordinary” dividends (which can effectively devalue the underlying shares to generate a capital loss on those shares). This limitation means that the anti-avoidance rule normally does not apply (e.g. to listed shareholders receiving regular dividends in the ordinary course of events).

Background (reduction of investment distributions; section 1 “dividend” definition; section 64B(5)(f)): Dividends between companies within the same group are exempt from tax under the notion that the underlying profits will eventually be subject to tax when those dividends leave the group. The proposed legislation seeks to ensure this result by allowing the exemption only if a group company receiving an STC-free dividend adds that dividend to profits. In other words, a corresponding reduction in profits for the distributing group company should be matched by a corresponding increase in profits for the recipient group company. Without this change, we understand that a number of transactions are ongoing that seek not only to create a permanent STC exemption but also an artificial capital loss.

(Ernst & Young; KPMG; The Banking Association SA; SAICA; SAVCA)

Comment #1: In accounting, distributions may be reflected on the books as a reduction in share investment as opposed to a dividend (see *International Accounting Standard 18*). This reduction in investment treatment especially occurs when a distribution comes from pre-acquisition profits. This reflection of a distribution as a reduction in investment should not give rise to immediate STC.

Response: *Accepted.* The accounting treatment of a distribution as a reduction in investment should not give rise to immediate tax. This reduction in investment (typically for distributions out of pre-

acquisition profits in respect of the newly acquired shares) is more akin to a capital distribution. With this envisioned shift, the proposed legislation will accordingly treat reductions in investment (in a group context) as a capital distribution that will generally give rise to immediate capital gain (without any STC), but this gain will be minimal or nil for newly acquired shares. The proposed legislative change (as altered) will solve the avoidance of concern without prejudicing taxpayers.

Comment #2: The required addition of profits for the recipient group company is unclear. What happens if profits are added but offset by recipient group company losses? The addition of profits in this latter circumstance should theoretically give rise to intra-group STC relief without regard to offsetting shareholder losses arising from other transactions.

Response: *Accepted.* The proposed legislation should merely require that the distribution is taken into account in the determination of profits in the hands of the group shareholder recipient (irrespective of whether there are offsetting losses). The proposed legislation will be altered accordingly.

Comment #3: Reliance on accounting profits as a pre-condition for the STC group exemption is misplaced. Tax legislation is complex enough without unnecessarily creating a debate on the meaning of accounting concepts.

Response: *Not accepted.* STC has relied on the concept of accounting profits as the base since its inception in 1993. The group exemption is merely an extension of this pre-existing reliance.

## 2.2 Group of companies relief

Background (narrowing the group definition; sections 1 and 41 “group of companies” definition): Various forms of tax relief exist for transfers between companies within the same group. The purpose of this relief is to treat the group as a single economic entity in certain circumstances. One key requirement of group status is for the companies involved to have a 70 per cent share ownership link. The proposed legislation seeks to ensure that this 70 per cent linkage is of a permanent nature, not just a transitory relationship. The proposed legislation accordingly excludes shares held as trading stock, shares subject to a contractual obligation to sell and shares subject to an option for sale.

(Ernst & Young; KPMG; The Banking Association SA; Werksmans)

Comment #1: The exclusion of trading stock shares is too wide. For instance, banks holding “properties in possession” housed in separate companies could be impacted.

Response: *Not accepted.* The exclusion for trading stock is designed precisely to target investments of the kind raised. Subsidiaries of this nature are not really part of a long-term group structure but more akin to a separate asset for potential sale.

Comment #2: The exclusion for shares subject to options is too wide. For instance, shares subject to pre-emptive rights as a security for financing, and “earn-in” arrangements (with employees earning into the shares of a company if certain conditions are satisfied) would be impacted.

Response: *Partially accepted.* Options that allow non-group parties to acquire shares at market value at the time of exercise will not trigger any de-grouping. Options of this nature (such as pre-emptive rights) do not give non-group parties any special claim vis-à-vis group ownership. This escape hatch, however, presumably does not assist employee earn-in arrangements, but earn-in relationships of this kind will rarely be of a sufficient percentage to cause a de-grouping.

Background (de-grouping charge; section 45(4)): Under current law, the group of companies definition includes all companies with a 70 per cent shareholder connection, regardless of whether those companies are domestic, foreign, or wholly or partly outside the tax net. However, only transfers to fully taxable companies within the tax net receive STC intra-group relief or trading stock/capital asset rollover relief. The proposed legislation narrows the group definition to include only domestic companies that are fully within the tax net (from a substantive law and administrative viewpoint). The narrowed group definition will be effective as of 1 July 2008.

(Deloitte; KPMG; SAICA; Webber Wenzel Bowens)

Comment #1: The proposed change will adversely impact foreign investment. Many foreign companies operate as the parent company to South African subsidiaries that lack any South African linkage with one another. The change also prevents foreign companies with South African branches from transferring assets to each other, even though these foreign companies are part of the same group. In the final analysis, any exclusion of foreign companies from this relief will be viewed as discriminatory.

Response: *Not accepted.* Firstly, the change is not discriminatory. Only companies fully within the tax net (from a substantive and administrative viewpoint) can be members of a group. Hence, the exclusion applies equally to foreign and domestic parties outside the net. Secondly, the argument is overstated because most foreign companies operate through a single channel. The narrowed group definition is important from a policy viewpoint if this form of tax deferral is to be effectively maintained in the long term.



Comment #2: The proposed change will prevent section 21 public benefit organisations from receiving dividends free from STC stemming from controlled subsidiaries. This change will undermine a valuable source of public benefit funding.

Response: *Not accepted.* The argument is flawed. Under current law, public benefit organisations already fall outside the scope of the intra-group STC exemption. The proposed amendment would effectively mean that the STC intra-group deferral regime can be converted into an outright exemption.

Comment #3: The proposed change will prevent group relief if a South African holding company solely receives dividends (all of which are exempt in the hands of the recipient even if the recipient is an otherwise taxable entity). Any exclusion from group status for exempt shareholders should depend on an exemption stemming from the nature of the shareholder as opposed to the nature of the revenue streams received (such as dividends that are exempt regardless of the recipient).

Response: *Accepted.* The proposed draft legislation admittedly contains a technical problem that creates this undesirable result for South African holding companies. The proposed legislation will accordingly be modified to remedy this concern.

Comment #4: One consequence of a narrowed group definition (to be effective as of 1 July 2008) is that company members previously within a single group may find themselves falling outside that group as of the implementation date. This de-grouping for pre-existing groups will trigger a de-grouping charge on 1 July 2008, thereby triggering gains and losses for previous rollovers. Therefore, the old group definition should be retained for previous group transactions to prevent this forced de-grouping.

