

# **Standing Committee on Finance (SCOF): Report-Back Hearings**

## **Draft Taxation Laws Amendments Bill, 2012 and Tax Administration Laws Amendment Bill, 2012**

### **Response Document from National Treasury and SARS, as presented to SCOF**

**(13 November 2012)**

#### **1. BACKGROUND**

##### **1.1 PROCESS**

The Draft Taxation Laws Amendment Bill, 2012 and Tax Administration Amendment Bill, 2012 were publicly released on 6 July 2012. National Treasury and SARS conducted the initial briefing before the Standing Committee on Finance on 31 July 2012. Public responses to the Committee were presented at hearings held on 22 August 2012 and 23 October 2012. Report back to the Committee occurred on 11 September 2012 and 6 November 2012.

##### **1.2 PUBLIC COMMENTS**

The National Treasury/SARS deadline for public written responses was 31 July 2012, but comments were allowed until 2 August 2012. These responses amounted to over 511 pages provided by approximately 58 organisations. Pursuant to recent practice, a series of National Treasury/SARS workshops were conducted with interested stakeholders to review all comments. In total, three general workshops were held on 30 July, 1 August and 2 August (one for individual and savings issues, one for business issues and one for international issues). Separate meetings were also held to review specific issues (e.g. mark-to-market taxation for banks, brokers and long-term insurers, real estate investment trusts (REITs) and short-term insurers).

#### **2. TEMPORARY DELAY OF DEBT/SHARE RULES**

The proposed legislation contains three sets of debt/share rules (i.e. sections 1 (“debt” and “equity share” definitions), 8F, 8FA and 23L), the core of which has a 2014 effective date. The main purpose of the proposed legislation was to deny or defer the deduction of interest if the debt at issue has significant share-like features or if the debtor has the power to defer payment. Given the tight schedule of the current legislative cycle, it was determined that these legislative proposals should be temporarily suspended (i.e. postponed for consideration in 2013).

#### **3. DIVIDEND CONVERSION SCHEME ANNOUNCEMENT**

On 31 August 2012, additional draft legislation was announced to close a series of related schemes designed to eliminate the dividends tax for foreign persons. While this sudden release of legislation is largely to be avoided after public hearings, the scale of the avoidance was so large as to place significant Government anticipated revenue from the Dividends Tax at risk. The scale of this loss required urgent action. The proposed comments below include taxpayer reactions to the proposed anti-avoidance legislation.

#### **4. POLICY ISSUES AND RESPONSES**

Provided below are the responses to the policy issues raised by the public comments received. Both policy and technical issues have been fully reviewed and included within the revised Bills as appropriate. Comments that fall wholly outside the scope of the Bills have not been taken into account for purposes of this response document. The references to the Bill provided below only link to the main references (i.e. the references are not exhaustive).

#### **5. INCOME TAX: INDIVIDUALS, SAVINGS AND EMPLOYMENT**

##### **5.1 Additional medical expenses converted to medical tax credits (Main references: Sections 6A and 6B)**

*Comment:* Between the proposals removing the unlimited medical deduction, and the static interest exemption, taxpayers age 65 years and older are being dealt a double blow. We propose that National Treasury reconsider the medical proposals particularly in view of ever-increasing medical costs and the fact that taxpayers at this late stage have no way to recover from the effect of these changes.

*Response:* Not accepted. The vast majority of taxpayers (and particularly those in income tax brackets below the 30 per cent bracket) will be better off. Only taxpayers taxed at a rate exceeding 33.3 per cent will receive less relief. More importantly, the relief will be more equitable and the marginal benefit will no longer be linked to income.

*Comment:* Persons with disabilities and taxpayers aged 65 years and older are particularly vulnerable and have less control than other individuals over medical costs, especially out-of-pocket expenses. Therefore, it is proposed that the rates of conversion for the medical credit be increased or that the current unlimited deduction be retained.

*Response:* Not accepted. The proposed changes (regarding out of pocket expenses) will only take effect in the 2015 tax year. Moreover, only taxpayers taxed at a rate exceeding 33.3 per cent will be negatively affected.

*Comment:* In order for an individual's qualifying medical expenses to exceed the 7.5 per cent ceiling, the circumstances have to be extraordinary. In essence, the current out-of-pocket regime is merely covering catastrophic medical events. A

review of the proposed 25 per cent conversion rate is accordingly requested as too low. The conversion rate should be at least 33.33 per cent.

*Response: Not accepted.* The intention has always been to provide tax relief (in addition to the tax relief provided for medical scheme contributions) for catastrophic medical events in particular. The 25 per cent conversion rate is most reasonable.

*Comment:* The proposed medical credit will not benefit taxpayers falling below the tax threshold because the credit is not refundable. It is proposed that a tax incentive be implemented to encourage medical scheme participation for low-income persons if that is the intention.

*Response: Comment misplaced.* The public health system benefits those below the income tax threshold. The proposed National Health Insurance plan is intended to expand and improve the health delivery system.

*Comment:* Medical tax credits in excess of annual taxes payable should be carried over to following tax years. This carryover would be similar to the carryover rules for non-deductible retirement annuity fund contributions.

*Response: Not accepted:* This approach is administratively unfeasible. As a matter of course, roll-overs are generally limited to business taxation. Taxation of individuals should be kept as simple as possible.

*Comment:* The definition of “dependent” for medical scheme credits is narrower than for medical out-of-pocket expenses. No reason exists for this disparity.

*Response: Noted:* There is arguably a difference between the definitions. Historical changes over the last 10 years have created some anomalies. The current wording ensures that the current and accepted language is kept in place until these anomalies are resolved without creating any unintended consequences.

*Comments:* It is proposed that the medical scheme tax credit apply monthly in the case of all taxpayers (regardless of age). Employers should be allowed to process the medical schemes credit on the payroll for employees who separately contribute in their own individual capacities.

*Response: Comment misplaced:* The Income Tax Act already allows for payroll withholding adjustments where employees pay their own medical aid contributions and provide proof to the employer. The adjustment requested accordingly exists without any need for a change in law (see paragraph 9(6) of the Fourth Schedule to the Income Tax Act).

- 5.2 Exemption for compulsory annuity income stemming from non-deductible retirement contributions  
(Main references: Sections 10C and 11(n); paragraphs 5(1) and 6(1)(b) of the Second Schedule)

*Comment:* The non-deductible contribution aspect of the compulsory annuity proposal does not refer to the correct funds. Contributions cannot be made to preservation funds. Preservation funds obtain funds only in respect of transfers from other funds (including the rollover of non-deductible contribution amounts). The fund references should be changed accordingly.

*Response:* Accepted. The references to preservation funds will be removed.

*Comment:* The new exemption does not apply to non-deductible contributions to provident funds to the extent that these funds may provide compulsory annuities to their members. It is proposed that the exemption be extended to include these types of funds to eliminate any prejudice.

*Response:* Noted. As National Treasury is in the process of considering broad changes to the provident fund regime as part of overall retirement reforms, this issue will be deferred until these broad changes are made. However, it should be noted that non-deductible contributions made to a provident fund will still be available as a set off against other compulsory annuities.

*Comment:* Many non-residents receive annuities and may have made non-deductible contributions. However, if these non-residents are not required to submit a tax return, there will be no opportunity to apply the exemption and provide these non-residents with a refund. It is requested that another alternative be considered to assist this class of annuity recipients.

*Response:* Not accepted. Withholding taxes apply irrespective of whether a taxpayer is registered or not. However, should a taxpayer wish to receive a refund, it is required that the taxpayer register with SARS so that the refund can be processed. As such, non-residents will continue to be required to register with SARS and submit a tax return in order to claim refunds. It is difficult to see how any other alternative would be less onerous without creating opportunities for evasion.

*Comment:* This proposal will require significant system changes and sufficient time is required to update systems to take into account the proposed legislation. It is therefore proposed that this proposal be effective only from 1 March 2014.

*Response:* Accepted. The effective date for this proposal will be 1 March 2014. This date will be aligned with other retirement reforms announced earlier this year.

5.3 Completion of the “clean break principle” when dividing retirement interest in divorce  
(Main references: Paragraph 2A)

*Comment:* The phrase “becomes payable” is confusing in the context of divorce. It is requested that the wording be clarified to differentiate whether the timing pertains to the date that the divorce order is assigned against the fund or pertains to the date that the election is made by the non-member spouse.

*Response: Partially accepted:* The proposed wording will be amended to “due and payable” as this wording is an accepted and an understood phrase as used in the Income Tax Act. The use of this wording means that neither the date of election nor the date of payment is the deciding factor. Instead, the timing event is the day that the amount becomes “due and payable” in terms of the divorce order (i.e. is collectible by the non-member spouse).

*Comment:* It is proposed that the tax-free pre-1998 portion for government employees be available to a non-member spouse when pension funds are split pursuant to a divorce transfer. In other words, both spouses should benefit from the pre-1998 exemption period, not just the member spouse.

*Response: Comment misplaced:* The proposal already achieves the requested objective. As with the member, the non-member spouse will retain the tax free portion for the first transfer to an approved fund. The overall policy is simply to divide the two pre-existing interests – tax-free allocations will be permitted as if the interests of both spouses were never divided.

5.4 Timing of certain forms of variable cash remuneration  
(*Main references: Section 7B*)

*Comment:* Various other income streams besides those listed may be classified as “variable remuneration”, all of which create similar payroll timing issues in respect of employer-dealings with SARS. It is proposed that the definition of “variable remuneration” be extended to include these other sources of income so as to eliminate similar payroll issues.

*Response: Noted:* The proposed amendment in respect of “variable remuneration” is intended to ease some of the common difficulties that employers are experiencing in respect of employees tax. More information is required before the list should be extended (that said, National Treasury opposes a generic description that could extend the regime to unintended items).

5.5 Fringe benefit valuation of rented employer-provided vehicles  
(*Main reference: Paragraph 7 of the Seventh Schedule*)

*Comment:* Reliance on the term “operating lease” to exclude financial leases from the rental employer-provided vehicle dispensation is too narrow. If the main concern is the implicit transfer of ownership, the definition of an “instalment credit agreement” under the Value-added Tax Act would be more appropriate. Alternatively, the requirement that the vehicle must be rented from a lessor who leases to the general public for time periods of less than a month should be dropped as overly restrictive.

