

Portfolio Committee on Finance: Report-Back Hearings

(21 October 2008)

Revenue Laws Amendment Bills, 2008

Response Document

1. BACKGROUND

1.1 Process

The Revenue Laws Amendment Bills, 2008 represent the second instalment of this year's tax proposals as announced in the 2008 Budget Review. These Bills cover the more complex substantive issues, including the first substantive amendments to convert the Secondary Tax on Companies into a Dividend Tax on shareholders.

National Treasury and SARS briefed the Portfolio Committee on Finance (PCOF) on 19 August 2008. Public hearings were conducted by the PCOF on 20 August 2008.

1.2 Public comments

Website release of the draft Revenue Laws Amendment Bills occurred on 31 July 2008 as announced by the Portfolio Committee on Finance. An additional legislative release occurred on 20 August 2008 after the initial briefing. The Portfolio Committee on Finance set a public written response due date of 5 September 2008. National Treasury set a public written response due date of 29 August 2008 for the initial release, followed by a 5 September 2008 due date for the additional legislative release.

2. GENERAL COMMENTS

2.1 Legislative amendments and sufficient consultation times

The National Treasury and SARS are sympathetic to concerns raised in respect of the ongoing breadth and depth of tax amendments since 2000. The source of these changes has many causes, including policy reforms, technical improvements and anti-avoidance measures. One of the most far ranging amendments contained within the Revenue Laws Amendment Bills, 2008 deals with reform of the Secondary Tax on Companies – a longstanding item on the reform agenda requested by many business taxpayers.

A key challenge revolves around the adequacy of the consultation process for proposed tax legislative changes, particularly for proposed draft tax legislation. While the benefits of an extended consultation period are highly desirable, various constraints and deadlines operate that require a shorter consultative process after the legislation has been published. The official period for comments has been open for one month; taxpayers have been given access to hearings before the Portfolio Committee on Finance; and National Treasury and SARS convened an open 1-day work session with tax practitioners so that formal comments presented to the Committee could be better

understood. This response document seeks to make public the rationale of the policy decisions made in the light of these comments. Public comments amount to over 500 pages. These comments have been fully taken into account as the draft Bills are prepared for formal introduction.

2.2 Effective dates

The hearings on 20 August 2008 have brought to the fore longstanding issues regarding the effective dates of various ongoing tax amendments. This is not an item specifically arising out of the draft Revenue Laws Amendment Bills, 2008. Every effort is being made to adjust these Bills so that they do not contain inadvertent retroactive amendments to the detriment of taxpayers.

The issue of effective dates is a complex one, often requiring different policies depending on the nature of the amendments involved (e.g. changes in rates and changes to the tax base). Moreover, taxpayers cannot disregard their role in this area. Taxpayers often seek retroactive change for their own benefit. Indeed, the comments presented contain a number of taxpayer requests for retroactive change.

3. POLICY ISSUES AND RESPONSES

Provided below are the responses to the policy issues raised by the (formal and informal) comments. This document does not deal with comments that fall wholly outside the scope of the Bill.

A. RETIREMENT ISSUES

1. *Taxation of pre-retirement withdrawals from retirement funds*

Comment: The proposed change will be prejudicial to lower and middle income taxpayers who withdraw from retirement funds after having been fund members for many years. In addition, the current system of deducting tax at the average rate is more likely to give a result that approximates the benefit enjoyed by the taxpayer while contributing to the fund. In essence, the proposed change will tax pre-retirement lump sums at rates that are significantly in excess of the benefit received by the taxpayer while contributing. (Deloitte).

Response: Accepted. The pre-retirement lump sum tax regime will be modified so that instead of using the annual rate tables, a rate table similar to that used for retirement lump sums will be used. Instead of the R300 000 exemption for a retirement lump sum an exemption equal to 7.5% of R300 000 (i.e. R22 500) will be available. Instead of the first R300 000 of the remaining retirement lump sum being subject to a tax rate of 18%, the first R587 500 will be subject to a tax rate of 18%.

Comment: Clarity is required as to whether lump sum pre-retirement withdrawal benefits must be aggregated over the lifetime of the taxpayer or whether the taxpayer may apply the tax tables afresh for each tax year during which a lump sum withdrawal benefit accrues. Similar clarity is required in respect of the exemption. (LISPA).

Response: Noted. The withdrawals are aggregated over time. The purpose of the aggregation is to ensure that chronic withdrawals between job changes are not encouraged. This aggregation will remain under the revised proposal. The aggregation will also carry over from the pre-retirement to the post-retirement system, so that no advantage can be obtained by utilising the pre-retirement system.

Comment: Clarity is required as to whether or how the previous R1 800 exemption will be incorporated into the new regime in view of the proposed aggregation principle. In other words, will use of the R1 800 exemption operate as an offset against the new exemption? (LISPA, Momentum, Life Offices' Association).

Response: Noted. The proposed draft does not contain any offset mechanism nor is one intended. Taxpayers that previously benefited from the R1 800 exemption will not trigger any going forward offset for that amount. Hence, no special rules are required in the law itself, but this point will be explicitly stated in the explanatory memorandum. The *de minimis* nature of the prior R1 800 exemption does not justify the administrative or compliance cost of an offset regime.

2. *Transfers from pension to provident funds*

Comment: While it is accepted that the transfer from a pension to a provident fund should give rise to taxation, this tax should not apply at this point of conversion. Tax should only arise at withdrawal. (SAICA).

Response: Not accepted. While a pension-to-provident fund transfer does not by itself represent a removal from retirement savings, provident funds freely allow lump sum withdrawals while pension funds do not. The tax system does not provide employee deductions for provident fund contributions (whereas pension contributions are deductible). Therefore, employee pension deductions should be effectively recouped upon transfer to a provident fund because a direct contribution would not generate an employee deduction in the first instance.

3. *Living annuities*

Comment: Request is made for a technical correction stemming from the Taxation Laws Amendment Act, 2008. In that Act, SARS Note GN 18 was incorporated into law. This note defined permissible living annuities in respect of retirement savings. While most of the legislative incorporation into law is acceptable, the added requirement of having a death benefit payable to dependents is problematic from a compliance point of view and should accordingly be dropped. The former rule of having sums paid to a nominee (or to the deceased's estate in the absence of a nominee) should be reinstated. (LISPA).

Response: Accepted. Permissible annuities will be limited to death benefits paid to nominees or to the deceased estate in the absence of a nominee. The reference to "dependents" will be dropped. This change should restore prior practice as enshrined in current living annuity contracts.

Comment: A second request is made for a technical correction stemming from the prior Taxation Laws Amendment Act, 2008. In this instance, the legislative incorporation of SARS GN Note 18 causes problems by requiring that the value of the underlying assets must be "held" by the annuity provider (as opposed to "owned" by the annuity provider). This required holding by the annuitant effectively excludes life insurers from providing life annuities. (LISPA).

Response: Accepted. The use of the words "by or on behalf of that person or fund" will be dropped. The ownership language gives rise to unintended issues outside the scope of the definition. The goal of the technical correction was merely to ensure that the value of the annuity has a meaningful economic nexus to the underlying investment assets.

B. ESTATE DUTY

1. *General anti-avoidance rule*

Comment: The proposed general anti-avoidance rule is overly broad. Moreover, the general anti-avoidance rule is not specifically tailored to the Estate Duty. For instance, one key escape hatch is the existence of a dominant business purpose for undertaking the transaction. This business purpose escape hatch is inappropriate in the context of estate planning, which often has other forms of non-tax motivations (e.g. fund preservation, especially against ill-advised spending). (SAICA, Law Society of South Africa, SA Institute of Tax Practitioners).

Response: Accepted. The proposed general anti-avoidance rule for Estate Duty will be withdrawn for reconsideration. Certain practices can be remedied more effectively through targeted legislation (e.g. revision of the valuation formula in section 5(2)). We note with some concern the widespread use of various Estate Duty freezing techniques that lack true arm's length principles (such as sales using interest-free loans with capital that is never repaid or repaid over extended periods). These Estate Duty freezing techniques must eventually be addressed if the Estate Duty is to be properly applied as intended.

2. *Life insurance and retirement savings*

Comment: The removal of Estate Duty on life insurance policies will open the door to avoidance. This removal also opens the door to exempting the savings element as well as the pure death benefit of life insurance products. This Estate Duty exclusion of the savings element would effectively allow the conversion of dutiable property into property free from the Estate Duty without much effort. This provision will also discriminate against other forms of savings. (Life Offices' Association, LISPA, BOE, Momentum).