Response: *Partially accepted.* The recommendation creates administrative difficulties. Two systems would have to be maintained – one group definition for older transactions and one for newer transactions. Moreover, taxpayers forget that the new regime also has benefits, such as the 6-year limit on the de-grouping charge. If the old regime were to be retained for older transactions as suggested, would these taxpayers be willing to forego the benefit of the 6-year limit on the de-grouping charge for these older transactions (or are they seeking the best of both worlds)? Again, the proposed problem can be remedied through a restructuring in most cases by simply adding a holding company to act as a single entry point into South Africa. This restructuring can generally be accomplished free from South African tax. Given the fact that some companies may have difficulty with restructuring due to issues other than tax, the proposed 1 July 2008 effective date will be shifted to 1 January 2009.

Comment #5: Two different effective dates for the narrowed group definition exist – one for intra-group STC relief and one for intra-group rollover relief. The group definition for STC applies as of 1 October 2007, and the group definition for rollover relief applies as of 1 July 2008. The STC group definition date should be moved to 1 July 2008.

Response: *Not accepted.* The split effective date was intended. A narrowed group definition for intra-group STC on 1 October 2007 is consistent with the reduced STC dividend rate from that date. The date in respect of the narrowed group definition represents a different trade-off, which allows taxpayers to avoid the de-grouping charge with appropriate restructuring. No de-grouping charge is at stake in the case of intra-group STC relief.

Comment #6: The revised formula for the de-grouping charge still does not work. The revised formula gives rise to double losses and is out of line with the formula for section 23J (the formula for determining depreciation cost for connected person sales).

Response: *Accepted.* Despite intentions to the contrary, the proposed de-grouping charge does indeed give rise to various problems. The proposed legislation will accordingly be withdrawn for further internal review.

### 2.3 Company reorganisations

Background (removal of financial instrument prohibitions in respect of domestic rollovers and combination of the company formation and share-for-share rollover regimes; sections 41 – 47): Under current law, rollover relief for domestic reorganisations generally does not apply to the transfer of financial instruments or to the transfer of financial instrument holding companies (i.e. companies mainly containing financial instruments). The proposed legislation eliminates this restriction. Current law also contains two sets of related rollover relief – one for company formations and the other for share-for-share transactions. These two sets of relief have been combined because the distinction is no longer relevant with the removal of the financial instrument holding company test.

(Old Mutual; Webber Wenzel Bowers)

Comment #1: While the deletion of the financial instrument holding company test is most welcome, removal of the domestic financial instrument holding company definition is still premature. The definition will still have limited relevance in certain other contexts (e.g. for purposes of the participation exemption for the sale of foreign shares).

Response: *Accepted.* It is agreed that the removal of this definition was premature given its use in other contexts. The definition will accordingly be retained.

Comment #2: The effective date for the proposed changes should be accelerated. Certain practical difficulties with the share-for-share regime can be removed if the proposed changes could cover most of 2007.

Response: *Accepted.* Given the fact that change should be widely favourable to taxpayers and that the change will cover years of assessment for which tax returns have not been submitted, the effective date of the proposed amendment will be accelerated. The proposed legislation will accordingly apply to transactions entered into from 1 January 2007.

Comment #3: The new regime for asset-for-share acquisitions generally removes a number of unnecessary restrictions. However, one benefit of the old share-for-share regime has been overlooked. While target company shares received by the acquiring company generally obtain a rollover tax cost (i.e. the tax cost of each target company transferor), the share-for-share regime allowed for the acquiring company to receive a market value tax cost in listed situations. This market value rule is important in listed situations because the number of target shareholders involved makes reliance on target shareholder tax records impractical (which would otherwise be required for rollover tax cost treatment).

Response: *Accepted.* The fair market value rule associated with the old share-for-share regime will largely be retained within the new asset-for-share regime.

Background (connected person depreciation limitations; section 23J): Current law contains a number of isolated provisions limiting the depreciable cost of property when that property is transferred among connected persons. The proposed legislation combines all of these isolated provisions and seeks to eliminate the double tax elements of these isolated regimes.

(ABASA; SAICA)

Comment: The proposed regime requires the person who acquires the depreciable property to account for all previous holdings by connected persons. This accounting is required even if these holdings occurred many years earlier. This long-term tracking of connected persons is impractical.

Response: *Accepted.* The problem of tracing back through a potentially endless array of connected persons is a feature of the isolated provisions of current law. The new regime will accordingly be limited mainly to situations in which taxpayers directly acquire property from a connected person. A special anti-avoidance rule will also apply if property was held by a connected person within two years before the acquisition. Tracing back to the previous holdings of connected persons will otherwise be eliminated.

Background (sale-repurchase of equivalent shares; paragraph 42A of the 8<sup>th</sup> Schedule): Under current law, the sale of shares at a gain triggers tax, even if equivalent shares of the same company are repurchased shortly thereafter. The proposed legislation provides relief if parties are forced to sell their shares pursuant to a court order under section 311 of the Companies Act, 1973. This relief allows the parties under court order to obtain rollover relief for the forced sale if they repurchase the same kind and quality of shares within 90 days of the forced disposal.

(ABASA; SAICA)

Comment #1: The proposed legislation applies only to listed companies, not to unlisted. All companies should benefit from this relief.

Response: *Not accepted.* Internal research suggests that the transactions of concern mainly arise in listed situations. Further factual information would be required before the proposed regime could be expanded to cover unlisted situations.

Comment #2: The proposed relief applies only to arrangements between the company and its shareholders. The relief should also cover creditor workouts that fall within section 311 of the Companies Act.

Response: *Not accepted.* The proposed regime only allows for gain to be avoided upon the repurchase of shares of the same kind and of the same or equivalent quality as the shares sold. This relationship does not exist in creditor situations if debt is sold, followed by the purchase of shares.

Background (share cross-issues; section 24B): If a company issues shares in exchange for assets, the company generally receives a base cost in the assets received equal to their market value at the time of the share issue. One exception to this rule arises if two companies issue shares in exchange for the shares of one another. Under current law, the cross-issue results in each set of shares having a zero base cost. The proposed legislation provides an exception to this zero base cost rule in order to accommodate self-funding situations. If an operating company issues ordinary shares (or preferred shares convertible into ordinary shares) in exchange for preference shares issued by an investor company, the operating company obtains a market value base cost in the investor company shares.