*Response: Not accepted:* The definition of an “operating lease” will remain as initially proposed. What is envisioned is a vehicle obtained from an independent rental-vehicle provider that offers vehicles for a

period of a day, a week or a month. These situations are easy to value given the number of providers. However, it should be noted that the time requirement of “less than one month” does not preclude the providers of these vehicles from providing the vehicles for longer than one month. It merely serves to indicate that the providers must be in a position to provide these vehicles for periods of less than one month.

*Comment:* By inserting the requirement that the vehicle should be leased by the general public, certain lessor-provided vehicles are excluded, such as vehicles from a lessor with a majority of corporate entity clients. The term general public should include “corporate legal entities”.

*Response: Comment misplaced:* As a matter of interpretation, the definition of an “operating lease” does not exclude corporate lessees. The requirement merely clarifies that the “general public” should in fact be able to obtain these vehicles via these operating lease agreements.

*Comment:* The requirement that the “operating lease” must have been concluded at “arm’s length with an unconnected third party” requirement is overstated. It is proposed that the requirement be changed so that the transaction instead must be simply concluded at a market related price.

*Response: Not accepted:* The “arm’s length” principle is firmly established in the Income Tax Act (see section 31). Taxpayers must set a price at arm’s length in an open market. In addition, connected persons are to be excluded because of the potential collusion in setting a price.

*Comment:* It is proposed that fuel costs be included as part of the fringe benefit calculation relating to rental vehicles. The total fringe benefit to be included should therefore be the cost of the rental (in line with the proposed legislation) as well as the fuel costs directly related to that vehicle. This change will ensure that the employer-owned and employer-rented company car regimes will operate on a similar basis.

*Response: Accepted:* The fuel costs that are directly associated with a rental vehicle used by an employee will be viewed as a fringe benefit to be included within the remuneration calculation of an employee. The employee can, upon assessment, claim his or her business kilometers travelled in respect of this benefit.

5.6 Co-ordination of deduction and exemption rules in respect of employer-owned employee-related insurance policies  
*(Main reference: Paragraph (d)(ii) of the definition of “gross income” in section 1, and sections 10(1)(gH), 11(w), and 23B(5))*

*Comment:* The proposed exclusion to section 11(w) in respect of a workplace-related policy seems to apply only when the triggering event (death, disability, or severe illness of an employee) occurs. The result is that it would be impossible to determine whether a policy premium should be deductible in terms of section 11(a) or section 11(w) until the actual event triggering the payout occurs. It is proposed that the coverage offered by the specific policy should be the deciding

factor (i.e. if the policy only covers the death, disability, or severe illness of an employee upon occurrence of a workplace-related event, the policy will fall outside the ambit of section 11(w)).

*Response: Accepted:* The wording will be amended. The exclusion will apply if the policy only covers the death, disability, or severe illness of an employee if the death, disability, or severe illness occurs as a result of a workplace-related event. The wording will focus on coverage so as to avoid the concerns raised.

*Comment:* In the area of insurance, employers can provide two types of fringe benefits. An employer can pay premiums in respect of a policy taken out by an employee, or an employer can take out a policy for the employee (and again pay the premiums). The first scenario results in a fringe benefit for the employee at a zero value if indemnity insurance is involved (e.g. to protect against negligence or malpractice) whilst the second scenario results in a fully taxable fringe benefit.

*Response: Accepted:* Indemnity policies should not trigger a fringe benefit for employees if the employer funds the premiums. The relief should apply regardless of whether the employer or the employee takes out the insurance.

*Comment:* Application of the “gross income” calculation under paragraph (d)(iii) is unclear when insurance funds are indirectly transferred to employees.

*Response: Accepted:* This provision should apply if an employer receives an insurance payment and makes a subsequent payment of that amount to the employee. The words “directly or indirectly” will be inserted to clarify the position.

- 5.7 Cession of employer-owned insurance policies (with investment values) to retirement funds  
(Main reference: Paragraph (d)(iii)(cc) of the definition of “gross income” in section 1)

*Comment:* The explanatory memorandum states that a transfer of insurance policies by an employer to an approved retirement fund should not be taxable. However, the legislation continues to state otherwise.

*Response: Accepted:* The proposed amendment will be aligned with the explanatory memorandum.

## **6. INCOME TAX: BUSINESS TAX (GENERAL)**

- 6.1 Revised “share” definition  
(Main reference: Section 1 (definition of “share”))

*Comment:* The definition of a “share” should cover a member’s interest in a co-operative and a non-profit organisation. Without this coverage, the special rules relating to these entities will be rendered partially inoperative.

*Response:* Accepted. The current selective references to certain paragraphs of the company definition will be changed and reference will be made to all entities described in the “company” definition (thereby encompassing co-operatives and non-profit organisations).

*Comment:* The definition of “share” should encompass foreign co-operatives. South African companies often receive distributions from these entities via Netherlands and tax uncertainty could slow these repatriations.

*Response:* Accepted. The changes discussed in the response above should also address the concerns involving foreign co-operatives. Membership interests in these foreign co-operatives should accordingly be viewed as shares given the changes suggested.

6.2 Introduction of a definition of “debt”  
(Main reference: Section 1 (definition of “share”))

*Comment:* The proposed debt definition is too wide. The new definition seemingly includes non-credit arrangements (e.g. liabilities arising from lawsuits), which cannot be the intention.

*Response:* Accepted. Debt will not be defined in section 1. However, the terms relating to debt will be used consistently throughout the Income Tax Act with the term “debt” bearing its ordinary meaning.

6.3 Revised version of the hybrid equity and third-party backed share proposals  
(Main reference: Sections 8E and 8EA)

*Comment:* As currently drafted, relief from both anti-avoidance provisions is too restrictive because the consideration applied may not be used for purposes other than “solely” for the acquisition of shares. This restriction is unrealistic because consideration of this nature is often applied to transaction costs.

*Response:* Accepted. The word “solely” will be removed. The exception will apply as long as the “share is issued” by the issuer for the appropriate purpose, which will include transaction costs attendant thereto.

*Comment:* Relief from both anti-avoidance provisions does not allow for the acquisition of shares in respect of pre-existing group companies, even if the shares are acquired from a wholly independent minority. While the prohibition of the use of funds to acquire shares already held within the group is understood (because intra-group acquisitions of this kind could render the purpose test meaningless), the prohibition against acquiring shares from an independent minority should be dropped.

*Response:* Accepted. The language will be redrafted to ensure that purchases from independent minority shareholders are permissible. Only purchases of shares already held by group members should be excluded.

*Comment:* Third-party guarantees should be permissible if made by any group company in relation to the issuer. No requirement should exist that the



guarantee provided by the group company should bear some form of relationship in terms of ranking and quality in respect of another group company member.

*Response:* Accepted. The ranking comparison will be removed as impractical. All group companies related to the issuer, the other issuer and operating companies will be allowed to provide guarantees regardless of ranking.

*Comment:* The 20 per cent ownership requirement for holders of the operating company, the issuer and the other issuer is too high. The level should be reduced. Natural persons, community trusts and employee trusts often own a much lower percentage.

*Response:* Partially accepted. The 20 per cent per cent ownership requirement for special purpose holders will no longer apply to natural persons and community trusts. However, employee trusts will still be subject to the 20 per cent ownership requirement (out of anti-avoidance concerns).

*Comment:* The relief for acceptable purposes under the hybrid instrument and third-party backed share provisions appear to read contrary to the intended purpose due to the use of the word “or”. Taxpayers may have mixed purposes for the acquisition, each which is acceptable but not as an aggregate. A combination of good purposes should be allowed.

*Response:* Accepted. The language will be clarified to state that acceptable purposes can be taken into account individually or in combination.

*Comment:* The third-party backed share rules appear to adversely impact standard hedging. Standard derivative hedges are often applied in respect of both the share as well as any associated dividends.

*Response:* Accepted. The anti-avoidance rules will be limited to preference shares. Ordinary shares will no longer fall within the anti-avoidance rules. The exclusion of ordinary shares should eliminate most of the concerns raised because standard hedging practice mainly relate to ordinary shares (i.e. shares that lack an interest-like yield).

*Comment:* The anti-avoidance rules for hybrid equity instruments and third-party backed shares do not cater for multiple redemptions or serial transactions as intended.

*Response:* Accepted. The allowable purposes in the hybrid equity instrument and third-party backed share provisions will make reference to each other, thereby allowing for serial redemption or serial transactions.

*Comment:* Earlier versions of the new hybrid equity instrument provisions allow for restrictions upon distribution (e.g. restrictions prevent distributions to protect collateral or to prevent distributions from undermining solvency or liquidity).

However, the proposed provisions have removed this allowance. These types of restrictions should be permitted.

*Response:* Not Accepted. The restriction relief requested is unnecessary because the allowable purpose test overrides all other purposes. In other words, if the purpose is valid (i.e. to acquire shares in an operating company), all of the various restrictions (including the restrictions upon distribution) are irrelevant.

*Comment:* The part-year rules relating to hybrid equity instruments and third-party backed shares are too harsh. The “income” taint for impermissible features even applies in respect of portions of the year in which those features exist when the holder does not have ownership.

*Response:* Not accepted. The problem seems to be more theoretical than real. No facts were provided to substantiate the request.

*Comment:* If the instruments contemplated in section 8E and 8EA are viewed as akin to debt, shouldn't these instruments be viewed as generating both deductible interest for the payor and interest that is received or accrued by the payee?

*Response:* Noted. The comment raises legitimate concerns about creating an “interest deduction” as a matter of fairness / symmetry. However, the provision is an anti-avoidance provision and counter-concerns exist that the deemed interest deduction could then be used for a new form of avoidance. If taxpayers want an interest deduction for interest, they have the power to label the instrument as debt so as to ensure the deduction.

*Comment:* If the anti-avoidance rules for hybrid equity and third-party backed shares apply, the Dividends Tax should not apply. At present, the income yield from these shares appears to lead to double taxation.