Response: Accepted. This proposal will be withdrawn. The initial goal was to exempt the risk element of life insurance policies from the Estate Duty as a way of encouraging safety net protection for dependents (similar to Government's policy of encouraging retirement savings protection). However, the opportunities for avoidance are simply too strong, especially in the light of the concurrent decision to drop the proposed general anti-avoidance rule.

Comment: The exclusion of retirement lump sums from "deemed property" treatment is welcome, but a further exclusion is required from the definition of "property." Without this further exclusion, certain forms of retirement lump sums may inadvertently remain within the Estate Duty net. (Life Offices' Association).

Response: Accepted. Retirement savings will be removed from the definition of "property" as suggested (in addition to the initially proposed exclusion from "deemed property").

C. EMPLOYERS AND EMPLOYEES

1. *Repayable employee benefits*

Comment: Because the proposed amendments do not trigger a PAYE refund from SARS if an employee is required to repay the full value of the benefit (such as a bonus) to his employer, these amendments do not alleviate the cash flow problems encountered by such employees. (Development Bank of South Africa).

Response: Not accepted. The PAYE system is not suited to the proposal. Refunds of this nature will be made on assessment of the year's tax return.

Comment: The proposed amendments to section 23 allow for a deduction against "remuneration" for returned amounts. Reliance on "remuneration" as opposed to "gross income" is overly narrow. Gross income would include all cash plus allowance (e.g. travel) components. On the other hand, remuneration includes all cash components but only a percentage of the allowance components. In other words, the required return of unspent travel funds advanced may not yield a deduction for the employee even though the employee is forced to return these unspent funds. (Cliffe Dekker).

Response: Accepted. The proposed amendment will be adjusted to allow a deduction for all salary-related amounts previously included in the taxable income of the employee that are returned to employers (including returned employee travel advances). Reliance on the term "remuneration" will be dropped.

Comment: The proposed deduction for repayable employee benefits is often inadequate as a practical matter. If an employee receives salary in one year but has to return that salary in a later year, the deduction is only allowed in the later year. This delayed deduction is meaningless if the employee is no longer working in the later year. (Deloitte).

Response: Noted but not accepted. The commentators are essentially asking for the carryback of deductions (and the refund of tax beyond that which is owed for a particular year) which requires the re-opening of prior year returns. While we have sympathy with the issues raised, this form of change will require significant system changes. Few countries allow for the re-opening of prior year returns under these circumstances because of the systems implications.

2. *Personal use of business cell-phones and computers*

Comment: It is not clear whether electronic communication instruments other than business cell phones and computers will fall under the proposed fringe benefit simplification. (Momentum, SAICA).

Response: Accepted. The proposed amendment will be reworded so that it is made clear that the amendment covers related items. All telephone and computer equipment will be covered (e.g. modems and memory cards).

3. *Consolidation of deemed employee regimes*

Comment: The proposed “personal service provider” regime imposes a flat 33 per cent withholding regime for trusts, companies and individuals that are effectively viewed as deemed employees. This rate creates an unfair burden for smaller independent contractors who would otherwise be subject to a lower (marginal) rate if the independent contractor were an actual employee earning the same amount. The proposed definition also creates a denial of many deductions for individual independent contractors that would not otherwise occur. (PWC).

Response: Accepted. The proposed unification of regimes was intended to remove the duplication of deemed employee regimes, especially the need for SARS exemption certificates for labour brokers for PAYE withholding by employers. However, the initial proposed change actually adds to the compliance burden when overall relief was intended. The proposed personal service provider regime will accordingly be changed to unify only the personal service company and trust regimes. The labour broker regime will also be limited solely to individuals. This narrowing of the “labour broker” definition will eliminate most of the exemption certificates currently being requested.

4. *Payroll donations*

Comment: The proposed payroll donation amendment implies that the employer is obliged to take into account donations made through their payroll systems in determining the amount of PAYE to be deducted. This amendment should only be implemented at the option of the employer so as not to cause an insurmountable problem for certain employers. (SAICA).

Response: Noted. The proposed legislation does not require employers to provide for the deduction of donations through their payroll systems. The proposed legislation merely provides that if an employer’s payroll system provides for the automatic deduction of donations made by employees, the employee will be entitled to immediate corresponding employees’ tax relief.

Comment: The 5 per cent donation ceiling for employees’ tax purposes is understood but SITE taxpayers may be entitled to additional deductions given the fact that deductible donations have an annual 10 per cent ceiling. These taxpayers should be permitted to apply to SARS to take the additional donations into account. (SA Institute of Tax Practitioners).

Response: Comment misplaced. The possibility of applying to SARS for additional relief is already provided for by the amendment to paragraph 11B(4) of the Fourth Schedule effected by section 44 of the Taxation Laws Amendment Act, 2008.

D. INDIVIDUALS

1. *Deductions in respect of disability expenses*

Comment: The term “long-term” should be added to the definition of disability. (NCPDPSA).

Response: Comment misplaced. In order for a limitation to qualify as a “disability” as defined, the limitation must last for more than one year. The “long-term” requirement sought is therefore already part of the definition.

Comment: The proposed regulatory list of tax deductible expenses should be updated annually, after consultation with the various organisations representing persons with disabilities. (NCPDPSA).

Response: Accepted. The list will be regularly updated by SARS with the consultation requested.

Comment: The proposed regulatory list of tax deductible expenses should be determined in consultation with the Department of Health. (SAICA).

Response: Noted. SARS will be primarily responsible for compiling the list, and will consult with all relevant role players (including the Department of Health, if appropriate).

Note: The possibility of compiling a list of categories of disability expenses (as opposed to a detailed list of such expenses) has been raised. This will be considered.

Comment: The definition of “handicapped person” has been removed from section 18, and the definition of disability has been defined in more detail. The two definitions have different tax consequences: “handicapped” resulted in all related expenses being deductible, while “disabled” resulted in all related expenses below the 7,5 per cent threshold qualified for deduction. By removing the definition of “handicapped” and not replacing it, the two concepts have inadvertently been joined together, which cannot have been the intention (LOA).

Response: Accepted. This result was never intended. Persons with disability will be eligible for section 18 relief without regard to the 7,5 per cent floor. Expenditure in respect of a physical impairment (e.g. expenses for eye glasses and contact lenses to correct short-sightedness) will remain deductible, subject to the 7,5 per cent floor.

2. *Broad-based employee share schemes*

Comment: Admittedly, the increase in the tax-free ceiling from R9 000 over a period of three years to R50 000 over a period of five years is a significant increase. However, it is doubtful whether this increase is sufficient to generate a significant take-up of the scheme. To achieve a significant take-up, it is recommended that the tax-free ceiling per employee be raised to R100 000 over a period of five years. (SAICA, Deloitte).

Response. Not accepted. The R50 000 amount was determined in consultation with key stakeholders regularly engaged in employee share schemes. Industry practice typically would require a 1/5th formula (a fifth year bonus for salaries within the R50 000 per annum range). The R100 000 amount suggested lacks any analytical support.

Comment: Although the reduction of the participation threshold from 90 per cent to 80 per cent addresses the practical issue of excluding non-performing employees, it does not address the issue where an employer has introduced a broad-based employee share

plan ("BBESP") in previous years and allowed employees to freely trade in those shares. Such employees will have to be included in any subsequent BBESP introduced by the employer in determining whether the 80 per cent requirement is met even though they should be excluded (given their prior rush to sell). (Sanlam).

Response: Not accepted. Employees who are entitled, under a BBESP introduced by their employer, to freely trade in the shares awarded before the expiry of a period of five years should not be penalized for what they are entitled to do legally. The law has never prevented an employer from imposing restrictions that prevented an employee from trading in the shares awarded under a BBESP within a 5 year period. The tax law merely triggers ordinary revenue for employees seeking a quick sale of shares received pursuant to a BBESP. The tax law should not be forced to accommodate situations that employers could have avoided.

E. CORPORATE AND COMMERCIAL ISSUES

1. *Secondary Tax on Company (STC) Reforms*

a. *Conversion from STC to dividend tax*

Comment (meaning of paid): It is not clear what the term "paid" encompasses. For example, if a dividend is credited to a loan account by the paying company, would this mean that the amount is "paid" as contemplated, thereby triggering the dividend withholding tax? In addition, are unclaimed dividends held in an account viewed as paid? (Deloitte, Cliffe Dekker).

Response: Accepted. The wording of the proposed provisions will be clarified. The focus is when the dividend accrues to the shareholder (i.e. when a shareholder obtains an unconditional right to a dividend as opposed to the mere announcement of a dividend declaration by a listed company).