(Sanlam)

Comment: While the proposed relief for operating companies utilising the cross-issue of shares is welcome, comparable relief should be available for the investor company.

Response: *Not accepted.* From the operating company's perspective, the transaction is akin to a loan. Hence, the reacquisition of the "loaned" amount cannot be viewed as gain except to the extent the amount returned exceeds the loaned

amount. However, from an investor company's perspective, the relationship is more akin to the receipt of shares in exchange for services (with the full benefit to the investors triggering ordinary revenue without offset). Second, National Treasury and SARS are reluctant to trigger base cost for either of the cross-issuing parties without some level of corresponding tax recognition. The proposed solution for the cross-issue of shares achieves this result (one party is triggering ordinary revenue with the other party to the transaction benefiting from a market value cost).

## 2.4 Capital versus ordinary shares

Background (capital treatment for 3-year shares; section 9C): Under current law, the facts and circumstances analysis of case law generally prevails as to the ordinary or capital status of shares. However, taxpayers may make an election to treat all listed shares held as having a capital status if held for at least 5 years. The proposed legislation treats JSE listed (domestic and foreign incorporated company) shares and other (domestic incorporated company) shares as having capital status if held for at least three years (this capital treatment is mandatory, not elective).

(ABASA; Association of Trust Companies in SA; Deloitte & Touche; KPMG; Maillinicks; Old Mutual; PKF; PWC; SAICA; Werksmans)

Comment #1: Clarification is required as to the ordinary or capital status of shares sold before close of the 3-year period (or to any other disposal of shares falling outside the system).

Response: *Accepted.* The proposed legislation only addresses shares held for more than 3 years. Shares outside the new legislation simply revert to pre-existing law as to their capital versus ordinary nature. To the extent not done so, this point will be clarified in the Explanatory Memorandum.

Comment #2: No reason exists to exclude holdings in unlisted foreign shares from this deemed capital treatment. Admittedly, the participation exemption for foreign shares of a capital nature may be of concern because this capital treatment results in exemption (as opposed to a lower rate afforded for assets of a capital nature in a domestic context). However, this concern should lead only to the exclusion of foreign shares eligible for this exemption.

Response: *Not accepted.* Several tax differences exist between domestic and foreign shareholdings. The background analysis (e.g. tax and business practice) leading to the amendment only covered domestic share impacts.

Comment #3: All shares should receive the benefit of capital treatment in respect of shares held for at least three years. No reason exists to exclude preference shares from this regime.

Response: *Not accepted.* Preference shares that have no participating stake in underlying profits are in many ways more akin to debt than pure equity. The preference share dividend yield bears similarities to interest (and indeed is often determined with reference to interest rates of some kind). It is questionable whether automatic deemed capital treatment should prevail in these circumstances.

Comment #4: In calculating the 3-year time period, the pre-existing holding periods of former assets should be added to the calculation if the shares held are received in exchange for former assets as part of any tax-free reorganisation rollover. No exclusion for section 42 asset-for-share rollovers and for section 46 unbundlings should be contained in the final legislation.

Response: *Not accepted.* The purpose of the exclusions is to prevent other long-term assets from being effectively converted into long-term shares qualifying for automatic 3-year capital treatment. For instance, if the proposed recommendation were accepted, taxpayers with 3-year holdings in real estate could simply incorporate that immovable property (i.e. transfer the immovable property for shares in a wholly owned company), thereby automatically obtaining the 3-year capital treatment for the shares of this newly formed property company.

Comment #5: The 5-year election regime of section 9B provides special rules for shares received in substitution by reason of a subdivision or similar arrangement or from an issue of capitalisation shares. Under these special rules, the newly issued shares can take into account the time periods of pre-existing holdings of identical shares. None of these special rules exist in the new 3-year capital treatment regime.

Response: *Partially accepted.* Taxpayers should not be required to start a new time count simply because shares are consolidated or subdivided. The rules in this area will follow the principles of paragraph 78 of the 8<sup>th</sup> Schedule, which provide similar rollover relief for re-arranging the same class of shares in a single company.

Comment #6: The proposed legislation treats tainted section 24A shares more harshly than the former 5-year election regime of section 9B. The old regime essentially allowed pre-1999 section 24A shares to receive capital treatment under the 5-year election of section 9B. The new 3-year capital treatment regime should not undermine this pre-existing situation.

Response: *Accepted.* The proposed legislation will not contain any exclusion for tainted section 24A shares after having taken into account the costs and benefits of administrative enforcement. Taxpayers previously benefiting from the prior rollover of ordinary

revenue as prescribed in section 24A will effectively obtain the added benefit of converting that ordinary revenue to capital.

Comment #7: The proposed legislation contains an ordering rule for multiple share holdings. This ordering rule treats the longest held shares as being disposed of first (i.e. the ordering rule relies on a FIFO formulation). This rule is potentially in conflict with the capital gains tax rules, which provide ordering rules based on the specific identification method, the FIFO method or the weighted average method. For compliance ease, the two sets of rules need to be aligned.

Response: *Not accepted.* While it is appreciated that two different ordering rules will apply for the same set of shares, one relates to the valuation of the shares and the other to determining which shares are being disposed of. For instance, the capital gains regime allows for a weighted average approach in calculating base cost for capital gains tax purposes; no such ordering rule is possible for determining the time for which shares are held for purposes of the 3-year rule.

## 2.5 Intellectual cross-border payments

Background (enhanced transfer pricing; section 31): Current law requires an arm's length standard for prices relating to the cross-border supply of goods and services if the cross-border supply is between connected persons. This supply includes the transfer and use of intellectual property as well as the associated services. The proposed legislation lowers the connected person threshold to include all 20 per cent shareholders of a company even if other parties own a majority stake in that company.

(KPMG; SAICA; Sasol)

Comment #1: The new connected person test appears to apply to all of section 31, which includes not only the arm's length requirement (section 31(2)) but also the thin capitalisation rules (section 31(3)). Presumably, the new connected person test should apply solely for purposes of the arm's length requirement (section 31(2)).

Response: *Accepted.* The proposed connected person test was intended solely for transfer pricing, not the thin capitalisation rules. The proposed legislation will be altered accordingly.

Comment #2: The new connected person test appears to apply to all cross border supplies of goods and services, not only to transfers of intellectual property. Presumably, only intellectual property should fall within the ambit of the new connected person test.

Response: *Accepted.* The proposed connected person was intended to deal only with cross-border intellectual property

transfers (and related services). The proposed legislation will be altered accordingly.