*Response:* Comment misplaced. The current proposal in respect of section 64F(1)(l) seeks to exempt dividends from Dividends Tax that were not exempt from normal tax. While this language should be sufficient, the language will be further clarified to exempt a dividend if that “dividend constitutes income”.

*Comment:* The exception to the hybrid equity and third-party backed share anti-avoidance rules appear to allow for the acquisition of a domestic company but not that of a foreign company. This distinction lacks any policy rationale.

*Response:* Accepted. The acquisition of a foreign operating company will also be included as an allowable purpose. The inclusion of foreign operating companies should not represent any additional risk to the fiscus.

*Comment:* The permissible uses of preference shares should be expanded. Taxpayers should be allowed to use debt-like preference shares to fund dividend distributions and redemptions, amongst others.

*Response:* Not accepted. The intention is to limit the use of preference shares solely to finance the acquisition of qualifying equity shares. If the other purposes are accepted, the anti-avoidance regime will be rendered essentially meaningless.

*Comment:* The hybrid equity and third-party backed share anti-avoidance rules should allow for additional layers beyond the two layers of special purpose vehicles currently allowed. At present, the rules appear to solely allow for two sets of back-to-back issuers of preference shares. Certain structures are more complex, containing further chains even though the goals are essentially the same.

*Response:* Comment misplaced. The current wording allows for multiple levels. (Note: legislative use of the singular and the plural are interchangeable in accordance with the Interpretation Act).

*Comment:* The hybrid equity and third-party backed share anti-avoidance rules should allow for syndicated security special purpose vehicles. These vehicles add to the level of funding security when a group of funders are involved.

*Response:* Noted. We understand that these special purpose vehicles are shell entities solely to add legal strength to the guarantees involving group funders. However, further information is required from stakeholders at this stage before this matter can be addressed. This issue will be taken into account for possible inclusion in the next budget cycle.

*Comment:* The rules allowing for the acquisition and redemption of preference shares (previously used for valid purposes) should include the settling of accrued dividends in respect of those shares.

*Response:* Accepted. The payment of accrued dividends will be specifically included in the good purpose test.

*Comment:* Given the ongoing changes to the hybrid equity and third-party backed share anti-avoidance rules, the proposed effective date should be further delayed.

*Response:* Accepted. The proposed amendments to hybrid equity and third-party backed share anti-avoidance rules will come into operation on 1 January 2013 and apply in respect of dividends and foreign dividends received and accrued during years of assessment commencing on or after that date. However, in order to prevent the artificial acceleration of dividends before the effective date (i.e. amounts that are declared before but only paid afterwards), dividends paid in cash after the effective date (but accrued before) will generally be subject to tax under the new regime

(if accruing on or after 1 April 2012). This caveat to the deferral of the effective date will prevent artificial accelerations of amounts before the effective date.

6.4 Qualifying interests in asset-for-share reorganisations  
(Main reference: Sections 42 and 46)

*Comment:* Current law allows for foreign shareholders to hold up to 20 per cent of the unbundling company after the transaction. No reason exists for this threshold to be reduced to 10 per cent, especially if these shareholders are not part of the unbundling transaction.

*Response:* Accepted. The foreign limitation in respect of unbundlings will remain at 20 per cent for the time being. The rules denying unbundlings in the case of foreign shareholders need to be revisited. The real issue is whether the unbundling distribution is to foreign shareholders, not whether foreign shareholders exist. Hence, this area must be re-examined as part of the proposed review of company tax reorganisations.

*Comment:* The roll-over relief in respect of unbundling transactions should also cover return of capital distributions.

*Response:* Not accepted. This amendment is not necessary as a company is free to elect whether to distribute dividends or contributed tax capital. Therefore, taxpayers can simply avoid the issue by not electing to utilise contributed tax capital.

6.5 Share-for-share recapitalisations  
(Main reference: Section 43 and paragraph 78 of the Eighth Schedule)

*Comment:* The proposed rollover relief in respect of share-for-share recapitalisations of a single company should be allowed in the case of non-equity for non-equity share exchanges. This form of share-for-share relief would merely leave the shareholders at issue in roughly the same position as before.

*Response:* Accepted. Relief will be provided in the case of substitutive share-for-share rollover transactions for non-equity swaps that do not change the nature of the interest (i.e. where a person disposes of a non-equity share for a non-equity share by means of a subdivision or consolidation).

*Comment:* The removal of the previously existing share-for-share relief under paragraph 78 of the Eighth Schedule is premature. Those rules also addressed share distributions (i.e. scrip dividends), and the new rules do not cover this aspect.

*Response:* Accepted. Although paragraph 78 of the Eighth Schedule is being repealed, pre-existing section 40C should apply to deem a nil base

cost for distributed equity instruments. Therefore, this aspect will be fully covered.

6.6 Value mismatches involving share and debt issues  
(Main reference: Sections 24BA and 24BB)

*Comment:* The consequences of a share mismatch (taxable gains associated with value shifting) should be measured with reference to the arm's length price of the assets *vis-a-vis* the shares exchanged as opposed to the market value thereof.

*Response: Accepted.* The share mismatch rules will apply if one or more assets are acquired by a company in exchange for the issue of shares and the transaction would not have been entered into between independent parties dealing at arm's length. The market value test will be dropped. The share issue must simply be measured in isolation to determine if the issue would stand on its own using arm's length principles. Because the concerns involving debt only arise in the context of intra-group rollovers, the debt mismatch rules will be dropped.

*Comment:* The proposed anti-avoidance rules undermine the reorganisation rules, especially within the context of group members (e.g. if assets are transferred to a wholly-owned subsidiary).

*Response: Accepted.* These rules will not apply to transactions between companies that are part of the same group of companies. Although the initial group rules assumed that most group transactions occur at book value (as opposed to market value), it should be noted that avoidance concerns do exist in the group context.

*Comment:* The "value shifting" rules should not be completely removed because these rules cover transactions other than share or debt issues.

*Response: Accepted.* The "value shifting" rules will be retained. However, where the "value shifting" rules apply, the proposed share mismatch rules will not apply.

6.7 Debt-financed acquisitions of controlling share interests  
(Main reference: Sections 23K and 24O)

*Comment:* The use of the word "solely" for permissible debt-funded share acquisitions is overly restrictive. The debt may be applied to transaction costs and the acquisition may include shareholder loans.

*Response: Accepted.* The words "solely" and "directly" will be removed. As a result, the funds may be applied for transaction costs and the settlement of shareholder loans.

*Comment:* Permissible deductible interest should include situations where the debt is used to acquire foreign shares. The rules at present allow only for the acquisition of domestic shares.

*Response:* Noted. This issue will be considered for the next legislative cycle. At this stage, concerns exist that an interest deduction in these circumstances could give rise to local deductions without any direct or indirect corresponding income.

*Comment:* The percentage threshold for permissible debt-funded share acquisitions should require a lower threshold. At present, the acquiring company must acquire at least 70 per cent of the target company.

*Response:* Not accepted. The rules are designed to mirror section 45, which is premised on a 70 per cent threshold.

*Comment:* The rules for permissible debt-funded share acquisitions should cover creeping acquisitions. At present, a 70 per cent percentage point increase in the target company is required.

*Response:* Comment misplaced. If a taxpayer owns less than 70 per cent and acquires additional shares to reach the 70 per cent threshold, the new rules currently apply. The parties at issue need not acquire the full 70 per cent amount in the transaction.

*Comment:* The rules for permissible debt-funded share acquisitions allow only for an interest deduction against the taxable income of the acquiring company. While this deduction is appreciated, the acquiring company is often a shell holding company that cannot use the deductions as a practical matter. Therefore, for this new rule to be fully effective, the associated interest deductions should be allowed against the target company's taxable income.

*Response:* Not accepted. We note that what the comment really seeks is a form of group taxation in respect of losses. However, this request falls outside the scope of the current Bill. Transfer of losses among group members will require a major policy review.

*Comment:* The proposed relief for debt-funded share acquisitions should be more closely linked to section 11(a) so that the deduction for interest is fully assured. At present, only the "production of income" test has been dropped. The parties at issue must still be engaged in a trade.

*Response:* Accepted. The "production of income" and related trade requirements for the deduction will be dropped. Instead, the target company must either be an operating company or a holding company that controls an operating company.

*Comment:* Persons other than companies should be allowed to utilise the permissible debt-funded share acquisition rules. Natural persons and trusts often engage in debt-funded share acquisitions.

*Response:* Not accepted. The regime mirrors section 45, which requires a company purchaser.

*Comment:* The rules for permissible debt-funded share acquisitions appear to limit the nature of the seller. Under the literal wording of the rule, the selling party can only be the target company itself.

*Response:* Accepted. The target company should not be required as a party to the deal. Any seller should be allowed (e.g. including a shareholder of a company) because no restriction exists of this nature in a section 45 acquisition.

6.8 Debt reductions for less than full consideration  
(Main reference: Section 19 and paragraph 12A of the Eighth Schedule)

*Comment:* The base cost of assets acquired with borrowed funds that are later cancelled should not be reduced again under paragraph 20(3)(b) if reduced under the debt cancellation provisions. At present, the debtor appears to undergo a double reduction in base cost for the same debt cancellation.

*Response:* Accepted. No double reduction of base cost was ever intended. The base cost reduction provision in paragraph 20(3)(b) to the Eighth Schedule will only be applicable to the extent that the provisions of section 19 are not applicable to prevent double reduction of base cost. For similar reasons, the base cost reduction rules of paragraph 20(3)(b) to the Eighth Schedule will also not apply to base cost reductions under 12P (“amounts received or accrued in respect of government grants”) (see below).

*Comment:* The debt cancellation rules should be applied only to decrease the base cost of assets to nil. Reductions from debt cancellations should not create a negative base cost.

*Response:* Comment misplaced. The interpretation of the term “reduced” means “reduced” to nil (not below).

*Comment:* The proposed debt reduction rules for ordinary revenue overlap with section 24J(4A). Both provisions should not apply to the same debt cancellation.

*Response:* Accepted. Section 24J(4A)(b) will be amended so that this provision does not apply to the extent the ordinary debt reduction rules apply.