Comment (operation of STC credits): While the decision to carry STC credits over into the new regime is welcome, STC credits should be used for the benefit of the dividend declaring company as opposed to the shareholder. The currently proposed section 64I should be replaced with a rebate mechanism that will allow the STC credit as a rebate against the liability to normal tax of the dividend declaring company when dividends are paid (see section 6quat). (PWC, Banking Association of South Africa, SAICA).

Response: Not accepted. The request is mainly driven by financial accounting concepts as opposed to tax principles (i.e. in order to preserve STC credits as deferred tax assets for financial reporting purposes). The STC credit principle espoused by taxpayers was mainly one of double taxation (the new Dividend Tax should not be imposed in addition to the previous STC). The STC credit regime contained in the Bills eliminates this potential double tax. Preservation of STC credits for financial reporting purposes would result in the paying company obtaining a benefit for dividends paid to exempt shareholders (e.g. pension funds). This approach would lead to double non-taxation in these cases rather than preventing double taxation. No theoretical tax reason exists to undo the prior STC regime in this fashion. If it is accepted that the request was not intended to give this result, a mechanism for transferring the STC credits in a group situation, similar to that contained in the Bills, would have had to be developed. When coupled with such a transfer mechanism the request gives rise to additional administrative difficulties because the STC credit regime proposed would require integration of the new Dividend Tax with the normal tax on income.

Comment (expiry of STC credits): The continued utilisation of STC credits for only a limited period may cause distortions in the economy, thereby forcing companies to

declare dividends during this shortened transition period that would otherwise not be declared. It is proposed that existing STC credits be allowed for a five-year period (instead of the proposed three-year period) to allow for a proper phase-in period (SA Institute of Tax Practitioners, Edward Nathan Sonnenbergs, Cliffe Dekker).

Response: Accepted. Although interactions with major companies have indicated that a period of three years would suffice, existing STC credits will be allowed for a period of five years after the date of introduction of the Dividend Tax. It must further be noted that the announcement that STC credits will be discontinued was originally made in February 2008. Given that the target date for the introduction of the Dividend Tax is the end of 2009 or early 2010, companies will in fact have almost seven years to declare dividends for the purpose of utilising credits.

Comment (collateral issues): Certain issues (e.g. foreign dividends, cession of dividend income streams, share/scrip lending arrangements) have not been dealt with by the proposed Bill. It is also not clear how deemed dividends will be provided for under the new Dividend Tax regime. (Deloitte, Cliffe Dekker).

Response: Noted. As discussed in the media statement released along with the draft Revenue Laws Amendment Bills, 2008, a number of collateral issues associated with the Dividend Tax will be addressed at a later date before the new Dividend Tax comes into effect. Most of the issues raised (including anti-avoidance rules to prevent sales being disguised as tax-free dividends) are within this range of deferred issues. However, it should be stated that the cession of dividends is fully covered by the proposed legislation. The legislation effectively views the intervening cedent as a potential unregulated intermediary.

Comment (clubs): Clubs should be treated like exempt shareholders just like public benefit organisations. (SA Institute of Tax Practitioners, Edward Nathan Sonnenbergs).

Response: Not accepted. Unlike public benefit organisations, the club exemption for passive income is subject to a ceiling. This ceiling can only be determined at year-end on an annual basis. This annual aggregation cannot be achieved under the new Dividend Tax, which is calculated on a dividend-by-dividend basis.

Comment: Relief is required for dividends paid in kind by way of an *in specie* distribution (e.g. land distributions). Taxation of these distributions creates cash-flow problems because no cash is distributed. Request is made for tax relief in these circumstances. (Werksmans).

Response: Not accepted. A dividend paid in-kind is a dividend, notwithstanding the fact that the payment is not made in cash. In theoretical terms, the proposed regime is essentially no different than the current STC regime, which fully applies to in-kind dividends.

b. Revised dividend base

Comment (record keeping): The revised dividend base will result in domestic companies being required to keep yet another set of books in order to track the new concept of contributed tax capital (CTC). This change increases the administrative burden of companies, which previously could rely on company law concepts such as share premium and share capital. (Deloitte, PWC, Werksmans, Edward Nathan Sonnenbergs, BUSA).

Response: Not accepted. Although companies could indeed rely on the company law concepts referred to under prior law, there was nevertheless a difference between share

capital and share premium for purposes of company law and share capital and share premium for tax purposes (which excludes tainted amounts representing profits available for distribution). Consequently, companies have always been required to keep an extra set of books in any event. Moreover, the second set of books to be kept under the new system is fairly simple – as a general matter, contributed tax capital equals share capital and share premium stemming from the receipt of consideration for the issue of shares.

Comment (transitional starting point): Taxpayers should not be forced to recalculate historic events for purposes of future dividend determinations. CTC calculations should only begin once the new legislation is in effect. Pre-effective date calculations should depend on historic concepts utilised. One option would be to rely on “pure” share capital and “pure” share premium as classified immediately before the new dividend regime comes into effect. (Deloitte, Cliffe Dekker, Edward Nathan Sonnenbergs, SA Institute of Tax Practitioners).

Response: Accepted. The starting point for the new CTC will be based on a final share capital/share premium calculation under the old regime. “Pure” share capital and “pure” share premium as classified immediately before the new dividend tax regime becomes effective will be regarded as the “starting” CTC on the date of commencement of the new dividend tax. “Pure” share capital and share premium excludes amounts created by the reserving of profits and capitalisation share issues.

Comment (amalgamation and unbundling transitional starting point): The effective dates for the CTC impact of amalgamations and unbundlings need to be clarified. Of special concern is the apparent 2007 effective date for the CTC amalgamation calculation. (PWC).

Response: Accepted. The currently proposed 2007 effective date is no longer necessary once the historic regime is used as the starting point for the new CTC. This starting point takes into account the tainting of share premium and share capital required under section 44(9A) under current law (introduced on 21 February 2007). This exclusion under section 44(9A) prevents schemes using amalgamations to artificially increase share capital/share premium and reduce the STC tax base

Comment (foreign investors): The definition of CTC is unfair to foreign investors that contribute foreign assets in exchange for shares in a South African company because the current wording in effect yields a zero CTC. These assets should instead give rise to CTC equal to the market value of the assets contributed. (Deloitte, PWC, Bravura).

Response: Accepted. If an exempt entity (including a foreign investor) transfers an asset that is outside the South African tax net to a South African company in exchange for the issue of shares by that company, the transaction will give rise to CTC equal to the market value of the assets contributed.

Comment (asset-for-share rollovers): The new CTC definition discourages asset-for-share rollover transactions. Rollover of CTC (as opposed to a market value CTC) discourages this form of rollover. This rollover treatment for CTC potentially creates the potential for treble taxation caused by additional dividends. (PWC, Bravura).

Response: Not accepted. Section 42 asset-for-share transactions provide tax relief at the price of rollover tax attributes. These attributes include base cost under the Capital Gains tax, cost price under the trading stock rules with the newly proposed CTC regime added to the mix. In effect, pre-tax gains cannot be added to CTC. This differs from exemption because exempt assets (as outlined in terms of foreign investors) enter the tax system at market value, including market value CTC. While it is true that additional

dividends may be created, these additional dividends will often be offset by additional capital losses.

Comment (meaning of consideration): It is not clear how issues such as the cancellation of loans by a company and the provision of services will be dealt with in the context of CTC (i.e. whether these amounts are contributed for purposes of the definition of CTC). Loan cancellation and services should add to the CTC. (Cliffe Dekker, SAICA).

Response: Noted. Both the cancellation of a loan and the provision of services will indeed give rise to CTC. In both scenarios, (applying basic principles) an “amount” will be received by or will accrue to the company. Both points will be clarified via the explanatory memorandum to provide taxpayers with certainty.

Comment (CTC versus dividend treatment): Clarity is requested as to when CTC is repaid. More specifically, what proportion of a distribution constitutes a return of CTC versus a dividend? Also, is the CTC versus dividend distinction essentially elective or must CTC come out of distributions at a designated point in time? (Bravura).

Response: Accepted. The wording of the provisions will be changed in order to clarify that the CTC versus dividend distinction is elective. The explanatory memorandum will focus on this clarification for further certainty.

c. *Dividend tax withholding regime*

Comment (SARS refund period): There is no reason why the recipient should not be able to present the declaration (with supporting documents) immediately to SARS for a refund of taxes paid. It is not acceptable that there be a one-year waiting period involved and that the dividend declaring company operates as the primary party providing the refund. (Deloitte).

Response: Not accepted. The rules relating to refunds are designed to ensure that companies/intermediaries take due care in ensuring that they are aware of their withholding responsibilities. It is arguable whether companies/intermediaries would take the same level of care of ensuring that they are withholding correctly if shareholders concerned had an immediate right of refund from SARS. In other words, the companies/intermediaries need to be the first port of call for refunds, especially because they have more immediate access to the facts than SARS. The goal is to have a smaller level of unnecessary withholding rather than have excessive withholding (with companies/regulated intermediaries acting in an overly cautious manner) followed by extensive shareholder requests to SARS for refunds.