Background (charges against the South African tax base for South African developed intellectual property; section 23I): Intellectual property developed by a fully taxable party within South Africa should ultimately generate taxable ordinary revenue. The proposed legislation seeks to prevent artificial transactions that undermine this result. Mainly at issue are sale license-back transactions that involve deductible payments to parties that have no corresponding South African inclusion of gross income. The counterparties to these transactions are typically foreign parties outside the South African tax net or parties that are otherwise exempt from Income Tax.

(Deloitte & Touche; KPMG; Mallinicks; PWC; SAB; SAICA; Werksmans)

Comment #1: The proposed legislation is unnecessary because Exchange Control prevents the offshore transfer of intellectual property.

Response: *Not accepted.* Application of Exchange Control to cross-border intellectual property transfers lacks a consistent track record. Moreover, sole reliance on Exchange Control to prevent this form of offshore transfer is not sustainable.

Comment #2: The proposed legislation should create taxable gains at the point the intellectual property is transferred offshore. Subsequent payments for the domestic usage of this former South African intellectual property should be respected because all of these payments are made pursuant to pre-existing projects.

Response: *Not accepted.* Taxpayers are essentially asking for more than simple protection against retroactivity; they seek fiscal stability. In essence, they are seeking to use the existence of pre-existing contracts to prevent the application of any new tax legislation. It is widely recognised (even in private contracts) that new tax law can impact on pre-existing arrangements. A simple example would be the application of revised personal income tax rates to employment income derived from a pre-existing employment contract.

Comment #3: The proposed denial of deductions applies if any South African resident owned the intellectual property at any time. This requirement will be extremely hard to comply with, especially for intellectual property formerly owned by South African residents many years ago.

Response: *Not accepted.* Available records associated with intellectual property allow for a comprehensive tracing of historical ownership. The concern is overstated. Any time limitation would effectively mean that the sale license-back problem would eventually grow over time.



Comment #4: The proposed denial of deductions applies if the taxpayer at issue (or a connected person) wholly or partly discovered, developed, created or produced the intellectual property. This aspect of the legislation is too broad. Inputs into the intellectual property at issue can result in denial of tax, even though the contribution of the taxpayer (or connected person) is relatively insignificant when the intellectual property is considered in total.

Response: *Accepted.* The proposed anti-avoidance rule will be limited in this regard solely to situations in which the South African contribution wholly or mainly contributed to the development of the intellectual property (or a material part thereof). A more exact test is problematic, however, due to the ease with which intellectual property can be varied. Given these difficulties, the effective date for the legislation will be delayed until 1 January 2009. This delay will provide time for adjustments to the proposed legislation so that it does not have unintended consequences.

Comment #5: The interaction of the proposed legislation and tax treaties is unclear. Even if the payment is not income in the hands of the payee, the proposed legislation allows the taxpayer at issue to deduct 1/3<sup>rd</sup> of the intellectual property payment if the payment is subject to 12 per cent withholding tax under section 35. The proposed legislation does not address situations where tax treaties alter this 12 per cent rate.

Response: *Accepted.* The interaction of the proposed legislation and tax treaties will be clarified. The 1/3<sup>rd</sup> deduction will be limited to situations where the recipient is subject to tax at a rate of at least 10 per cent after taking into account tax treaties. Treaties lowering the rate below 10 per cent will prevent the application of this 1/3<sup>rd</sup> deduction.

## 2.6 Long-term insurers and controlled foreign companies (CFCs)

Background (impact of linked policies on CFC status; section 9D): Foreign companies that are owned or controlled by South African taxpayers are regarded as CFCs. CFC treatment can result in deemed income for South African taxpayers with a 10 per cent or greater stake in a CFC. In line with legal form, current law treats South African life insurers as owning all shares in foreign companies which they technically hold, even though a large portion of these holdings are held on behalf of investment policy holders. The proposed legislation addresses this situation by excluding investment policy holdings from the 10 per cent deemed attribution rule (these shares will still count toward CFC status). This exclusion is justified on the grounds that the life insurer is acting as a mere trustee on behalf of these policyholders.

(The Banking Association South Africa)

Comment #1: Investment policyholders moving into and out of foreign company investments may still result in a foreign company becoming or

ceasing to be a CFC. The proposed legislation only changes the rules for 10 per cent attribution, not the rules for determining CFC status. Every cessation of CFC status will continue to result in a deemed CGT event for the South African life insurer (who typically satisfies the 10 per cent shareholder threshold). The long-term insurer does not have control over these policyholder decisions.

Response: *Not accepted.* The proposed legislation only seeks to ensure that life insurers are not taxed on CFC income that stems from their trustee relationships. The proposed request now seeks a special dispensation that could arise outside the life insurer context.

Comment #2: It is submitted that other institutions investing on behalf of their clients in foreign collective investment schemes are faced with the same imputation problem on linked products as life insurers. The proposed legislation does not assist these other institutions.

Response: *Not accepted.* The analogy drawn between the problems of long-term insurers addressed in this Bill and other taxpayers is not accurate. Long-term insurers are unique from a tax perspective owing to the trustee principle of the four funds approach. No other class of taxpayers operates under this principle.

## 2.7 Depreciation

Background (commercial buildings; section 13quin): Under current law, owners of commercial buildings are not entitled to claim any depreciation allowances, except in special circumstances. The proposed legislation allows for depreciation to be claimed for all of these buildings (plus improvements) at a rate of 5 per cent per annum over 20 years.

(ABASA; Barloworld Motors; Deloitte & Touche; Ernst & Young; KPMG; Old Mutual; PKF; SAICA; The Banking Association South Africa; Werksmans)

Comment #1: The proposed legislation is limited to new and unused buildings. Pre-existing buildings do not receive the benefit of this regime. No reason exists for this distinction; all buildings should be treated equally.

Response: *Not accepted.* The proposed 5 per cent rate is intended to encourage the creation of new structures. Application of the 5 per cent rate to the acquisition of pre-existing commercial buildings would merely result in a substantial deadweight loss at great expense to the fiscus. Moreover, it should be noted that the 5 per cent rate is substantially above the rates generally applied

for financial accounting, which fall between 2 ½ per cent and 3 ½ per cent.

Comment #2: Even if the legislation is intended solely for new and unused buildings, the proposed legislation should at least cover new improvements on pre-existing buildings.

Response: *Accepted.* It was always intended that new improvements on pre-existing buildings would fall within the ambit of the new 5 per cent depreciation regime. Any technical wording to the contrary will be corrected.