*Comment:* We understand that the proposed debt reduction rules are aimed at assisting financially distressed debtors. However, the rules do not deal with issues associated with the longstanding “trade” requirement for maintaining a balance of assessed losses. The “trade” requirement should be eliminated (at least when the entity at issue is undergoing business rescue).

*Response:* Noted. While the arguments raised seemed reasonable, the “trade” test for losses falls outside the current focus of the bill. This issue will be considered in the next budget cycle.

*Comment:* The ordinary debt reduction rules in section 19 will be easier to apply if there is a straight ordinary recoupment without any reference to the reduction of losses. If the taxpayer has ordinary losses, these losses can still be used to reduce any ordinary revenue that would otherwise arise.

*Response:* Accepted. Ordinary debt reductions will be limited to cost price reductions and recoupments. The loss reduction concept will be removed.

*Comment:* The impact on allowance (i.e. depreciable) assets differs in the proposed law from the draft Explanatory Memorandum. In the draft Explanatory Memorandum, base cost is reduced first, followed by potential recoupments. In the proposed legislation, recoupments are addressed first. The approach suggested by the draft explanatory memorandum is preferred because the method used in the proposed legislation provides no relief for debt cancellations.

*Response:* Accepted. The draft Explanatory memorandum is correct. The base cost of assets should be reduced first. Once the base cost is zero, any further debt costs should give rise to potential recoupments. The proposed legislation will be amended accordingly.

*Comment:* The proposed debt cancellation rules require significant tracing. Unfortunately tracing is often difficult to perform when debt is used for aggregate purposes (e.g. credit lines, working capital facilities, general banking facilities, rolling credit facilities).

*Response:* Not accepted. The current law also requires the tracing of cancelled debt. Tracing will always be required as long as there is a capital/ordinary distinction.

*Comment:* Despite the statement in the draft Explanatory Memorandum, no rule explicitly alleviates the tax impact of tax debt reductions provided by SARS. Possible ordinary revenue or debt cancellation could accordingly continue to arise when SARS agrees to reduce tax debt (one of the major shortcomings of current law).

*Response:* Accepted. Tax debts will be specifically excluded from the capital gain debt cancellation rules. Taxing relief from SARS tax debt compromises essentially undermines the compromise agreed upon.

*Comment:* The tax rules do not provide any explicit coverage of how debt reductions impact pre-effective date assets of a capital nature. Special rules are required because these assets may have one of three base cost determinations (2001 market value, time-based apportionment and the 20 per cent proceeds rule).



*Response:* Accepted. All pre-effective date assets impacted by a base cost reduction will be treated as having a deemed disposal/reacquisition (similar to return of capital distributions) solely for base cost calculation purposes.

*Comment:* The debt relief rules for connected persons and liquidations do not appear to be necessary. The general rule automatically eliminates capital gain arising from debt cancellations.

*Response:* Comment misplaced. Relief is still necessary to avoid base cost/capital loss reductions in respect of debts that are not linked to assets.

*Comment:* Under current law, relief for debt cancellations in the context of company liquidations and connected person cancellations exists so as to prevent capital gains tax. This form of relief should be extended for debt cancellations potentially giving rise to ordinary revenue.

*Response:* Noted. The proposed rules for debt cancellation establish a new basic framework. Once this framework is established, the collateral rules (such as the relief mechanisms raised) will be addressed in the next budget cycle.

6.9 Conversion of share block interests to full title  
(Main reference: Paragraph 67B of the Eighth Schedule, section 9(19) of the Transfer Duty Act and section 8(19) of the Value-added Tax Act)

*Comment:* The rules for share block conversions are overly restrictive because these rules seemingly require the liquidation of the share block company. However, in many cases, the share block company continues to exist solely to govern (and hold title to) the common use areas (with the exclusive use areas now being in the hands of the shareholders in the form of full title).

*Response:* Accepted. The liquidation requirement was never intended for the reasons stated. Any language to the contrary will be eliminated.

*Comment:* Sometimes persons other than natural persons hold interests in the share block company undergoing the conversion. This form of ownership is permitted under the capital gains provisions but is seemingly absent from the transfer duty. Companies and trusts should also be exempted from transfer duty in the case of share block conversions.

*Response:* Accepted. The capital gains provisions are correct. The transfer duty will be adjusted to allow for persons other than natural persons to be exempt in the case of share block conversions.

*Comment:* The share block conversion rules fail to provide relief from Dividends Tax. This omission leaves these conversions vulnerable because any form of share block conversion will otherwise be subject to the Dividends Tax (unless the shareholder is another company).

*Response:* Accepted. A new exemption will be added so that share block conversions will be free from Dividends Tax.

## **7. INCOME TAX: BUSINESS TAX (FINANCIAL INSTITUTIONS AND PRODUCTS)**

### **7.1 Mark-to-market taxation of long-term insurers** (*Main reference: Sections 29A and 29B; paragraph 32(3A) of the Eighth Schedule*)

*Comment:* Introduction of an annual mark-to-market system is slightly premature in view of the four funds review. The market-to-market regime should be limited solely to 29 February 2012 – the item of sole concern stemming from the change in capital gains rates.

*Response:* Accepted. The mark-to-market system will be limited to a deemed disposal and reacquisition on 29 February 2012. Introduction of an annual market-to-market system will be reconsidered going forward.

*Comment:* Assets (e.g. collective investment scheme interests) held by long-term insurers conducting business as linked investment service providers are more directly linked to each policyholder (unlike assets held pursuant to a general long-term insurer license). For instance, a change in asset mix desired by the policyholder of a linked policy will result in a disposal by the long-term insurer (whereas, a change in asset mix initiated by other types of long-term policyholders may not trigger an actual disposal, only a reallocation or netting of assets by the long-term insurer). Therefore, the rationale for imposing the 29 February 2012 mark-to-market event does not apply in these cases and a deemed disposal should not apply.

*Response:* Accepted. The mark-to-market regime will not apply to the extent assets are held by a long-term insurer pursuant to a Linked Investment Service Provider (LISP) policy (i.e. a policy held pursuant to business conducted under a category 3 license granted in terms of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002)).

*Comment:* The mark-to-market regime should not apply to debt and related-interest bearing products (including related derivatives). Gains in respect of these instruments are nominal and the mark-to-market regime creates more of a compliance burden than any potential revenue raised.

*Response:* Accepted. Debt and other forms of interest bearing arrangements (as well as interest based derivatives) will be removed from the mark-to-market 29 February 2012 event for the reasons stated.

*Comment:* The special rules relating to derivatives are unnecessary. For a variety of reasons, the capital gain or loss in respect of derivatives will be appropriately taken into account under current law principles.

*Response:* Accepted. The definitions of “derivative” and “derivative difference” will be deleted. There will be no special mark-to-market rules for derivatives.

*Comment:* Relief is required for long-term insurers that hold reinsurance investment policies issued by local insurers. In these instances, the local reinsurer is subject to the deemed 29 February 2012 charge in respect of the underlying assets backing the policy. Therefore, the insurer holder of the reinsurer policy should not be subject to tax again on the value change in respect of the reinsurance policy. In addition, taxation of foreign reinsurance will disrupt pre-existing relationships.

*Response:* Accepted. The holding of reinsurance will not be subject to the 29 February 2012 mark-to-market charge. However, a problem exists in the case of foreign reinsurance because this form of reinsurance held by long-term insurers appears to have unwarranted relief from ongoing taxation. In particular, the redemption of foreign reinsurance claims appears to be exempt under pre-existing law. This exemption will be removed in 2013.

*Comment:* The market value rules for the 29 February 2012 event should differ from the standard definition used for long-term insurers. Value should be based on the value reported to policyholders.

*Response:* Partially accepted. Listed instruments and associated derivatives will effectively remain subject to the “market value” definition of section 29A(1) (because this value is readily determinable). However, the value of assets outside this paradigm will be based on amounts reported to policyholders.

*Comment:* The rules should apply to all policyholder funds (including the untaxed policyholder fund which is taxed at a rate of zero per cent). Insurers would prefer to have the same calculation for all policyholder funds.

*Response:* Accepted. The mark-to-market regime will apply to all policyholder funds for the reasons requested.

*Comment:* The lack of recoupment on 29 February 2012 in respect of immovable property assets creates an unfair advantage because taxpayers previously had the benefit of ordinary allowances. The increased cost could also be used as a starting point for future allowances.

*Response:* Partially accepted. The non-recoupment rule for allowance assets will remain. However, assets of a capital nature will no longer be eligible for deductions or allowances from 1 March 2012.

*Comment (paragraph 32(3B) of the Eighth Schedule):* The weighted average system for calculating base cost should remain (as proposed) for all assets subject to the mark-to-market regime (thereby implicitly excluding debt and debt derivatives, amongst others). In addition, long-term insurers should be freed from the loss denial rules for sales and repurchases occurring within 45 days (i.e.

paragraph 42 of the Eighth Schedule) because the weighted average method eliminates the schemes of concern.

*Response:* Accepted. The weighted average method will be mandatory for all assets subject to the 29 February 2012 mark-to-market event. In addition, weighted average assets of this nature will not be subject to the 45-day rules.

*Comment (paragraph 32(3B) of the Eighth Schedule):* The weighted average method should apply to all policyholder funds, including untaxed policyholder funds (which are taxed at a rate of zero per cent). Insurers would prefer a single method for all assets to simplify compliance.

*Response:* Accepted. The weighted average method will apply to all policyholder funds, including the exempt policyholder fund and will be available for all types of assets deemed to have been re-acquired on 29 February 2012.

*Comment (paragraph 19 of the Eighth Schedule):* Although rare, taxpayers should not be subject to the anti-loss rules for extraordinary dividends preceding the 29 February 2012 deemed sale. This deemed sale was not anticipated by taxpayers and any extraordinary dividends before the date would have been coincidental.

*Response:* Accepted. The anti-loss rule for extra-ordinary dividends will not apply to the mark-to-market event that was deemed to occur on 29 February 2012.

*Comment (section 29A(11)):* The proposed four-fund indirect expense deduction formula is supported because the proposed formula is far more principled than the random nature of the current deduction formula (the latter of which is the cause of many anomalies). However, the 29 February deemed gain should not be taken into account in the new formula (even if spread over a few years).