Comment (operation of company refunds): The rules relating to company refunds need to be clarified. It is unclear how the dividend declaring company can refund the shareholder without effectively paying a double tax, and how the refund procedure should work if the dividend declaring company wrongfully withheld funds if an exempt declaration is received before dividends are paid.

Response: Accepted. The legislation will be adjusted to contain an offset mechanism so that the dividend declaring company will have a right of offset against future withholding taxes to the extent dividend taxes are refunded. The rules will also be clarified as to when the shareholder can make a claim against the company (i.e. if the shareholder is late in presenting a declaration, the refund from the company should be deferred until the next dividend; if the shareholder presents a timely declaration of exempt status, the company should not withhold).

Comment (director/officer liability): The proposal to hold certain shareholders and directors personally liable in the event of a failure to withhold the dividend tax is too broad. The proposed legislation already gives SARS the ability to look to the paying company for any tax due but not paid. (Deloitte, Edward Nathan Sonnenbergs).

Response: Partially accepted. The rules for shareholder/director liability were intended only to cover situations where the parties responsible for withholding lacked sufficient assets for recovery of a withholding failure. This situation may arise for example if the responsible party has a transitory existence. Therefore, the rules for liability will be narrowed (to exclude listed companies and regulated intermediaries).

Comment: Collective Investment Schemes do not have the resources required to deal with the far reaching practical obstacles that would result from the implementation of the dividend withholding tax regime. Complications arise because dividends received are often partially reinvested. The dividend withholding regime becomes especially complicated if multiple tiers of Collective Investment Schemes are involved. (LISPA).

Response: Noted. The proposed legislation does not directly address the impact of the proposed regime on special entities such as collective investment schemes or four-fund life insurance companies (four-fund regime). These issues will be addressed in the next round of legislation before the new Dividend Tax becomes effective.

Comment: CSDPs should not be liable for the dividend withholding tax in the event of a failure to withhold. The ultimate liability should rest with the beneficial owner and the company declaring the dividend. (Nedbank).

Response: Not accepted. From a practical perspective, only the CSDP is in a position to withhold correctly. In the context of listed company, all dividends from uncertificated shares are processed through CSDPs with only the CSDP having any knowledge of the specific shareholders. In those instances the listed company cannot be held responsible for information not available to it.

Comment: In terms of the proposed section 64G(4)(c), a shareholder's declaration that it is deemed to be the beneficial owner of shares should not expire after three years but rather the validity of the declaration should be open-ended. (Ernst & Young).

Response: Not accepted. The purpose of the three year limitation is to ensure that the records held by entities required to withhold are kept reasonably current. If the validity of the declaration were to be open-ended, these records could easily become outdated to the detriment of the tax system.

Comment: In terms of the proposed dividend withholding regime, there are five different types of undertakings or declarations which a company or intermediary must obtain from various shareholders in order to administer the proposed dividends tax. When this is multiplied by the number of shareholders that any one company may have, it is clear that these provisions are too onerous for a company that is paying a dividend. (Media24).

Response: Not accepted. The proposed dividend withholding regime represents a concerted effort to ensure a balance between effective collection mechanisms and efficient administration. The declarations and undertakings effectively allow immediate exemption from the new Dividend Tax while maintaining an audit trail. Procedures to cater for exemptions and reduced withholding taxes are common when countries employ dividend withholding taxes.

Comment: In terms of the proposed section 64K(1), the beneficial owner of a share will have an obligation to pay the dividends tax on the same date as the "other person"

referred to in the provision, unless the tax has been paid by the other person. It will therefore be difficult for the beneficial owner to establish whether or not payment has been made by the other person in order for him to settle his own potential liability timeously. It is therefore recommended that the words “unless the tax has been paid by any other person” should rather read “unless the tax has been paid or withheld by any other person”. A similar problem with timing arises in section 64H(2) for an intermediary who will not know by the due date whether the tax has been “paid” by any other person (Ernst & Young).

Response: Not accepted. The beneficial owner will obtain relief from liability only if Government actually receives the dividend tax due. This rule matches the system utilised for PAYE. As a practical matter, SARS may provide relief for the beneficial owner if the company withholds the dividend tax but utilizes the sum for other purposes.

2. *Passive holding companies*

Comment (need for regime): The proposed passive holding company regime is unnecessary. In practice, individuals do not hold financial instruments in companies rather than holding them directly in order to benefit from an income tax rate arbitrage. This is because of the higher capital gains tax rate on disposals of financial instruments by a company as opposed to an individual, as well as the fact that the use of a company to hold financial instruments entails a higher administrative burden. (Deloitte, PWC, BUSA).

Response: Not accepted. Although it may not currently be the general practice of individuals to hold financial instruments in companies as opposed to holding them directly, there is nevertheless an opportunity for arbitrage that is well-accepted (i.e. the 40 per cent individual maximum rate versus the 28 per cent company rate). Mainly at issue is the new switch to a classical model of dividend taxation, which allows dividend taxes to be deferred through a chain of domestic companies until reaching a domestic individual investor.

Comment (transitional relief): If the new passive holding company regime is enacted, certain companies may find themselves suddenly qualifying as passive holding companies even though their affairs were arranged before the new law comes into effect. It is proposed that a transitional period should be allowed for these companies to unwind and restructure themselves or some other transitional relief be provided. (Ernst & Young, SAICA).

Response: Not accepted. This comment contradicts the comment made to the PCOF that passive holding companies are not encountered in practice. However, this aspect will be reconsidered depending on facts presented by commentators.

Comment (international practice): The passive holding company regime is not in line with international practice. Where such regimes exist (as in the United States), they are very different from the proposed regime. (Deloitte).

Response: Not accepted. Passive holding company regimes do in fact exist in many international jurisdictions (e.g. the United States, the United Kingdom, Canada, Australia and New Zealand). Differences between jurisdictions may be ascribed to differences between their overall tax regimes.

Comment (foreign companies): Foreign companies (including controlled foreign companies and foreign collective investment schemes) should be excluded from the passive holding company regime. (BUSA).

Response: Accepted. The passive holding company regime is designed to prevent domestic arbitrage; foreign arbitrage is addressed elsewhere (e.g. the controlled foreign company regime). The proposed legislation will be narrowed accordingly.

Comment (shareholder test): Companies that are less than 50 per cent owned by individuals (directly or indirectly) should fall within the definition of “excluded company”. If the company is not owned by individuals, the possibility of tax arbitrage (which is the main mischief that the new regime seeks to address) simply does not exist. (Deloitte)

Response: Accepted. The originally proposed legislation effectively reaches this result in a more circuitous way. However, the proposed legislation will be amended accordingly.

Comment (treasury operations): Treasury companies, holding/investment companies with multiple subsidiaries and intermediate holding companies held by excluded companies should be excluded from the PHC regime. These companies are holding funds to facilitate business growth for various trades within the group. (PWC, Werksmans).

Response: Accepted. The proposed legislation was never intended to prevent an active group of domestic companies from accumulating their funds for business reinvestment via a single treasury company. The goal is only to prevent passive holding companies accumulating funds to avoid individual-level taxes. The proposed legislation will be amended to exclude treasury operations of the kind raised by allowing taxpayers to apply the 80 per cent passive income test on a group-wide basis.

Comment (shareholder limit): It is unacceptable that a maximum shareholding requirement is not placed as a precondition for passive holding company status (as is the case in most other jurisdictions that have closely held company provisions). As a minimum, it should be a requirement that the company be controlled by a single person (Ernst & Young, Werksmans).

Response: Partially accepted. It is proposed that, in order for a company to fall within the definition of “passive holding company”, there must be five or fewer natural persons (taking into account connected persons) that hold more than fifty per cent of the participation rights in the company. The regime will therefore only apply in respect of closely held entities.

Comment (broad-based employee share acquisitions): The proposed application of punitive tax rates under the passive holding company regime can easily apply to certain forms of broad-based empowerment deals. The rules are especially problematic for broad-based special purpose vehicles. (Edward Nathan Sonnenbergs, Werksmans).

Response: Accepted. The passive holding company regime was never intended to add to the tax payable by broad-based special purpose vehicles used to fund the acquisition of empowerment shares. The five or fewer test should effectively eliminate this application as a practical matter.

Comment (taxation of capital gains): Concerns exist that the legislation as drafted imposes a 40 per cent charge on capital gains generated by companies. This concern stems from the section’s charge on taxable income, which include capital gains (SAITP).