Comment #3: The proposed legislation should have an accelerated effective date. Taxpayers have already contracted for commercial buildings with the knowledge of the pending amendment. The proposed effective date should apply from 21 February 2007, the date of announcement made by the Minister of Finance.

Response: *Partially accepted.* The proposed 5 per cent rate will apply to all new and unused buildings (and improvements) that are contracted from 1 April 2007 to the extent that construction begins from this date. The 1 April date corresponds with the new fiscal year and the financial year of many companies. The second requirement that construction begins from 1 April 2007 prevents the backdating of contracts.

Background (port assets; section 12F): The proposed legislation provides depreciation relief for port assets. The proposed rate of depreciation will be 5 per cent annually over 20 years (the same as airport assets).

(Deloitte & Touche; Safmarine; Transnet)

Comment #1: The proposed legislation should cover additional port assets used for transport, such as off-dock container depots.

Response: *Accepted.* The proposed legislation will be altered to cover a wider list of port assets associated with transport, including off-dock container depots. It should also be noted that the 5 per cent rate for commercial buildings will provide relief for many port-related items (such as warehouses).

Comment #2: The proposed legislation should cover capital works for marinas and fishing harbours. Port works dedicated to transport are not the only port infrastructure requiring tax relief.

Response: *Not accepted.* The background analysis leading to the 5 per cent rate only covered transport-related port assets. The subject of marinas and fishing harbours will require separate analysis for a later day.

Comment #3: The depreciation regime for port assets should not be conditioned upon the taxpayer at issue being solely engaged in the business of port operations. No reason exists to exclude a taxpayer that is actively engaged as a port operator merely because that taxpayer also has active operations dedicated to other areas.

Response: *Accepted.* The proposed regime will apply to all assets directly used for the engagement as a transport operator or as a port authority so that taxpayers are not prevented from simultaneously engaging in other operations. However, the limitation against leasing will be maintained.

Comment #4: The proposed effective date for port assets should be more inclusive. The new regime should cover all port assets brought into use on or after 1 January 2008.

Response: *Accepted.* The “brought into use” concept will be utilised so that depreciation will begin when the port assets are brought into operation in the production of income.

Background (environmental assets; section 37B): The proposed legislation provides comprehensive depreciation relief for environmental assets associated with the process of manufacturing. Assets that are closely associated with the manufacturing process (e.g. air pollution control equipment to control pollution emanating from manufacturing smoke stacks and water treatment that results in recycled water used for further manufacturing) will receive a 40:20:20:20 rate. This rate is on par with plant and machinery used in manufacturing. Environmental waste disposal sites, dams, etc. will receive a 5 per cent annual rate (which is on par with manufacturing buildings).

(KPMG; SAICA; Sasol)

Comment #1: The proposed legislation limits the relief solely to environmental items required for purposes of complying with the South African legal obligations providing for the protection of the environment. This limitation should be abandoned. No reason exists to discourage environmental efforts that exceed those legal obligations.

Response: *Not accepted.* The proposed legal limitation prevents taxpayers from artificially extending the environmental depreciation incentive to other structures that only provide marginal environmental benefits. Moreover, the limitation should not present a significant practical issue for genuine environmental applications. South African environmental legislation is in line with international trends, thereby requiring the most modern of environmental structures and equipment.

Comment #2: The proposed 5 per cent annual rate for environmental waste disposal assets is too low. A proposed 10 per cent annual rate is more consistent with the useful lives of the assets at issue.

Response: *Not accepted.* National Treasury's independent analysis suggests otherwise. Information from key companies suggests that accounting depreciation rates fall between 2 ½ per cent and 5 per cent for these permanent environmental structures. A higher rate exists for plant and equipment associated with environmental treatment and recycling. The proposed legislation separately covers this latter group of assets with a very generous 40:20:20:20 rate.

## 2.8 Exemption of occupational death benefits

Background (employer-provided death benefits; section 10(1)(gB): Under current law, only employer-provided death benefits payable in terms of the Compensation for Occupational Injuries and Diseases Act is tax-exempt. Some employers supplement these payments by paying additional amounts – these additional amounts are taxable.

(Deloitte & Touche; Ernest & Young)

Comment #1: The proposed amendment is not necessary. Proceeds of an employer group life insurance policy are not taxable in the hands of the employee concerned. It is further argued that direct death payments made by an employer to the deceased employee's dependants are not taxable.

Response: *Not accepted.* As suggested, the proceeds from an employer-provided life insurance policy are exempt in terms of the Eighth Schedule. However, direct death payments made by an employer to the deceased employee's dependants are generally taxable as a termination of employment benefit. The exemption is therefore required, but the law will be clarified to highlight this point.

Comment #2: It is unclear whether the proposed exemption of R300 000 for employer-provided death benefits will also qualify for the pre-existing R30 000 exemption for termination of employment by reason of death (i.e. for a total exemption of R330 000). The interaction should be clarified.

Response: *Accepted.* The interaction between the two exemptions will be clarified. Taxpayers will be limited to a combined R300 000 amount

## 2.9 Oil and gas fiscal stability

Background (fiscal stability agreements for oil and gas rights; paragraph 8 of the 10<sup>th</sup> Schedule): In 2006, an incentive regime for oil and gas was introduced that replaced the previous OP 26 lease system. This incentive regime contains a fiscal stability provision that provides a contractual guarantee that the incentives provided by the regime will not be altered to the detriment of taxpayers for the

duration of the oil and gas rights held. The proposed legislation clarifies a number of technical aspects arising from the fiscal stability negotiation process between National Treasury and industry stakeholders.

(PetroSA)

**Comment #1:** The proposed legislation allows the Minister of Finance to enter into a fiscal stability agreement with a potential oil and gas right holder as long as that right is acquired within six months. However, the time limit should be open-ended because the complexities of the arrangements pertaining to the underlying rights often entail a protracted negotiation process outside of the taxpayer's full control.

Response: *Partially accepted.* Taxpayers should not obtain fiscal stability unless their future receipt of an oil and gas right is sufficiently real. Pre-emptive requests are a waste of resources, and unused fiscal stability agreements are to be avoided. Nonetheless, the period in which an oil and gas right must be received will be extended to one year in order to cater for unexpected difficulties. Furthermore, even if a fiscal stability agreement lapses, nothing prevents taxpayers from requesting a new agreement if the oil and gas right is realistically pending.

**Comment #2:** The proposed legislation allows the fiscal stability protection to be freely transferred in terms of exploration rights (i.e. once fiscal stability is granted in terms of an exploration right, any subsequent holder of that right receives the same fiscal stability protection as the initial holder receiving the protection). The proposed legislation should similarly provide the same free transferability of fiscal protection in respect of production rights.