*Response:* Not accepted. The built-in gain realised as a result of the 29 February 2012 deemed sale event must be taken into account; otherwise, the deduction-level under the formula will increase unrealistically. However, because the new formula is delayed until 2013, only three years of this built-in gain will be taken into account (25 per cent in each of 2013, 2014 and 2015).

*Comment (section 29A(11)):* The transfer deduction ratio will be too high once the new changes in the deduction formula are taken into account. The ratio should accordingly be reduced by adjusting the current 50 per cent factor.

*Response:* Accepted. The current 50 per cent factor will be reduced to 30 per cent. The net result will leave most long-term insurers in approximately the same position as before (with an effective threshold of roughly 15 per cent).

*Comment (section 10B):* The new partial inclusion system for foreign dividends does not properly account for foreign dividends received or accrued in taxable policyholder funds. As a result, the rate for foreign dividends slightly exceeds the rate for other taxpayers.

*Response:* Accepted. The partial inclusion ratio for individual policyholder funds should be 15/30 and the partial inclusion ratio for company policyholder funds should be 13/28. The net effect is a 15 per cent rate (the same rate as for other taxpayers).

7.2 Annual Fair Value Taxation of Financial Instruments in Respect of Financial Institutions  
(Main reference: Sections 24J(9) and 24JB)

*Comment:* The proposed mark-to-market taxation of banks/brokers in respect of financial instruments will effectively tax all dividends as ordinary revenue if held for trading. This treatment of dividends as ordinary revenue will place banks and brokers in a worse position than other shareholders, making the banks and brokers uncompetitive. In addition, the additional charge on these type of company shareholders will result in double taxation of corporate profits.

*Response:* Noted. It is understood that taxation of all dividends in respect of shares held for trading will result in the consequences stated. On the other hand, the failure to tax dividends in a mark-to-market system will lead to readily available opportunities for tax arbitrage. The profit generated from dividend income will also be significantly reduced by related expenditure. Given the recent dividend conversions schemes (and the cost to the fiscus resulting from this avoidance), the potential loss of revenue of wholly exempting dividends in a mark-to-market context is too high to justify any changes without further consideration. Therefore, the effective date of the proposed mark-to-market regime will be deferred until 1 January 2014.

*Comment:* The “covered persons” eligible for the new regime are too narrow. The list of covered persons should either be extended or the current section 24J(9) election should be retained.

*Response:* Noted. The current system of elections under section 24J(9) lacks control and creates opportunities for arbitrage. If the list needs to be extended, the list should be extended without regard to elections. That said, the deletion of section 24J(9) will be delayed until 1 January 2014 (like the postponement of the new mark-to-market regime).

*Comment:* The coverage of financial instruments needs to account for certain types of share interests that are accounted for on a market-to-market basis due to internal management reporting. However, strategic stakes in companies reported on a mark-to-market basis for these reasons should be outside the system so as to avoid liquidity issues.

*Response:* Noted. The type of financial instruments within the regime still needs further refinements. For instance, the U.K. only takes into

account instruments held for trading under tax law purposes; whereas, the proposed system takes into account all instruments (even if held on capital account for tax purposes).

*Comment:* The rules seeking to close arbitrage between group companies – one of which is on the mark-to-market basis and the other of which is not, are overly broad. Given the number of intra-group transactions, the deviation from accounting will be significant, thereby undermining the proposed simplification.

*Response:* Noted. The need for a narrower rule is understood. On the other hand, this area represents a significant risk for the fiscus. The appropriate balance still needs to be found - hence, another reason for delaying the overall proposal until 2014.

*Comment:* The current rules do not create convergence between tax and accounting. For instance, loan impairments do not follow accounting (like the U.K. system) nor do other events follow mark-to-market accounting (like certain share incentive schemes). It would be simpler for the rules to move closer to accounting, thereby reducing arbitrage and promoting further simplification.

*Response:* Noted. A more comprehensive regime represents an attractive solution for both taxpayers and the fiscus. However, these issues require further research.

*Comment:* The transitional rules are overly complex. Tax values should be ignored. Taxpayers should simply be subject to a charge based on their deferred tax account associated with unrealised financial assets.

*Response:* Noted. The proposed regime is simply seeking to compare tax and accounting deviations. The short-cut solution is worth examining but will require further investigation to determine viability.

### 7.3 Creation of a unified system for taxing REITs (property investment schemes) (Main reference: Section 25BB)

*Comment:* The new system for immovable property entities (i.e. hereinafter referred to as REIT) should not be limited to listed entities. There are many other entities operating on a similar basis, including pension-owned property funds, insurer-owned property funds and various other forms of unlisted funds (some of which are referred to as incubator funds). No reason exists for these funds to be operating on a lesser basis (with the current listed vehicles effectively being given a permanent tax advantage).

*Response:* Noted. The creation of a special tax regime for REITs is being enacted through a phased approach. Other forms of REITs will be addressed in 2013.

*Comment:* The proposed regime for immovable property entities should cater for mortgage bonds. This extension would lower overall mortgage costs for the banking industry by making these bonds more liquid.

*Response:* Noted. Investment vehicles in mortgage bonds are a slightly different form of product. This type of investment vehicle may be aligned with either the proposed REIT system or an adjusted tax dispensation associated with Collective Investment Schemes. This issue will be considered going forward.

*Comment:* The treatment of a “property subsidiary” as a REIT is too restrictive. Distributions by foreign subsidiaries should be included as rental income when received by a REIT (or another property subsidiary).

*Response:* Partially accepted. The receipt of qualifying distributions from a foreign subsidiary will be treated as rental income. Hence, these amounts can be relied upon for purposes of the more than 75 per cent rental income determination. However, no reason exists to grant a deduction for an offshore entity that mainly falls outside South African tax jurisdiction.

*Comment:* The treatment of a “property subsidiary” implies a more than 50 per cent ownership threshold. However, a number of property investment entities hold a lesser percentage (20 per cent or more) in unlisted property vehicles. The threshold should accordingly be reduced to a more practical level.

*Response:* Partially accepted. Distributions from a 20 per cent or greater associate can be treated as rental income for purposes of the more than 75 per cent test (if that entity generates more than 75 per cent of gross income in the form of rental). However, this 20 per cent or greater associate is not eligible for the distribution deduction.

*Comment:* The treatment of a “property subsidiary” as a qualifying vehicle is too narrow because the term implies that the entity must be a company. Controlled trusts should also be included.

*Response:* Partially accepted. The trusts at issue are typically vesting trusts that directly hold immovable property or trusts that hold a company, which in turn holds immovable property. If the trust holds immovable property directly, no issue arises because the rental income will simply flow-through because a vesting trust is a conduit for income. The real problem is the vesting trust ownership of a subsidiary because that subsidiary is not a group company in an Income Tax sense (i.e. the trust breaks group company ownership). It is accordingly proposed that the group test be determined in accordance with International Financial Reporting Standards because this test would treat a subsidiary of this nature as part of the group (and this test would also be more consistent with the JSE rules).

*Comment:* The receipt of earnings from a REIT should continue to qualify as interest (which is exempt for foreign investors). Taxable income treatment may discourage foreign investors.

*Response:* Not accepted. Countries with real estate investment trust legislation do not grant exemption for yields distributed to foreign

investors. The standard paradigm is to treat the yield as taxable dividends subject to tax treaty relief. It is accordingly proposed that distributions from a REIT similarly be treated as a taxable dividend. It should be remembered that primary taxing jurisdiction in respect of immovable property and immovable property companies is typically reserved for the source country under tax treaties. However, this taxable treatment for foreign shareholders will be delayed until 1 January 2014 because taxable treatment will require system changes in respect of JSE listed shares.

*Comment:* The proposed system will create confusion for investors when receiving regular distributions because the nature of the yield may vary depending on the rental income generated by the REIT. Still worse, the level of rental income may not always be precisely known until after the distribution.

*Response:* Accepted. Distributions from a REIT will be treated as taxable dividends without regard to the level of rental income produced by the REIT. The level of rental income will only impact on whether the distribution is deductible by the REIT.

*Comment:* The determination of whether a distribution qualifies as a deductible rental distribution is based on the prior year of assessment. While this one-year look-back is preferred for certainty, this one-year look-back is impossible to apply during the first year of operations.

*Response:* Accepted. A special rule will be added for newly formed entities. The rental-to-gross income test for these entities will be measured prior to distribution during the current year for entities formed within that year.

*Comment:* It is unclear what types of income qualify as rental income for purposes of the 75 per cent threshold. Rental income should include all forms of income earned from the use of immovable property, not just pure rental.

*Response:* Accepted. Rental income will include all amounts received or accrued in respect of immovable property, including interest and penalties for failure to pay for that right. These amounts include income from basic rents, turnover rents and rent from collateral immovable assets, such as parking spaces and signs.

*Comment:* REITs should be allowed to generate net losses from rental distributions. Without this relief, timing issues could leave these entities in a double tax situation (with non-deductible distributions during a year even though the holders will treat the same distributions as ordinary revenue).

*Response:* Partially accepted. The timing of the deduction will be based on the date of resolution to declare a dividend as opposed to the payment date. Basing the deduction on the resolution date will effectively allow for a REIT to better time the deduction against available taxable income.



*Comment:* Although it is understood that the yield from financial instruments should generate ordinary revenue so as to discourage the use of this entity as a collective investment in financial instruments having no relationship to immovable property, the rules fail to account for the receipts on disposal of property entities. Proceeds on disposal of other property entities (e.g. other REITs) should be excluded from this automatic ordinary revenue treatment.

*Response:* Accepted. Proceeds on the disposal of interests in other qualifying property entities will not automatically qualify as ordinary revenue. Hence, a REIT can sell interests in a property subsidiary and still potentially claim the disposal gives rise to an exempt capital gain or loss (as opposed to automatic ordinary revenue or loss).

*Comment:* While the relief from capital gains taxation is welcome, the sale of immovable property of a capital nature could still generate recoupments. Entity level taxation upon a REIT's disposal of immovable property that qualifies as a capital asset should be completely eliminated (even if the capital asset generates depreciation allowance – i.e. the capital asset is an allowance asset).