Response: Accepted. It was never intended that the passive holding company regime should trigger a 40 per cent charge on capital gains. The regime was only intended to correct the potential arbitrage in ordinary rates between companies and individuals (as well as the deferral of the new 10 per cent Dividend Tax). Any drafting issues to the

contrary will be corrected to the extent necessary (and the explanatory memorandum will further clarify this point).

3. *Company reorganisations*

Comment (de-grouping charge): The proposed amendment still results in double taxation and needs to be clarified. The revised rules for loss of qualifying share status now also give rise to double taxation. (PWC).

Response: Accepted. The proposed amendment will be reworded in order to address the deficiencies. No double tax should exist in either case.

Comment (election): The removal of the election is ill-considered. It will allow unscrupulous sellers to pass the tax on the sale of an asset to an unwary buyer by simply not electing out of the rollover. It is far safer for companies to have to elect into these provisions (where an election would be obvious in any agreement) than for it to be automatic with an option to elect out. (Werksmans, Edward Nathan Sonnenbergs).

Response: Not accepted. As stated in the draft explanatory memorandum, the majority of taxpayers prefer rollover treatment to apply. In this context, an “election out” mechanism is generally more beneficial. However, assets of non-taxable foreign investors which are outside the SA tax regime and of other parties with exemptions will be excluded from the section 42 rollover regime because this group would generally prefer to be outside the scope of the section 42 rollover regime.

Comment (loss of qualifying shareholder status): The proposed legislation changes the tax calculation when qualifying shareholders lose their qualifying status within 18 months after a reorganisation (i.e. a section 42 asset-for-share transaction and an amalgamation). However, the calculation appears to trigger an additional charge for shares that are disposed of (which are already taxed under the standard disposal rules) (PwC, Deloitte, SAICA).

Response: Accepted. The amendment will be withdrawn for further consideration.

4. *Share issue anomalies*

Comment: Concerns exist about the new use of the term “in consequence of” instead of “indirect.” The proposed amendments to the anti-avoidance cross-issue rules of section 24B are overly vague (potentially overly broad or overly narrow). In the very least, an 18 month limit should apply as an objective measure of limiting the impermissible linkage. (PWC).

Response: Partially accepted. The section 24B use of the word “indirect” is out of place with the rest of the Income Tax Act. Linkage of transactions is more appropriately connected via the use of the changed terminology (see section 7). However, it is accepted that an 18-month limit is probably a reasonable time limit to address avoidance schemes (should facts ultimately prove otherwise, a further amendment will be proposed).

5. *Intellectual property arbitrage*

Comment (1) – Two Year Prohibition: While the revised version of section 23I represents an improvement over last year’s proposal, there are still instances where the anti-avoidance rules of section 23I are overly broad. For instance, if an individual owner of the intellectual property emigrates and the individual licenses the South African originated

intellectual property back to South African resident users, section 23I denies the deduction for the royalty paid by the South African resident users. (Deloitte).

Comment (2) – Two Year Prohibition: The proposed anti-avoidance rules penalise innovative South African residents who develop intellectual property, sell the intellectual property on arm's length terms to unconnected non-residents, and then licence back the intellectual property to South African residents. In essence, the South African resident will pay capital gains tax on any gain on sale, but South African users of the intellectual property thereafter will be denied a deduction for their royalties simply because the intellectual property has been the property of a South African resident within the preceding two years. (Deloitte).

Comment (3) – Two Year Prohibition: The situation created by the proposed two-year prohibition is untenable. If a South African resident (X) sells its intellectual property to a third party foreigner, who then licences the intellectual property to a South African resident who is totally unconnected to X, the licensee will not be entitled to a deduction. However, given that the licensee and X are totally unconnected, the licensee will have no way of knowing that it is not entitled to a deduction. (SAICA).

Responses: Partially accepted. The proposed legislation applies if intellectual property payments are made to an exempt party and the intellectual property was held by a taxable person two years before the initiation of exempt payments. This rule prevents intellectual property from being created in South Africa and transferred abroad with the purpose of undermining the tax base. However, the two-year rule is overly broad. The conditions on this prohibition will accordingly be narrowed to bare dominium schemes and to situations where the same going concern is being charged for intellectual property which had previously been within the tax net.

In terms of taxes on transfer, it is accepted that the transfer abroad may entail a capital gains tax charge. However, the charge represents a one-off tax at the price of all future growth and payments related to the intellectual property. This growth and future stream is what is at issue. Secondly, the charge referred to is often artificially reduced through various mechanisms.

Comment (1/3rd rebate): The 1/3rd rebate if withholding taxes exist is not exactly correct. The rebate should probably be slightly higher. (Werksmans).

Response: Not accepted. The 1/3rd rebate is a simplifying assumption. Due to the existence of various treaties, the withholding rate varies from country-to-country.

Comment (foreign takeovers): By denying royalty deductions, the proposed anti-avoidance rule creates a hindrance for foreign investors that acquire South African companies.

Response: Not accepted. This hindrance will only be a problem for foreign investors who externalise intellectual property previously owned by a South African company that is the object of the foreign acquisition. This form of externalisation is one of the key targets that section 23I is aimed at discouraging because this form of externalisation essentially operates in a manner similar to excessive debt structures used by private equity groups.

Comment (payments to foreign subsidiaries): Royalty contractual obligations undertaken by South African end-users to South African owned foreign companies should not be subject to the denial of deductions if the intellectual property is "discovered, devised, developed, created or produced" by South African end users in terms of the relevant licence agreement. (PWC).

Response: Not accepted. South African companies should not be charged for their value-added portion to the process. To the extent that intellectual property has local and foreign value-added processes, these can be distinguished *via* market value apportionment.

Comment (controlled foreign company rulings exemption): By preventing any potential deduction for royalties paid by a South African to a controlled foreign company, the proposed proviso to section 9D(10)(a)(iii) is overbroad if the intellectual property in question was never owned or developed in South Africa but happens to be licensed (*inter alia*) to South African residents that have an interest in the intellectual property owning company. For instance, a royalty should not be considered abusive if a newly acquired CFC owning the intellectual property has appropriate business substance and has itself developed the intellectual property without South African involvement (and before the acquisition). (PWC, Deloitte).

Response: Partially accepted. Active royalties will be exempt from passive/tainted income treatment of section 9D(9)(b)(iii). However, active royalties paid by a South African resident to a connected CFC will be subject to the diversionary rules contained in section 9D(9)(b)(ii). As in the case of other diversionary transactions, it will be possible to seek a ruling for relief if the royalty income of the CFC is subject to an acceptable level of foreign tax.

F. SMALL BUSINESS

1. *Micro business presumptive tax*

Comment: Professionals, trading trusts and VAT vendors should also be entitled to make use of the presumptive tax regime. (SAITP)

Response: Not accepted. The proposed presumptive tax regime is intended to reduce the tax compliance burden of micro businesses and not necessarily to reduce the tax liability of these businesses. The single rate table for all businesses types (e.g. manufacturing and services), sole proprietors and incorporated business was a compromise in an attempt to simplify the proposed system as much as possible. There is a case to be made for a separate rate table in respect of certain types of businesses (e.g. manufacturing vs. services) because they have different profit margins. However, given that many types of services have been excluded, the need for separate rate tables was considered not to be necessary. If more service-type businesses are to be included into the presumptive turnover tax regime, the single rate table will have to be reconsidered.

The above having been stated, the scope of the definition of “personal service” in section 12E of the Income Tax Act and “professional service” in the proposed Sixth Schedule will be reviewed going forward. It should be noted that it is not envisaged that trading trusts and VAT vendors will be included in the presumptive tax regime.

Comment: In terms of the proposed legislation, investment income includes income from trading in fixed property. It is not clear why these activities will not qualify for the turnover tax. A small entrepreneur rendering construction services may well have to buy land to develop and then sell if the entrepreneur does not secure any construction contracts. (SAICA).

Response: Not accepted. The regime is aimed at unsophisticated, micro operations with moderate profit margins and that do not have access to the skills necessary to manage tax compliance. Property development and dealing in land is not regarded as an operation of this nature.

Comment: The turnover tax regime includes previous allowances that are required to be added to normal taxable income. Because the small business would have lost the benefit of carrying forward any previous assessed losses, it is suggested that previous tax allowances should not be taxable under the presumptive turnover tax system. (SAITP).

Response: Partially accepted. Allowances allowed during a tax year preceding the year when the person became a registered micro business will only be included in taxable turnover to the extent they exceed assessed losses forfeited due to the application of the turnover tax regime.