Response: *Not accepted.* Free transferability of fiscal stability in relation to production rights is a larger debate reserved for the Mineral and Petroleum Resources Royalty Bill. At issue is how much Government wants to be locked-in for years to come as a price for stimulating investment. Acceptance of the request would mean that the lock-in period lasts 30 years for all South African rights across the country. The current proposed loss of fiscal stability upon transfer may allow for accelerated change in ownership. On the other hand, this same lack of free transferability may lead to distortions with some companies unduly holding onto rights rather than selling to more efficient parties.

## **2.10 Securities Transfer Tax ("STT")**

Background: The proposed legislation merges the Stamp Duty on unlisted shares with the Uncertificated Securities Tax ("UST") on listed shares. The proposed legislation incorporates existing law, aims to simplify administration of STT and applies a similar collection method to unlisted shares as is currently applied to UST.

(Bobby Johnson; PWC; Webber Wenzel Bowens; Werksmans)

Comment #1: The proposed STT imposes an obligation on unlisted companies to pay the STT on behalf of purchasers of unlisted shares. This obligation poses an unfair burden on unlisted companies (even though the STT can be recovered by the company from the purchaser).

Response: *Not accepted.* The proposed STT essentially follows the collection format of the previous UST. Centralised collection points are used with centralised collectors having a right of recovery from purchasers. The proposed regime for unlisted shares contains the same mechanism.

Comment #2: Penalties and interest stemming from STT violations may unfairly fall on unlisted companies. The violation may stem from actions of the purchaser, and yet no right of recovery exists for the company to recover these penalties and interest from the purchaser.

Response: *Accepted.* The proposed legislation will be altered so that the collecting agent can recover interest and penalties that are attributable to the actions of the purchaser.

Comment #3: In addition to the exemption for the cancellation of shares on liquidation, the proposed STT should contain an exemption for cancellations stemming from buybacks, redemptions and so forth.

Response: *Not accepted.* The calls for exemption on redemption (buyback, etc..) have consistently been rejected over several years. No policy reason exists for an exemption of this nature. Moreover, an exemption for redemptions can easily lead to avoidance (with the redemption exemption being used to disguise shareholder-to-shareholder taxable sales).

Comment #4: The proposed legislation places a minimum value on listed shares transferred. More specifically, the minimum value cannot fall below the lowest price/closing price. This lower threshold for listed shares may be problematic if the acquisition involves transfers of substantial shareholdings giving rise to block discounts.

Response: *Not accepted.* The proposed legislation merely leaves the current market value limits in place. The lowest price/closing price rule prevents price manipulation.

## 2.11 Miscellaneous – Income Tax

Background (foreign expatriate accommodation; paragraph 9 of the 7<sup>th</sup> Schedule): No taxable value is placed on employer-provided accommodation if

the employee is required to work away from home (i.e. this accommodation is effectively exempt). In the case of foreign nationals working temporarily in South Africa, claims were made that employer-provided housing for their South African work contracts should be exempt even if the contract lasted for an extended period (two-to-four years). The proposed amendment will limit this tax-free benefit to 6 months. This amendment will apply to tax years commencing on or after 1 March 2007.

(American Chamber of Commerce; Baker Hughes; Bhp Billiton; British American Tobacco; CitiBank; Douglas & Velcich; Edward Nathan Sonnenbergs; Ernst & Young; KPMG; PWC; PWC on behalf of Habitat for humanity; Safmarine; SAICA; Sasol)

Comment #1: More time is needed for implementation should this proposed legislation be adopted. Taxpayers cannot be expected to retroactively pay tax on salary received before the current legislation is adopted.

Response: *Accepted.* The proposed effective date will be changed. The legislation will be effective for tax years commencing on or after 1 March 2008.

Comment #2: Numerous comments were received relating to this proposed amendment. Concerns were raised that this amendment will significantly increase employer costs for obtaining foreign skilled employees working temporarily in South Africa. This change will therefore have a negative impact on South Africa's ability to attract and retain imported skills. It is further noted that other countries provide tax exemption for employer-provided accommodation to foreign expatriates.

Response: *Partially accepted.* While taxpayer interpretation leading to claims for exemption is misplaced, some concession may be necessary given prior history. The exemption period will accordingly be extended from 6 months to 1 year. All visiting expatriates will be eligible for the initial 1-year exemption even if they know their stay will extend beyond this period.

Background (foreign tax credits; section 6quat): Taxpayers are eligible for section 6quat rebates (i.e. credits) for foreign taxes paid in respect of foreign sourced income. No foreign tax credits are available for foreign taxes paid in respect of South African sourced income because South Africa retains the primary taxing right for activities occurring within its jurisdiction. South Africa's position in this regard is fully consistent with international tax practice. In regards to this issue, some foreign countries impose direct withholding taxes on South African management fees rendered in South Africa for the benefit of foreign operations. While no tax credits will be available in this circumstance for the reasons just described, the proposed legislation allows for these taxes on South African sourced income to be deducted like any other expense that reduces overall profits.



(Bhp Billiton; Deloitte & Touche; Ernst & Young; Mallinicks; PWC)

Comment #1: The proposed legislation unfairly limits the proposed deduction for foreign tax credits to total net income generated by the activity subject to the foreign tax. No reason exists for this limitation.

Response: *Not accepted.* The South African tax system ring-fences foreign losses so that these losses cannot be applied against South African income. In this case, taxpayers with the South African receipts and accruals at issue seek the benefits associated with foreign source income (offsets for foreign taxes). Hence, one price of this treatment is a form of ring-fencing associated with foreign sourced income.

Comment #2: The proposed legislation does not appear to allow for excess losses stemming from deductible foreign taxes to be carried over into later years. Carryovers should be expressly allowed.

Response: *Not accepted.* Carryovers are not permitted since they either reflect excess credits (e.g. 100% of capital gains taxed in foreign country but only 50% in South Africa) or the company is in a loss and thus does not suffer tax in South Africa.

Comment #3: Can taxpayers elect to choose to deduct foreign taxes even if these foreign taxes are creditable? This issue needs to be clarified.

Response: *Accepted.* The proposed legislation is only intended to allow for deductions if foreign taxes are not eligible for credits. As a general matter, few taxpayers would want this choice (i.e. credits are preferred if available), and therefore, no reason exists to add administrative complexity for a choice that few would make. The proposed legislation will be clarified accordingly.