*Response:* Accepted. The disposal of immovable property of a capital nature will be completely excluded from taxable income (even recoupments). Tax will only arise from disposals of immovable property that qualify as trading stock. However, the price of this exemption for immovable property of a capital nature is the loss of all depreciation allowances associated with immovable property.

*Comment:* The deduction of rental distributions is largely unnecessary because taxpayers can still deduct the interest relating to the debenture portion under current law. This deduction for interest does not contain the same level of restrictions proposed for qualifying rental distributions.

*Response:* Comment misplaced. The deduction of interest based on profits will soon be denied under proposed hybrid debt rules (to be revived next year). This pending denial should give these taxpayers an incentive to convert to the new system as soon as possible. REITs will also seek to invest in other entities qualifying as REITs so as to satisfy the more than 75 per cent rental threshold.

*Comment (section 43):* Taxpayers should be allowed to receive rollover treatment when converting current linked debentures to shares. However, current law only allows for share-for-share rollovers.

*Response:* Accepted. Taxpayers will be allowed to convert the debenture interests in an entity qualifying as a REIT (including a property subsidiary) into shares via the newly enacted rollover provisions. Rollover relief in this instance will defer tax events acting as a hindrance to the proposed debenture-share conversion.

*Comment:* Regulated intermediaries and other withholding agents for dividends tax will need additional time to prepare withholding systems for REIT dividends. Unlike most dividends, domestic dividends from a REIT are free from Dividends

Tax with only foreign persons being subject to Dividends Tax. The JSE will also need additional time to set the REIT classification process in motion.

*Response:* Accepted. The proposed effective date based on Ministerial notice will be removed. REIT taxation will generally commence from years of assessment commencing from 1 April 2013 for qualifying entities.

#### 7.4 Taxation of short-term insurance business (Main reference: Section 28)

*Comment:* The proposed acceptance of cash-back bonuses as a permissible reserve if based on a best estimate is welcome. However, the relief is technically deficient because a best estimate reserve includes a risk margin.

*Response:* Accepted. The tax rules will explicitly recognise the margin element if accepted by the regulator.

*Comment:* The short-term insurance reserve system contains special rules for recoverable amounts. However, premium refunds fall outside the system because these refunds are not recoverable amounts.

*Response:* Comment misplaced. Refunds are taken into account under the general provisions of the Income Tax Act (i.e. deductible) if previously included as income.

*Comment:* References to short-term policies under the Short-term Insurance Act can be confusing if the reference is intended to cover both domestic and foreign policies of insurance (and reinsurance). While technically correct, these references seemingly cover only domestic policies. If both domestic and foreign policies are at issue (e.g. as reinsurance), reference to the Short-term Insurance Act should not be used.

*Response:* Accepted. The definition of short-term policy will be clarified by dropping the linkage to the Short-term Insurance Act.

#### 7.5 Investment contracts disguised as short-term insurance (Main reference: clause 68; section 28A)

*Comment:* This system may result in double taxation in the case of employer-owned endowment policies for the direct or indirect benefit of employees. These policies already trigger a denial of deductions for the employer (or ordinary revenue for employees).

*Response:* Comment misplaced. The endowment policies described are largely in the form of long-term insurance. These policies should accordingly not be an issue because the proposed system only impacts short-term insurance viewed as an investment policy under IFRS.

### 8. INCOME TAX: BUSINESS TAX (INCENTIVES)

#### 8.1 Depreciation of supporting structures for energy projects

*(Main reference: Sections 12B(1)(h)-(i) and 12N)*

*Comment:* The ownership requirement to qualify for the electricity generation allowance is restrictive because the allowance does not cover foundations or supporting structures on leased land. To be eligible for relief, assets and their foundations or supporting structures should not be deemed to be immovable property owned by the lessor. The lessee should retain the allowance because the lessee will be the party utilising the structure.

*Response. Accepted:* The policy in respect of improvements undertaken on a lessor's land needs to be reviewed as a matter of principle. As an interim measure, lessees undertaking improvements on another person's property will be eligible for depreciation allowances in respect of electricity generating plant and machinery if associated with the Independent Power Producer Procurement Programme. A more liberalised way of dealing lessee improvements needs to be considered for legislative relief going forward.

*Comment:* The depreciation relief proposed should be limited to the generation of electricity. The expansion of the relief to include all forms of energy is premature.

*Response: Accepted.* The depreciation relief at issue will remain solely applicable to electricity. Other forms of energy relief (such as biodiesel and biofuels) must be found under other pre-existing provisions.

*Comment:* The depreciation relief proposed should be limited to smaller hydropower projects because trade-offs exist between electricity and water supplies.

*Response: Accepted.* The depreciation relief proposed will remain limited to 30 megawatts. However, electricity generation will cover all forms of hydropower (not only hydropower related to gravitational forces) so that hydro power associated with sea currents can qualify. The 30 megawatt limitation will be re-examined in consultation with the Department of Energy.

## 8.2 Revision of the Learnership Allowance Incentive

*(Main reference: Section 12H)*

*Comment:* The time period allowed to register learnerships should be extended from 6 months to 12 months after the end of the year of assessment. Delays occasionally do occur beyond the six-month period due to factors outside the employer's control.

*Response: Accepted.* The time period for registration of learnership agreements will be extended from 6 months to 12 months after the end of the year of assessment.

## 8.3 Oil and Gas incentive and stability revisions

*(Main reference: Sections 26B(2), 64B and paragraphs 2, 3 and 6 of the Tenth Schedule)*

*Comment:* Taxpayers generating oil and gas income that have concluded a fiscal stability agreement should be allowed to re-enter into a new fiscal stability agreement if potential relief granted under the Tenth Schedule becomes more favourable.

*Response:* Comment misplaced. As a general matter, an oil and gas company that concludes a fiscal stability agreement under the Tenth Schedule may at any time unilaterally terminate the stability agreement with the Minister. The taxpayer is then free to enter into a new agreement. Fiscal stability agreements are designed to assist taxpayers, not to bind them.

#### 8.4 Taxability of Government Transfers and Subsidies

*(Main reference: Section 12P and paragraph 20(3)(b) of the Eighth Schedule)*

*Comment:* The provisions regulating the tax treatment of in-kind government grants under the proposed regime appear to make these grants taxable. This result is contrary to what is intended because government grants awarded in-kind for the taxpayer's benefit should be exempt like all other grants under the same programme.

*Response:* Comment misplaced. The current rules are technically correct but complex. Exempt government grants awarded as in-kind benefits are proposed to be exempt with an effective tax cost of zero. In order to clarify the policy, the zero tax cost associated with the assets received via an exempt Government grant will be made explicit. (Note: These assets should have a zero tax cost because these assets are paid directly by Government; no expense is incurred by the taxpayer).

*Comment:* The list of exempt grants in the proposed Eleventh Schedule should be broadened to include government transfers and subsidies for "on-grid" electrification (as opposed to only "off-grid" electrification).

*Response:* Accepted. The list of exempt grants under the Eleventh Schedule will be expanded. The list will specifically include government transfers and subsidies for "on-grid" electrification.

*Comment:* The base cost of assets acquired but later reimbursed by exempt government grants should not be reduced again under paragraph 20(3)(b) of the Eighth Schedule if reduced under the grant provisions. At present, these assets appear to undergo a double reduction in base cost.

*Response:* Accepted. The base cost reduction provisions in paragraph 20(3)(b) to the Eighth Schedule will not apply to assets funded by exempt Government grants (similar to the rules for debt reductions as discussed above).

*Comment:* While the proposed regime is generally taxpayer favourable, the potential for recoupment can be adverse for a small group of taxpayers. The retroactive date should accordingly be reconsidered.

*Response:* Accepted. The effective date will be moved from 1 January 2012 to 1 January 2013.

## **9. INCOME TAX: INTERNATIONAL**

### **9.1 Revised rollover regime for cross-border reorganisations (Main reference: Sections 41 through 47; paragraph 64B of the Eighth Schedule)**

*Comment:* The exclusion of share consideration from the capital gains tax participation exemption narrows the exemption without providing corresponding rollover relief in the corporate reorganisation rules. Many companies enter into share-for-share transactions as an acquisition tool so the participation exemption must either continue for share consideration or this form of transaction should be permitted as a rollover.

*Response:* Accepted. The proposed exclusion of share consideration will be deleted. The revised participation exemption will provide an exemption if an interest in a foreign company is disposed of to an independent third party for any consideration, including shares. As a pre-condition for this relief however, the proposed value-for-value rule will be retained in order to prevent indirect corporate migration. More specifically, the consideration received or accrued must be equal to, or exceed, the value of the shares disposed.

*Comment:* Application of the proposed exit charge to disposals that qualify for the capital gains tax participation is not clear. In particular, if there is a disposal of a chain of controlled foreign companies (i.e. a parent controlled foreign company holding a chain of subsidiary controlled foreign companies), it is unclear whether the participation exemption applies to the disposal of the parent company as well as the chain of controlled foreign companies below (all of which would otherwise be subject to the proposed exit charge). Failure to provide relief from the exit charge throughout the chain will greatly undermine the utility of the participation exemption.

*Response:* Comment misplaced. The participation exemption should apply to a chain of CFCs if the top CFC is disposed of. However, the wording will be reviewed to determine if there is any further clarity required on the matter.

*Comment:* The exclusion of loss assets from foreign rollover relief causes practical liquidity problems yet does not pose a risk to the tax base. More specifically, the acceptance of loss assets in a foreign transferee does not pose a risk of those losses being imported into the domestic tax base. Differentiating gain and loss assets in a foreign context also adds significant complexity to the use of the proposed rollovers.

*Response: Accepted.* The exclusion of loss assets will be removed from rollover relief applicable to transfers to foreign entities. More specifically, the exclusion of loss assets will be limited to inbound restructurings in order to prevent the importation of losses into direct South African taxing jurisdiction.

*Comment:* In line with rollover relief for domestic and inbound share-for-share transactions, the foreign share-for-share rollover relief should allow for the transfer of target shares held as trading stock.