Comment: The annual exemption of R200 000 from the STC in respect of dividends declared by an entity that is a very small business is welcomed. However, this limit should not be a monetary amount. Clearly, this rule is aimed at the after-tax net profit of a business (conducted as a company) distributed to its shareholder. This would mean that the effective tax rate of a company (that qualifies as a very small business) will be higher than that of a natural person if net profit exceeds R 200 000. (SAICA).

Response: Not accepted. This limit is necessary to counter the use of the micro business presumptive turnover tax regime to strip companies with substantial pre-existing retained earnings of those earnings tax free. Bearing in mind that the turnover limit for a micro business is R1 million, the R200 000 limit in annual dividend distributions is considered reasonable. As far as the effective tax rate is concerned, micro businesses with a net profit percentage in excess of 20% are under taxed in terms of the presumptive tax regime, a situation which the imposition of STC or the Dividend Tax on distributions in excess of R200 000 goes some way to addressing.

Comment: Registered very small businesses are required to keep records of all assets purchased with a cost price of more than R5 000 and all liabilities which exceed R5 000. This requirement seems inconsistent with the objectives of the regime which are to reduce record-keeping requirements for very small businesses. (SAITP)

Response: Partially accepted. Reduced record-keeping requirements come at the price of leaving SARS with less knowledge of the growth potential and capital structure of the micro businesses concerned. In order to try to align the turnover requirement with the growth in the capital structure of the enterprise, SARS requires some idea of the net asset value of the underlying micro business and the growth thereof. However, it is accepted that the threshold is relatively low. It is therefore proposed that it be increased to R10 000 and only required at year end.

2. *Venture capital company regime*

Comment (impact of the passive holding company regime): A strict interpretation of the passive holding company requirements suggests that a VCC might be classified as a PHC although it obviously is not a tax saving vehicle. Is this intended? (Edward Nathan Sonnenbergs).

Response: Accepted. The legislation will be changed to exclude VCCs from the application of the passive holding company regime..

Comment (minimum investment thresholds): The monetary thresholds for minimum capital investments by the VCC are too high at R50 million and R250 million respectively. (Ernst & Young, Andre Bresler).

Response: Partially accepted. The proposed thresholds for investments by a VCC in qualifying shares of qualifying companies and junior mining companies will be reduced to R30 million and R150 million respectively.

Comment (junior mining start-up period): The proposed period of 18 months from the time the shares are issued, within which trade should commence for investee companies is considered to be too short, this is especially so for junior mining companies who have to comply with an array of regulatory formalities before trade commences.

Response: Partially accepted. The period within which trade must commence will be extended to 36 months for junior mining companies.

Comment (investor pre-conditions): The proposed legislation only allows a natural person or a listed company (or a controlled group company of a listed company) to obtain a deduction when investing in a qualified VCC. This limits providers of capital to the VCC. (SAVCA, Finmark Trust).

Response: Not accepted. Regarding the types of investor that qualify, there is a need to protect the R750 000 individual deduction limit. Allowing unlisted corporations to invest in the VCC will undermine this objective because individuals could then channel their investments *via* controlled entities.

Comment (investor preconditions): The draft legislation limits the amount that a listed company group may invest in a VCC to 10 per cent. Depending on the size of the fund managed by the VCC, this limit could be inappropriate and in fact onerous. It is proposed that the deduction be claimed on the lesser of the percentage holding in the VCC or a fixed investment amount. This fixed investment amount should be R25 million. (SAVCA).

Response: Not accepted. The 10 per cent limit does not prohibit corporate investors from holding more than 10 per cent of the shares issued by the VCC. It serves only to limit the deduction to the extent of 10 per cent of the shareholding. This measure on its own should not limit the amount of investments into VCCs by corporations. Corporations moving beyond this level most likely have strategic reasons for wanting to invest (none of which requires an additional tax incentive).

Comment (VCC income restrictions): Venture capital funds operate on the basis that a fee is charged by the fund managers on the capital invested in the fund. In addition, fund managers supplement income by charging fees to investee businesses in return for advisory services. The requirement that VCC gross income must consist solely of income from financial instruments would preclude these management fees. (SAVCA, Finmark Trust, BUSA).

Response: Accepted. The proposed legislation will allow for management fee income as well as a *de minimis* amount of other income (e.g. rentals). More specifically, a maximum of 10 per cent of the VCC gross income may consist of income other than income from financial instruments and management fees.

Comment (VCC asset minimums): The explanatory memorandum refers to “minimum gross assets of at least R50 million”. Is this the capital invested in the fund, or the asset value of the underlying investments/investee businesses?

Response: Noted. This refers to the amounts invested in qualifying shares. This threshold will be reduced to R30 million.

Comment (VCC percentage investment in small investee companies): Although the incentive is targeted at narrowing the equity gap, the requirement that 80 per cent of investments made by a VCC must be in qualifying companies that hold assets with a market value of not more than R 10 million is too narrow. Having this requirement at 80 per cent hampers the balancing of the VCC portfolio of investments. This is especially the case where investments are made in very early stages of high growth potential businesses all of which require higher amounts than R10 million. The 80 per cent threshold should be reduced. (PwC, SAVCA, Finmark Trust).

Response: Not accepted. The incentive scheme is specifically targeted at the lower end of the equity market. At this level, there is a perceived gap in terms of the supply of equity. There is therefore a need to ensure that the funding will go towards this intended purpose. As a side matter however, the reference to market value will be changed to refer to the expenditure incurred to acquire assets. This is much easier to measure, especially in the case of smaller businesses.

Comment (permissible investee company trades): The definition of “impermissible trade” is too narrow, especially as it relates to dealing in land and property development, financial services and franchising. Conceptually, the definition should allow for tourism-type activities, such as guest houses and hotels or game farms, which may have a property or land element but are essentially operating businesses. (SAVCA, Finmark Trust).

Response: Partially accepted. The definition of “impermissible trade” will be re-drafted to accommodate tourism-type activities such as bed & breakfasts, hotels, game farms, certain financial services activities and franchisors. However, property development and franchisees *per se* will remain excluded from the regime. The incentive is targeted at channeling equity investments into under-served (under-capitalised) and perceived high-risk sectors of the market.

Comment (permissible investee company passive holdings): In terms of the tax relief for small business corporations under section 12E, shareholders of small business corporations are prevented from holding shares in other businesses except for a list of allowable shares. It would make sense to include, in the list of allowable shares, shares held in a VCC. (SAITP).

Response: Accepted. The exclusion from the small business corporation regime discussed is mainly designed to prevent income splitting (the splitting of a large business into smaller business so each can obtain small business corporation relief). Therefore, this exclusion does not apply to listed share investments, collective investment schemes and other purely passive investments that do not create this income splitting possibility. Shares in a VCC will accordingly be allowed on the same basis.

Comment (permissible investee company ownership): Prohibiting the VCC from holding more than 40 per cent of the equity share capital of any investee company is counter-productive. Given that the intention of the incentive is to inject equity capital into small businesses and the reality that start-up businesses valuations are low, capital investors may in fact require controlling stakes initially. (SAVCA, Finmark Trust).

Response: Partially accepted. The 40 per cent shareholding restriction will be changed to prevent venture capital companies from controlling a qualifying company. The venture capital fund manager can arrange with the entrepreneur/founder shareholders to protect their investment interests in the investee company through other means but not through a tax incentivised controlling interest.

Note 1: A lifetime limit will apply for individuals investing in VCCs of three times the annual limit of R750 000, i.e. R2.25 million. A sale of shares will be regarded as a recoupment and a replenishment of the lifetime limit. In addition, this incentive will be subject to a sunset clause of 12 years with a compulsory review after 10 years.

Note 2: The comments received on the need for a more comprehensive regulatory framework for the new VCC industry to be created are noted. National Treasury will engage all industry and financial regulation stakeholders over the next few months in order to develop the most suitable structure to regulate VCCs. The current regulatory framework for collective investment schemes could be considered as a departure point.

G. MISCELLANEOUS INCOME TAX ISSUES

1. *Depreciation allowances for residential units and UDZ*

Comment: The requirement for occupancy certificates should be revisited because these certificates are not always available, especially for very old buildings. (Ethekewini Municipality).

Response: Accepted. The requirement will be deleted. The current certificate of location requirement will suffice for reporting purposes. SARS can still use a certificate of occupancy required by municipal law (e.g. for new buildings) as proof that the building has been brought into use as alleged.

Comment: How are the 1,000m² and five unit minimum to be applied in practice? (Ethekewini Municipality).

Response: Noted. The 1,000m² requirement was put in place to ensure a measure of scale. Upon further consideration, it has been decided that the five unit minimum requirement should be removed for reconsideration.