Background (foreign currency hedging; section 9D(9)): Under current law, currency gains and losses arising from transactions between CFCs of the same group do not give rise to tainted section 9D income. The proposed legislation seeks to neutralise any hedging with outside parties in respect of these CFC intra-group loans.

(Deloitte & Touche)

Comment: The proposed legislation is welcome. However, it is requested that the effective date of the change be made from late 2006 (since the initial request for change dates back this far).

Response: *Partially accepted.* The proposed legislation will be given an effective date for years of assessment ending on or after 1 January 2007. There is a limit in which Government can go back in terms of legislation without creating the complexity of re-

opening tax returns. The mere fact that a request is made for change does not mean that the change can automatically be made as of the date of the request. The legislative process takes time. Care is also required in respect of retroactive changes because these changes may assist some taxpayers while disadvantaging others.

Background (ordinary income for salary in the form of shares; section 8C): Top executives have long sought to reduce their tax liability on salary through receipt of equity-related instruments of their employer company. In 2005, a new regime was added for enhanced enforcement of salary received in this manner. The essence of the new regime is to allow for deferral of tax if rights to equity instruments are received. However, the deferred tax charged applies at ordinary rates (and at a time when full value can be readily accounted for).

(Deloitte & Touche; KPMG; Mallinicks; PWC; SAICA; The Banking Association SA)

Comment #1: The proposed legislation extends the definition of equity instruments to include any financial instrument that “derives its value with reference” to a share. This extension means that “phantom shares” (a common practice) will now be subject to the anti-avoidance regime.

Response: *Accepted.* The proposed legislation will be withdrawn. The mischief of concern can be addressed through enforcement of current law.

Comment #2: The proposed legislation extends PAYE withholding beyond the technical employer, including associated institutions (such as employee trusts). This extension is unacceptable as it will mean that two different parties will be liable for the same tax,

Response: *Not accepted.* The proposed regime merely ensures that SARS has more than a single option for collection. The party issuing the shares is often not the same as the party paying remuneration in cash and from which PAYE can be deducted. The proposed provision cannot be used to collect the same underlying tax twice (i.e. one from each separate party). To the extent any doubt exists on this matter, the legislation will be clarified accordingly.

Comment #3: The proposed legislation is retroactive. The proposal not only applies to equity instruments “acquired” on or after 30 October 2007, but also to those pre-existing equity shares “held” on or after that date.

Response: *Accepted.* The proposed legislation will not apply to equity instruments “held” to the extent the proposed legislation increases the tax burden on these instruments. (See clause

11(1)(f.) Only newly acquired shares will be subject to this higher burden.

Background (reduction of assessed losses for creditor compromise; section 20): Current law potentially reduces the assessed loss of a debtor business when certain creditors cancel their debts. The proposed legislation clarifies the ambit of this reduction of assessed losses due to creditor debt cancellation.

(PWC)

Comment: The proposed legislation goes too far. Only debt cancellations stemming from trade creditors should adversely impact a debtor's outstanding assessed losses.

Response: *Not accepted.* The principle at issue is recoupment. Debtors that enjoy the benefit of an ordinary loss due to an expenditure funded (directly or indirectly) by borrowed funds should recoup that ordinary loss if that debt is later cancelled. Narrow tracing in accordance with the suggestion would unfairly prejudice the fiscus.

## 2.12 Miscellaneous – Other taxes

Background (Skills Development Levy and public benefit organisations; section 4 of the Skills Development Levies Act): Current law exempts certain public benefit organisations from the Skills Development Levy. Proposed legislation seeks to eliminate this exemption. Small public benefit organisations would still benefit from the R500 000 exemption threshold for smaller operations. This change is motivated in part by the fact that public benefit organisations can participate in trading activities.

(The Non-Profit Consortium)

Comment: The proposed amendment should be rejected. The additional charge on employees of public benefit organisations will put further strain on scarce funding.

Response: *Accepted.* While the proposed amendment has legal grounds, the proposed amendment will be dropped. Further sector analysis is required.

Background (VAT direct and indirect exports): Presently, the Export Incentive Scheme in Regulation GN 2761 regulates indirect exports. It is proposed that the references to paragraph (a), (b) and (c) of the definition of "export" be deleted. As a result, exports may only be zero rated as contemplated in the regulations.

(SAICA)

Comments. The only regulations currently issued in respect of exports are the VAT export incentive scheme, which deal with indirect exports.

No regulations have been issued for direct exports; and, therefore, no direct exports will be covered.

Response: It is proposed that the requirements, which have to be met in order for the direct and indirect export of goods to fall within the definition of exported, be prescribed by regulation. The shift to regulation will not prejudice direct exports.

Background (customs and intellectual property): Section 15 of the Counterfeit Goods Act (CGA) empowers customs officers to seize and detain counterfeit goods which are imported into the Republic. In order to supplement the provisions in the CGA, section 113A was inserted into the Customs and Excise Act, 1964, (CEA) in 2002.

These provisions have been the subject of litigation and although SARS has enjoyed an encouraging degree of success in this regard, Senior Counsel had this to say in a legal opinion regarding the possible amendments to the CEA in relation to counterfeit goods:

“[T]he enactment of section 113A of the CEA and the inter-relationship between the two pieces of legislation is not exactly clear and it is likely to pose more questions in the future that will have to be dealt with by the courts...”

We propose that the provisions dealing with customs officers and counterfeit goods be streamlined and contained in only one piece of legislation, namely the CEA. We also propose that customs act mainly as a filter for goods under customs control and relinquish control and responsibility for the goods to the proper authorities.”

The proposed amendments are aimed at these ends and are also in line with the World Customs Organization’s (WCO) model legislation. One of the primary considerations of the WCO in drafting the model legislation is that the holders of intellectual property rights have the primary responsibility to take measures to protect their rights. The actions of a customs officer are therefore limited to detention of the goods and the officer will not seize goods. The right holder will have to approach a competent court for a determination that the goods detained are counterfeit goods that may be seized.

An industry commentator’s views on these amendments were succinctly put in the Business Day of 8 October; “I welcome the proposed changes to the Customs and Excise Act as it clearly and concisely sets out the powers, rights, obligations, time frames and procedures for SARS to deal with counterfeit goods.”

Comment #1: The provisions of the CGA and the proposed amendment are in conflict.

Response: *Accepted.* There will be consequential amendments to the CGA to support the amendment in Chapter XB. Discussions with the dti in this regard are ongoing. Although the consequential amendments to the CGA will follow a separate Parliamentary

process, both sets of amendment will come into operation simultaneously on a date to be determined.