*Response: Not accepted.* Rollover relief for foreign share-for-share transactions is not intended for the restructuring of portfolio shareholdings. The relief is limited to the restructuring of long-term investments in line with the capital gains tax participation exemption.

*Comment:* The current foreign share-for-share rules are too restrictive. The rules do not appear to permit the transfer of shares in a target foreign company if that foreign company is not a controlled foreign company (is not more than 50 per cent held). Taxpayers should be permitted to shift smaller equity stakes within an offshore group.

*Response: Accepted.* Smaller stakes in a foreign company will be permitted if the transfer is to foreign transferee that is at least 70 per cent owned by a resident (or the same group). This adjustment will allow for greater flexibility to move target foreign companies around within a single group.

*Comment:* The current wording of the exclusion from rollover relief in the case of foreign asset-for-share transactions does not capture the intended purpose. In particular, the transfer of foreign equity shares by a foreign controlled company technically falls outside the regime because the rollover relief applies only if the disposal would be taken into account for the purposes of determining the net income of the 'transferor'. On the other hand, a transfer by a controlled foreign company can only be potentially taken into account as taxable income of a direct or indirect shareholder of the controlled foreign company transferor.

*Response: Accepted.* Strictly speaking, it is true that the controlled foreign company rules only attribute net income in relation to a resident even if the transferor is a controlled foreign company. The reference to the 'transferor' should accordingly be changed to "any resident".

*Comment:* The definition of a foreign amalgamation transaction should not be premised on the "disposal" of assets of an amalgamated company and the "termination" of that company because these concepts might not exist in foreign law. These concepts should be abandoned in favour of more general concepts of "amalgamation or merger".

*Response: Comment misplaced.* The concerns appear resolvable through interpretation. In South African law, the concept of "disposal" is defined widely enough to include "operation of law" (especially in terms of capital

gains). Similarly, the concept of “termination” has a wider meaning. The mere lack of ongoing existence should be viewed as a termination.

*Comment:* The current exclusion of amalgamation transaction rollover relief in the case of a subsidiary-parent combination is overly broad. The purpose of the exclusion is to prevent an overlap with the liquidation rules, but the exclusion also implicitly prevents the merger of a parent company into a subsidiary company (as opposed to a liquidation of a subsidiary into a parent company). The exclusion should accordingly be narrowed to the exclusion’s true intention.

*Response:* Accepted. In order to simplify the wording, the exclusion will apply solely to transactions that fall under the “liquidation distribution” definition.

*Comment:* The exit charge should not apply if a company ceases to be a controlled foreign company as a result of an amalgamation transaction. The exit rules are intended to apply only if assets leave taxing jurisdiction. In the case of rollover amalgamations, the assets will either be moving to a new controlled foreign company or to a domestic company.

*Response:* Accepted. In line with the intended purpose of rollover relief, the amalgamation of a controlled foreign company will not give rise to an exit charge (as long as the transferee is a controlled foreign company – i.e. an offshore reorganization requirement). A specific rule will be added to that effect.

*Comment:* The 50 per cent direct interest requirement in the “after test” is unduly restrictive. The requirement should be deleted as long as the distribution is in accordance with the effective interests of the shareholders and the unbundled company is a controlled foreign company.

*Response:* Not accepted. The purpose of the unbundling rollover relief is to facilitate offshore group restructurings. This purpose is in line with the domestic unbundling rules in the context of unlisted shares.

*Comment:* One of the qualifying requirements for inbound and foreign liquidation distributions is that at least 50 per cent of the holding company must be directly or indirectly held by residents immediately after the liquidation. This requirement is unduly restrictive and should be deleted as long as the holding company is a controlled foreign company immediately after the liquidation.

*Response:* Not accepted. The purpose of the liquidation distribution rollover relief is to facilitate offshore group restructurings. This is in line with the domestic liquidation distribution rules. The entities must remain in the same overall group.

*Comment:* The exit charge should not apply if a company ceases to be a controlled foreign company as a result of a liquidation distribution transaction. The exit rules are intended apply only if the assets leave taxing jurisdiction. In the case of rollover liquidations, the assets will either be moving to a new controlled foreign company or to a domestic company.

*Response: Accepted.* In line with the intended purpose of rollover relief, explicit rules will be added to ensure that the liquidation distribution of a controlled foreign company in a rollover context will not give rise to an exit charge (see also the comment above dealing with amalgamations).

*Comment:* The limitation of foreign intra-group relief to the transfer of equity shares held as capital assets is overly restrictive. In contrast, domestic intra-group rollover relief is allowed in respect of the transfer of any asset (both physical assets and shares) held as capital assets or trading stock. Foreign intra-group relief should accordingly be extended.

*Response: Not accepted.* The rules are designed to facilitate offshore restructurings of long-term investments. Moreover, the rules substitute the capital gains participation exemption for the disposal of foreign shares to a group controlled foreign company. This exemption was only available where shares are disposed of and held as capital assets.

9.2 Exit charge upon ceasing to be a resident in South Africa  
(Main reference: Section 9H; paragraph 12 of the Eighth Schedule)

*Comment:* The proposed exit charge will result in double economic taxation. The new charge will apply not only to the existing company but also to the shareholders of the exiting company. This application of the exit charge at the shareholder-level will be especially harsh because the shareholders do not realise any cash-flows from the event nor do these shareholders have possession of any of the underlying assets exiting South African taxing jurisdiction.

*Response: Accepted.* The deemed exit tax charge falling on the shareholders of the emigrating company will be removed. The exit charge will apply solely at the exiting entity level (including a deemed dividend *in specie*).

*Comment:* The proposed exit charge needs to be harmonised with the current capital gains tax exit charge. In particular, it appears that two sets of exit charges apply when a controlled foreign company becomes a resident.

*Response: Accepted.* The rules will be clarified so that paragraph 12 of the Eighth Schedule applies when a controlled foreign company becomes a resident. If a controlled foreign company moves outside indirect South African jurisdiction, the exit charge of section 9H is intended to apply.

*Comment:* The proposed exit charge should be deferred at the election of the taxpayer until the actual disposal of exiting company assets. This deferral could be made subject to the provision of appropriate security by the taxpayer. Similar provisions are found in other jurisdictions, such as Australia and Canada.

*Response: Not accepted.* The enforcement of a tax claim after emigration of the taxpayer is highly risky for the fiscus. Nor is there any policy benefit for Government to defer the exit charge (over any other charge arising from a deemed disposal).



*Comment:* The proposed exit charge in respect of controlled foreign companies appears to be onerous. The rules can be literally read to trigger an exit charge whenever the link between any foreign company and any South African shareholder is broken.

*Response:* Accepted. The exit charge was intended to apply only once a controlled foreign company is no longer a controlled foreign company. The fact that the ownership connection is lost between a single shareholder and a foreign company was never intended to be the sole trigger. The legislation will be clarified accordingly.

*Comment:* The proposed exit charge makes the headquarter company regime unattractive for existing local companies to use. As a result, South African multinationals will be forced to hold foreign investments in a foreign jurisdiction.

*Response:* Not accepted. Any transfer of assets to a foreign entity will trigger gain. The proposed gain on transfer to a headquarter company simply mimics this result.

*Comment:* The exit charge for domestic companies becoming a headquarter company is misplaced. Most of the assets of these companies (i.e. large equity stakes in foreign companies) are exempt from tax (under the participation exemption).

*Response:* Noted. The charge probably needs to be shifted. The real issue is the shares of the domestic company. These shares are initially taxable but potentially become exempt once the company converts to headquarter company status.

*Comment:* The proposed exit charge in respect of domestic companies becoming a headquarter company is meaningless. Taxpayers can largely escape the charge due to the exemption for assets attributable to a permanent establishment.

*Response:* Accepted. The permanent establishment escape hatch for domestic companies becoming headquarter companies will be temporarily removed. This issue will remain a subject of further study.

*Comment:* The deemed Dividends Tax charge upon departure is overstated. In particular, the charge should apply solely to built-up profits within the exiting company. Stated differently, application of the Dividends Tax based on the market value of underlying assets should be reduced for contributed tax capital and for outstanding liabilities.

*Response:* Comment misplaced. The deemed Dividends Tax is already reduced for liabilities and contributed tax capital.

*Comment:* While the deemed Dividends Tax charge takes fixed liabilities into account, the charge fails to account for contingent liabilities. The deemed Dividends Tax charge should simply fall on the net value of the exiting company.

*Response:* The deemed Dividends tax charge will be changed so as to be based on the exiting company's net value. This value will be based on the total share value of the exiting company.

*Comment:* The proposed exit charge is deemed to have come into operation on 8 May 2012 with the effect that certain taxpayers will be retrospectively liable for tax. This date will be difficult to enforce in respect of taxpayers that have already emigrated.

*Response:* Not accepted. The amendment is not retroactive in view of the 8 May media statement released by the National Treasury. Government is allowed to take action with immediate effect (if necessary) in order to protect the tax base.

*Comment:* Application of the provisional tax system in respect of an exiting taxpayer is uncertain. It must be clarified whether a second provisional tax payment is required by the exit date (which includes the deemed closure of the year of assessment).

*Response:* Accepted. A provisional tax payment is required in accordance with the provisions of Part III of the Fourth Schedule by the end of the year of assessment. This point will be clarified in the explanatory memorandum (see paragraph 21 of the Fourth Schedule).

### 9.3 Rationalisation of withholding taxes on payments to foreign persons (Main reference: Sections 35 and 37J through 37N)

*Comment:* The use of the word "payable" is unclear. The word "payable" can have two different meanings (applying when the liability accrues or possibly when the debt becomes due and payable). It is not clear which interpretation ought to be given.

*Response:* Accepted. In order to provide certainty, the phrase "due and payable" will be used. Hence, the amount must actually be available for payment to the non-resident.

*Comment:* The legislation should provide clarity as to the withholding tax implications relating to repurchase arrangements. Stated differently, the exemption for banks appears limited to interest from debt instruments, which do not include repos. The exemption should apply to all forms of interest paid by banks.

*Response:* Accepted. The reference to interest paid in respect of "debt" owed by a bank will be substituted for a reference to interest paid by a bank. All forms of interest paid by the bank will accordingly be covered, regardless of whether a debt instrument is involved.