Comment: There is no definition of the term “geographic vicinity” in which the five housing units have to be located. (Ethekewini Municipality).

Response: Accepted. Due to the difficulties with the application of the term, the requirement that the relevant units be in the same geographical vicinity has been removed. The owner must merely use five or more residential units in a trade within South Africa.

2. *Employer sales of low cost housing to employees*

Comment: It is not clear how the 1 per cent rental rule will work. The definition of low cost housing has to be indexed for building inflation. (Johannesburg Development Agency).

Response: Accepted. The initial rental charge will be based on 1 per cent of the cost of the building plus a proportional share of the cost of land and infrastructure in the case of standalone units, and 1 per cent of the cost of the building in the case of apartments. The rental charge restriction is proposed to ensure that the targeted properties are used by low income tenants. A provision will be included to allow for the rental to be increased by up to 10 per cent per annum.

Comment: The R200 000 and R250 000 thresholds are low in the current building cost environment. There should be annual inflation linked adjustments to these figures. (Ethekewini Municipality).

Response: Partially accepted. The thresholds are based on building costs as well as affordability for low-income households as defined in the national housing policy. These monetary thresholds will be adjusted over time.

Comment: Although the proposed amendments are welcome, they are meaningless unless the benefit is excluded from fringe benefits tax. (SAITP, Edward Nathan Sonnenbergs, Deloitte).

Response: Noted. A review of the fringe benefit tax in the case of housing falls beyond the scope of this budget, which focused on supply side measures. However, this issue will be considered for the next budget cycle.

3. Allowances in respect of expenditure on government business licenses

Comment (social expenditure): Clarity is requested regarding the nature of the expenditure that will be allowable as deductible in respect of government business licenses. For example, social expenditure for various members of the public required as a precondition for the license should be deductible. Moreover, expenditure required by sector charters should also be covered. (SAICA, BUSA, MTN).

Response: Partially accepted. Social expenditure required as a precondition for obtaining a license necessary to conduct a trade will be allowed (as if the funds were paid directly to Government). However, expenditure resulting from sector charter requirements are not dealt with in the proposed amendment. These costs are as a general matter not sufficiently closely connected to business operations as a precondition for conducting a trade (except in the area of mining because the scorecard operates as a precondition for obtaining a new order mineral right). In general, this provision will be limited to the petroleum, telecommunication and gambling industries.

Comment (permissible Government spheres): The allowance for licenses should be expanded so that the allowance applies to license expenditure in respect of not only Government, but all organs of State as well as regulatory agencies. (SAICA, BUSA, MTN, Edward Nathan Sonnenbergs).

Response: Accepted. License deductions should equally apply to such amounts payable to government as well as regulatory entities subject to the Public Finance Management Act.

Comment (exclusivity fees): Fees for exclusivity rights (rights to exclusively operate within a particular geographic area) should be amortised like any other form of license (Tsogo Sun).

Response: Not accepted. An exclusivity fee will not be deductible under the new regime because the right to which it relates is not a precondition for conducting a trade (but an added enhancement).

Comment (perpetual licenses): Certain licenses are granted in perpetuity, but are often linked to an exclusivity fee that has a limited life. Both the license fee and the exclusivity fee should qualify for the allowance and the deduction period should be allocated over the exclusivity period. In the absence of a linked exclusivity period, the allowance should be deducted over a period of 15 years (Tsogo Sun).

Response: Partially accepted. As discussed above, an exclusivity fee is to be distinguished from a license fee (only the latter should give rise to an allowance under the new regime). However, a rule is needed for licenses granted in perpetuity. These licenses should be amortised over a 30 year period.

Comment (effective dates): An effective date of 1 January 2008 is proposed. (SAICA, BUSA, MTN).

Response: Accepted. The legislation will apply to expenditure incurred during years of assessment ending on or after 1 January 2008.

Comment (annual license fees): Annual license fees are of a non-capital nature and should be expensed under the new legislation. (MTN).

Response: Not accepted. Annual license fees are not covered by the proposed amendments. Ordinary principles should apply. As a general matter, these licence fees would be deductible under the general deduction formula (depending on the circumstances).

Comment (unsuccessful license applications): The proposal is silent on the issue of an allowance when the application is unsuccessful. Expenses of this nature (e.g. legal and consulting) should be allowed as a deduction as a business expense if the taxpayer is trading in the relevant business sector in these circumstances. (Tsogo Sun).

Response: Not accepted. These expenses are outside the scope of this legislation. The proposed legislation only addresses payments required to acquire a license operating as a precondition for trade. Costs associated with an unsuccessful application raise a different set of issues.

4. Allowances in respect of industrial policy projects

Comment: The beverages industry has been specifically identified in the National Industrial Policy Framework as a relatively labour intensive sector that spans the primary, secondary and tertiary parts of the economy. It cannot have been the intention, in light of this framework, to exclude this industry from the application of the proposed section 12I. (Heineken SupplyCo).

Response: Not accepted. The intention behind a tax incentive of this nature is, firstly (and primarily), to address certain binding constraints (resulting from market or government failures). Secondly, the incentive seeks to ensure additionality (i.e. investments that are likely to be made without the tax incentive should not benefit therefrom). Given the nature of the alcoholic beverage industry, it is unlikely that it would require additional incentives to invest or that incentives for this industry could be justified.

Comment: The incentive programme excludes a number of sectors that are in the National Industrial Policy Framework. These sectors should also be entitled to the allowance. (Deloitte, BUSA).

Response: Noted but not accepted. The incentive programme is by design targeted at the manufacturing sector with specific exclusions. The proposed tax incentive is not intended to deal with specific sectors. It is intended to deal with generic market failures and support the broad objectives of the industrial policy action plan.

Comment: The 25 per cent rule for upgrades may exclude a number of projects whose monetary value is more than R200 million but where the percentage is less than 25 per cent of gross assets. (Deloitte).

Response: Accepted. The 25 per cent test was never intended as a measurement against total company gross assets. This measurement was always intended as a

comparison against total project gross assets. Any inference to the contrary will be clarified in the Explanatory Memorandum.

Comment: This incentive programme excludes improvements in energy efficiency not related to manufacturing. (BUSA).

Response: Not accepted. Section 12I is aimed at the manufacturing sector in support of the industrial policy action plan. Energy efficiency is one of the qualifying criteria and one of the elements of the point scoring system. The possibility of a more comprehensive incentive regime for energy saving equipment will be investigated over the next few years.

Comment: Use of second-hand or refurbished assets should be allowed, especially if the assets come from abroad. (Deloitte).

Response: Not accepted. Only new and unused assets qualify. This restriction is to ensure that firms invest in state-of the-art equipment and avoid importing old technology that may already have been discarded in other countries.

5. *Promotion of biodiversity*

Comment: In addition to Protected Areas, the deduction for conservation and maintenance expenses should be extended to include those expenses incurred by landowners in implementing any agreement to manage a Nature Reserve or National Park in terms of sections 20 and 23 of the National Environmental Management: Protected Areas Act, 2003. These agreements require management expenses that are at least equal to protected areas currently covered. (Ezemvelo KZN Wildlife, Botanical Society of South Africa, Cape Nature).

Response: Accepted. The proposed legislation will be modified to address this issue. The exclusion of Nature Reserves and National Parks was never intended.

Comment: The draft Bill allows the cost of land (and capital expenditure) for land owners with National Parks and Nature Reserves to be deemed as a deductible donation to Government. This deeming creates a 10 per cent limit. This limit should either be removed or the excess should be carried over for potential deduction in a later year. (Botanical Society of South Africa, WWF, South Africa, Cape Nature).

Response: Partially accepted. If this approach were to be followed, donations made in other circumstances would also have to be considered. However, the legislation will be modified so as to allow for the deduction to be spread over 10 years, which will have a similar effect to allowing the excess to be carried over for potential deduction in later years.

Comment: In terms of deducting restricted land, a landowner may not deduct the value of that portion of land over which that landowner retains a right of use. Where a right of use is retained and that use is regarded as sustainable use, this should not result in any disallowance of a deduction. (WWF South Africa, Botanical Society of South Africa).

Response: Not accepted. From a practical perspective, it is impossible to define such areas. However, it should be noted that the comparison of retained rights versus rights transferred is based on value. The retained rights of sustainable use will have little value as a practical matter; and therefore, should have little practical impact for purposes of the formula.

Comment: The proposed biodiversity management incentive should clearly specify what areas have high importance for biodiversity and should therefore be prioritized for purposes of qualifying for the incentive. This will assist statutory conservation bodies in coping with the flood of applications from landowners in areas of low biodiversity importance. (WWF South Africa, Cape Nature).