Should further amendments to the CEA be necessary to ensure proper alignment between the CGA and CEA or to improve the control over counterfeit goods, they will be effected.

Comment #2: No provision is made for an extension of the time period prescribed to deliver the written notice to the Commissioner and to the affected party.

Response: *Accepted.* A provision is inserted to empower the Commissioner to extend the time period for an additional period not exceeding ten days on good cause shown.

### **3. Newly added legislation**

#### **3.1 Hyperinflationary currencies**

Current law taxes currency gains and losses with reference to the taxpayer's currency used for operations. Therefore, if a taxpayer operates a business establishment in a foreign country, currency gains and losses are generally determined with reference to the currency of that country. If no business operations are involved, the currency gains and losses are determined with reference to the Rand.

The current system works reasonably well unless the business establishment reports in a foreign currency that is devaluing due to hyper-inflation. In situations of this kind, the taxpayer is suddenly subject to significant currency gains for any holdings of funds of that foreign business establishment that are in a non-hyperinflationary currency. As a practical matter, these non-hyperinflationary currency holdings are common because businesses subject to a hyper-inflationary currency seek to hold outside currencies as a hedge against the rapid deterioration of their currency.

In order to alleviate this situation, the proposed legislation seeks to mitigate the adverse tax effects of hyperinflationary currencies. Taxpayers in this circumstance will be freed from the business establishment currency. Third currency holdings will instead be measured against the Rand (a measure that eliminates all artificial hyper-inflationary gain). The proposed legislation also deals with certain collateral matters, such as removing the hyperinflationary impact on the financial instrument holding company tests as well as adjusting the rules for blocked currencies (blocked by Exchange Control of the foreign country or otherwise). This latter set of rules will now allow for blocked income/gain to be reduced by subsequent losses.

#### **3.2 Research and development ("R&D")**

In 2006, Government added a 150 per cent deduction for R&D expenditure and a 50:30:20 depreciation rate for R&D buildings. While the initial legislation is well

intended, the avoidance concerns are many. In the Taxation Laws Amendment Act, 2007 adopted earlier this year, a stop-gap measure was introduced to prevent artificial acceleration of R&D expenditures between connected persons by denying the 150 per cent rate for all connected person funding.

The proposed legislation repeals the stop gap measure as excessive. Connected person funding will again be eligible for the 150 per cent rate to the extent the connected person recipient actually spends the funds. Other adjustments are the removal of the 150 per cent rate for interest on borrowed funds dedicated to R&D and for rentals dedicated to R&D.

### **3.3 Tax on Retirement Funds repeal**

The Tax on Retirement Funds was repealed as of 1 March 2007. The last payments in respect of the tax were due on May 2007 (with reference to the six-month period of 1 September 2006 to 28 February 2007). Discussions have been ongoing with industry to provide a hard cut-off of future audits in respect of the repealed tax. This hard cut-off is important for certainty. The proposed legislation clarifies that no further assessments will be raised from 1 September 2008 except for fraud, misrepresentation or non-disclosure of material facts (with no assessments allowed from 1 March 2010 even if fraud, misrepresentation or non-disclosure is present). These dates give taxpayers long-term certainty while allowing SARS a final opportunity to raise assessments where appropriate.

### **3.4 Pension adjustments**

The Pension Funds Act was amended with effect from 13 September 2007 to allow for the payment of certain court orders (e.g. maintenance orders and divorce orders) by a retirement fund before the member exits that fund. Payments in terms of a divorce order were previously noted by the fund and paid when the member retired or discontinued his or her membership of the fund.

These payments will become taxable on the day the fund makes a payment in terms of the court order and will be taxed as withdrawal benefits in the hands of the fund member. The fund may pay the amount stipulated in the court order to the relevant person and may also release the tax due on the amount paid to SARS. In the case where the court order is made terms of the Divorce Act, the fund member will have a right of recovery against the non-member ex-spouse for any taxes suffered on the divorce payment paid to the ex-spouse.

Payments made by a fund in terms of a maintenance order (lump sum awards and ongoing payments) will be taxable in the hands of the fund member and tax exempt in the hands of the recipient. The fund member will not have a right of recovery against the recipient for the tax maintenance payment.

### **3.5 Taxation of fishing persons and seafarer salaries**

In 2006, the definition of "Republic" was extended from 12 nautical miles off the South African coast to 200 nautical miles. This change is consistent with the UN convention and with law (including tax law) which governs any issue on the sea.

As a result of the change, foreign fishing persons and other foreign seafarers operating within the 12-200 nautical range are now fully subject to tax at ordinary rates on their salary. Similarly, some South African fishing persons and seafarers will lose the benefit of the salary exemption relating to absences from the Republic of more than 183 days. This change came into effect as of 1 March 2007.

While the legal impact of the change was understood at the time the 2006 legislation was adopted, National Treasury and SARS have been informed that the change has largely taken the fishing and seafaring industry by surprise. The industry has not reacted by changing compliance systems for the collection of the associated PAYE stemming from the new legislation. In order to relieve the potential back-tax liability (plus interest and penalties thereon), the proposed effective date of the legislation will be delayed until 1 March 2008 in respect of fishing persons and seafarers.

### **3.6 Withholding relief for pre-retirement withdrawals**

Tax legislation (adopted earlier this year) sought to exempt PAYE withholding for pre-retirement withdrawals of up to R43 000. The R43 000 amount is consistent with the individual tax threshold for salaries. Unfortunately, there was not sufficient time allowed for an adjustment to the computer system used by SARS to accommodate the R43 000 withholding exemption. The proposed withholding relief of R43 000 is accordingly deferred to 1 March 2008 so SARS has sufficient time to properly adjust its computer systems.

### **3.7 CFC rulings**

In 2006, legislation was passed authorising the Commissioner to exempt certain limited CFC activities from tainted income treatment via the advance tax ruling system. This authority for exemption seeks to ensure that the objective CFC standards do not create unfair results for unique facts and circumstances. The Commissioner can only authorise this limited form of relief if satisfied that a ruling of this nature will not result in an undue erosion of the tax base.

The tax base erosion limitation is proving to be too restrictive for SARS to issue any advance rulings in this area. In practical terms, the tax base erosion test has prevented the issue of any SARS rulings that mitigate the potential harshness of the CFC rules. The tax base erosion test will accordingly be repealed. SARS must, however, take all the related facts and circumstances pertaining to the CFC at hand into account before issuing any advance rulings.