Response: Not accepted. The Department of Environmental Affairs and Tourism must set this prioritisation. The tax system can only provide incentives for areas chosen.

Comment: The meaning of the term “geographical vicinity” is unclear and should be clarified.

Response: The term “geographic vicinity” will be replaced with the term “immediate vicinity”. The intention is to have the trade on the same plot as the biodiversity agreement, an adjacent plot or in a plot within the same neighborhood.

Comment: Clarity is required when the recoupment rules are triggered by the breach of a management agreement. This breach trigger should apply only after the dispute resolution process has been exhausted. (Botanical Society of South Africa).

Response: Not accepted. As drafted, the law already presumes this result. However, this issue will be further clarified in the explanatory memorandum

Note: Based on further informal discussions, the proposed legislation is also being clarified in respect of deductible conservation and maintenance expenses under section 37C(1) regarding protected areas. The deduction will now be made available for both owners and lessees. In addition, the applicable trade against which the expense can be deducted can either be located on the land or in the immediate vicinity.

H. VALUE-ADDED TAX

Comment (inbound duty and tax-free shops): The definition of “inbound duty and tax free shops” should be formulated in the Customs and Excise Act in order to provide clarity on the supplies that will qualify for newly proposed zero rate. (SAICA).

Response: Partially accepted. Provision will be made for inbound duty free shops in the Rules to the Customs and Excise Act.

Comment (industrial development zones): If goods are never returned to the customs controlled area, a cascading impact occurs because the vendor would have declared output tax as a result of section 8(24) and in the normal course another charge occurs upon subsequent sale to third parties. Consideration should therefore be given to removing this double charge. (SAICA).

Response: Accepted. Relief will be provided in this circumstance. It was also necessary to provide relief for the situation where goods are temporarily removed from the customs controlled area and are disposed of by the vendor before the expiry of the 30 day period or such period approved by the Controller.

Comment (conversion to the micro business turnover tax): Why does the relief for switching out of vendor status apply only to parties that register for the very small business presumptive tax regime? (SAICA).

Response: A vendor is deemed to make a supply of goods and services upon deregistration for VAT. If a vendor opts to be registered for the presumptive turnover tax then that vendor is forced to deregister for VAT. It was therefore necessary to afford

these affected vendors monetary relief (in consideration of the deemed supply) for the forced deregistration.

Comment (increase in registration threshold): Consideration should be given to the back dating of the effective date of the change in the registration threshold (from R300 000 to R1 million). The effective date should be moved to the date of the announcement by the Minister of Finance or that a sunset clause be enacted for businesses that have acted upon the Minister's announcement in error. (SAICA).

Response: Not accepted. It was always intended that the turnover tax regime and the increase in the R1 million VAT registration threshold converge. While a Ministerial announcement existed, taxpayers cannot rely on that announcement until promulgated into law if the Budget Review does not specify a date.

I. CUSTOMS

Buying commission

Comment: There appears to be confusion regarding the purpose of the amendment. (Shepstone & Wylie, Edward Nathan Sonnenbergs, Shoprite Checkers).

Response: Noted. The explanatory memorandum will be amended to indicate that a buying commission is paid to an agent, not the seller of the goods, and therefore cannot be reflected on the seller's invoice. No specific provision for the deduction of the buying commission, as previously contemplated in section 67(2)(b)(v), is necessary.

J. CLAUSE-BY-CLAUSE

1. *Amendment of section 8C (executive share schemes)*

Comment: The proposal to tax capital distributions on restricted equity instruments is unfair to holders of these instruments. Currently, these distributions are only subject to STC. Moreover, distributions are made by companies – a decision over which holders have no control. Alternatively, it is submitted that the correct policy would be to subject the holder to tax in terms of the normal rules applicable to capital distributions. (Werksmans).

Response: Not accepted. From an employee perspective, capital distributions represent a salary-cash-out just like a sale of the employee shares. These distributions should be subject to tax as ordinary revenue when distributed.

2. *Research and Development Incentive*

Comment: It is hoped that the withdrawal of the recent change contained in the Taxation Laws Amendment Act, 2008 was unintended. It is therefore submitted that the proposed amendments to section 11D(7) and (8) should be redrafted to achieve the desired objectives without withdrawing the 150 per cent deduction for contract researchers funded by foreign persons (or other exempt parties). (PWC, Deloitte).

Response: Accepted. The amendments will be withdrawn for reconsideration.

Comment: The amendment adding the "novel and inventive" criteria as a precondition for the 150 per cent deduction for computer copyrights is unfortunate and inappropriate. It is not proper to import patent law concepts to regulate copyright law (or to determine income tax). In any event, originality is already a requirement for the existence of a

computer program under the Copyright Act, and it would therefore be redundant to create another requirement to the same effect in the Income Tax Act. (SAICA, Deloitte).

Response: Accepted. The amendment will be removed for reconsideration.

3. *Corporate conversions, share consolidations and share subdivisions*

Comment: While it is argued in the explanatory memorandum that the relief rules for corporate conversions, share consolidations and share subdivisions are unnecessary (i.e. section 40A, section 40B and paragraph 78(2) and (3) of the Eighth Schedule), it is submitted that the deletion of these provisions will result in a lack of certainty and should therefore be retained. (PWC, Bravura, CulminIT).

Response: Accepted. The proposed amendments will be withdrawn. These amendments will be reconsidered at a later stage.

4. *Stamp Duty*

Comment: It is proposed that an exemption from Securities Transfer Tax apply if the tax payable in respect of a particular transfer is less than R100. It is submitted that the draft legislation does not reflect this intention with the draft instead applying only when the aggregate tax payable over the period of a month is less than R100. (Computershare).

Response: Not accepted. The proposed wording of the amendment correctly reflects the desired intention. The suggested R100 *de minimis* rule would undermine the Securities Transfer Tax base, especially in respect of listed shares.

K. DRAFT REVENUE LAWS SECOND AMENDMENT BILL

1. *Provisional Tax*

Comment: The proposed amendment removes the safety net of the “basic amount” for purposes of penalties in relation to the underpayment of the second provisional tax payment (leaving taxpayers only with a 10 per cent margin of safety in terms of year-end estimates). This change upsets a very simple way of calculating and paying provisional tax. Many taxpayers cannot estimate their taxable income with any certainty at year-end and are often dependent upon external factors that have a significant effect on their taxable income. Such factors include the effect of exchange rates on the results, timing differences that can only be calculated after year-end, details of interest and capital gains from fund administrators, reliance on third party accountants to produce financial statements reflecting financial results for the year and reliance on the issuance of IRP5 certificates to individuals that are only issued after year-end.

Alternatives suggested include an automatic 10 per cent per annum increase in the basic amount if it is out of date or a reduction in the minimum estimate required for the automatic safe harbour from a penalty for under estimation be reduced from 90 per cent to 70 or 75 per cent. (Foschini Group, Banking Association of South Africa, Edward Nathan Sonnenbergs, Life Offices’ Association, BUSA, Werksmans, Deloitte).

Response: Partially accepted. Management accounts, trial balances, books of account, pay slips, bank statements, fund manager statements, etc. will be available to taxpayers for at least 11 months of the year. Taxpayers will also have a sense of the income for the final month as well as the magnitude of adjustments to be made from prior experience. That said, it is accepted that achieving the 90 per cent minimum may be challenging at present. Accordingly a reduction to an 80 per cent minimum is proposed.

In cases where the estimate falls short even of the 80 per cent minimum, the Income Tax Act provides for a waiver of the penalty on the shortfall if SARS is satisfied the estimate “was not deliberately or negligently understated and was seriously calculated with due regard to the factors having a bearing thereon...”.

2. *SARS Rulings*

Comment: In order to ensure transparency and the fair and equitable administration of tax legislation, the Commissioner should be compelled to publish all rulings (even if these rulings are the same). (SAICA).

Response: Not accepted. Private rulings are published in anonymous form and may not be relied upon by anyone other than the applicant for the ruling. Publishing duplicate rulings will not add to the ability of the public to review and comment on the principles set out in the rulings.

3. *Advancing 31 March due dates by up to two days*

Comment: The proposed provision does not specify when the Minister must publish the notice setting out the earlier due dates. (Ernst & Young)

Response: Accepted. A requirement that the notice be published at least 30 days before the earlier due date will be added.

4. *Possession and use of firearms*

Comment: The reference to “imminent or future death” is ambiguous and needs clarification. The word “future” needs amplification. (Edward Nathan Sonnenbergs).

Response: Accepted. Although the phrase referred to was drawn from the Criminal Procedures Act, 1977, the clause has been deleted. Officers using firearms in self defence or defence of another will be subject to the common law.