*Comment:* The withholding tax on interest will negatively impact foreign borrowings by the Development Bank of Southern Africa and the Industrial Development Corporation. The withholding tax will increase the cost of borrowing for these entities, which will naturally be passed on to clients. These government-owned entities should thus be exempt from withholding tax on interest in the same way as commercial banks.

*Response:* Accepted. Interest paid by the Development Bank of Southern Africa and the Industrial Development Corporation will be exempt. This exemption is in line with the general exemption for interest paid by commercial banks. Both entities are designed to exist as lenders where standard commercial bank lending is unavailable.

*Comment:* The normal tax and the withholding tax appear to overlap. The normal tax appears to apply in circumstances where the foreign taxpayer lacks any meaningful nexus to South Africa (i.e. lacks a 183 day presence or a permanent establishment presence). Foreign taxpayers in these circumstances should be subject only to the withholding tax.

*Response:* Accepted. The current cross-references appear to have the unintended impact suggested. The law will be clarified to eliminate this overlap. More specifically, the normal tax should apply only when a meaningful nexus exists (under the 183 day or permanent establishment tests). The withholding tax should potentially apply when this nexus is lacking.

*Comment:* Due to time constraints in relation to the effective implementation of withholding tax, the effective date of the interest and royalty withholding taxes needs to be moved to a date later than 1 January 2013. It should also be noted that taxpayers are still coming to grips with the Dividends Tax.

*Response:* Accepted. The effective date for the revised royalty and interest withholding regimes will be moved to 1 July 2013.

9.4 Removal of controlled foreign company (CFC) exemption from interest and royalty withholding  
(Main reference: Sections 10(1)(h), 10(1)(l), 37J(1), 37K(3) and 37L(1))

*Comment:* Interest paid to foreign government-owned entities is generally exempt in terms of tax treaties. However, in order to claim this exemption, the holder of the debt instrument needs to provide a prescribed declaration to the issuer. From a practical point of view, questions arise as to whether the issuer can simply rely on this declaration or whether the issuer still needs to verify the ownership of the holder from the foreign government involved.

*Response:* Noted. The level of information required is an administrative issue. As a technical matter, a mere declaration from the exempt foreign entity is sufficient unless further proof of status is specifically requested by SARS.

*Comment:* Intra-group funding between residents and controlled foreign companies is often provided on more favourable terms than third party funding. The proposed primary withholding tax on payments to controlled foreign companies and subsequent exemption of the relevant controlled foreign company net income will discourage the use of intra-group financing of this nature. This proposal should accordingly be deleted.

*Response:* Not accepted. Offshore inter-group funding is merely being placed on par with other funding. The current exemption for payments to a controlled foreign company results in a fairly straight-forward mechanism for avoiding withholding taxes.

9.5 Relief from effective management test in the case of high-taxed controlled foreign companies (CFCs)

*(Main reference: Section 1 (paragraph (b) of the “resident” definition)*

*Comment:* The proposed Bill provides a carve-out from the residency test via local effective management if a controlled foreign company is based in a high tax jurisdiction and has a business establishment in that jurisdiction. It is contended that the foreign business establishment requirement is administratively onerous and should be deleted as unnecessary. The only issue should be the tax level because no reason exists to extend South African taxing jurisdiction if little or no South African revenue is at stake (after tax credits are taken into account).

*Response:* Not accepted. The foreign business establishment requirement ensures that there is genuine separation of active operations versus management in terms of location.

*Comment:* It is proposed that the carve-out from the residency test in the case of highly-taxed controlled foreign companies should be elective and not automatic because there may be companies that would prefer to be treated as residents. In particular, certain companies may wish to avoid foreign tax status to avoid the exit charge.

*Response:* Not accepted. Elections create unnecessary complexity and cannot be effectively administered.

*Comment:* The proposed residency carve-out for highly-taxed controlled foreign companies will trigger an exit charge when companies that previously qualified as residents cease to become residents.

*Response:* Partially accepted. The exit charge will be narrowed so that the exit charge will not apply if the proposed carve-out comes into effect on the initial effective date.

*Comment:* The proposed residency carve-out for highly-taxed controlled foreign companies does not mirror the test set out in the controlled foreign company net income imputation rules. In particular, the provision is silent as to the treatment of losses brought forward and in respect of group losses in determining whether the foreign taxes equate to at least 75 per cent of the South African taxes that would otherwise be payable.

*Response: Accepted.* The treatment of carryover losses and group losses will not be taken into account for purposes of the high-tax calculation required for the proposed carve-out. This treatment matches the high-tax carve-out from controlled foreign company imputation as suggested.

*Comment:* The proposed residency carve-out for highly-taxed controlled foreign companies should not take into account the high-tax status of the controlled foreign company. It is proposed that the high-tax requirement should be substituted for an enhanced foreign business establishment requirement. Stated differently, relief should exist if the entity is either high-taxed or contains a business establishment. Relief for business establishments should be allowed where the foreign company is benefiting from a tax holiday (such as an offshore manufacturing operation enjoying a tax holiday within in a development zone).

*Response: Not accepted.* The foreign business establishment test and the effective management test operate differently. The effective management test is an all-or-nothing test; the foreign business establishment test exempts income on an allocable basis. Furthermore, the purpose of the proposed exemption is to ease administration where no significant South African tax is at stake.

9.6 Relief from transfer pricing in the case of high-taxed controlled foreign companies (CFCs)  
(*Main reference: Section 31*)

*Comment:* The proposed legislation provides transfer pricing relief in respect of intra-group financing between a resident and a controlled foreign company. In order to qualify for this relief, the resident must own at least 10 per cent of the controlled foreign company, the controlled foreign company must be highly taxed (at least 75 per cent of the South African tax), and the controlled foreign company must have a foreign business establishment. It is proposed that the 10 per cent participation requirement is too narrow because the requirement caters solely for direct participation without taking into account indirect relationships.

*Response: Accepted.* The wording for this transfer pricing relief will be adjusted to take into account equity shares and voting rights held by a resident taxpayer (alone or together with any other company forming part of the same group of companies as the taxpayer). The net result is to take into account certain indirect relationships as suggested.

9.7 Foreign tax rebates (i.e. credits) for service fees improperly subject to foreign withholding taxes  
(*Main reference: Section 6quin*)

*Comment:* Foreign tax credits for improperly imposed taxes are limited solely to foreign taxes imposed in respect of South African source income. However, foreign source income may also be improperly subject to foreign taxes (e.g. when a double tax agreement is not observed by the foreign jurisdiction and otherwise South African source income is deemed to be foreign source by virtue of tax treaty). A credit should also be allowed in these circumstances.

Response: Accepted. The credit for improperly charged fees will be extended to cover South African sourced income treated as foreign sourced under a tax treaty and taxed in contravention of the tax treaty.

9.8 Further refinements to the headquarter (HQ) company regime  
(Main reference: Section 9I)

*Comment:* Since the tax rate applicable to headquarter companies cannot be reduced without the risk of South Africa being blacklisted as a tax haven, a tax credit system that applies only to headquarter companies that has the impact of reducing the effective tax rate should be considered. Reductions of this kind are the only way to make South Africa an investment holding company destination.

*Response:* Not accepted. The credit system proposed will be viewed in the same light (i.e. as a black-listed tax haven activity). The goal of the headquarter company regime is not to undermine the tax base of other countries but merely to ensure that the flow of funds through South Africa does not create an added cost. The proposal suggested would mostly likely endanger South Africa's ability to negotiate tax treaties with other countries.

*Comment:* If a shelf company starts trading mid-way through the year, it appears that the shelf company may not qualify for the intended relief from the 10-per cent minimum shareholder test. This disqualification is problematic because shelf-companies are rarely acquired at the exact start or end of a year.

*Response:* Accepted. The 10 per cent ownership requirement should apply only once a trade begins during the current year of assessment. Periods before any trade begins should be ignored regardless of whether this pre-trade period ceases mid-year or lasts longer than a year. In addition, the 10-per cent minimum shareholder test will also be limited to solely to a year-by-year analysis (without regard to whether the test applied in prior years).

9.9 South African fund managers of foreign investment funds  
(Main reference: Section 1("foreign investment fund" and "resident" definitions))

*Comment:* The definitional rules pertaining to the structure of foreign investment funds are overly restrictive. Foreign investment funds may come in various forms, including a company, trust or similar entity recognised under foreign law. Foreign funds may not necessarily come in the form of a collective investment scheme as suggested by the legislation.

*Response:* Accepted. The draft legislation will be adjusted to require that the entity "carry on activities of an investment scheme" and that the entity must merely hold a portfolio of financial instruments. The entity need not be in the form of collective investment scheme or similar arrangement.

*Comment:* While the proposal eliminates the possibility that a foreign investment fund can be a South African resident by virtue of a South African manager, there

is still a possibility that fund managers may create permanent establishment status for the foreign investment entity.

*Response:* Noted. This issue was not raised by those close to the issue, and thus the surrounding fact patterns of concern are not clear. The issue will accordingly be deferred until the 2013 legislative cycle to determine if a problem truly does exist (i.e. is more theoretical than real).

*Comment:* The exit charge should not apply merely because a foreign investment entity ceases to be a resident pursuant to the amendment coming into effect.

*Response:* Comment misplaced. The problem is more theoretical than real. The current rules have essentially prevented the activity from occurring locally (so there is currently no entity that exists that will be deemed to shift offshore).

*Comment:* The requirement for local investment managers to be a licensed financial services provider under the Financial Advisory and Intermediary Services Act should be removed.

*Response:* Not accepted. This requirement ensures that the amendment is of limited scope and only available to managers that operate within a regulated environment. The goal is to assist these local service providers so that they do not have to move offshore to perform their job functions.

*Comment:* The relief should be extended to private equity funds with South African or Southern African investments. Funds should not be limited solely to investments in listed and listed-type instruments.

*Response:* Not accepted. Private equity represents a completely different class of investment than portfolio investment fund management, thereby raising different concerns. Further study will be required for this regime to be extended as requested.

*Comment:* The investment limitation is too narrow. Widely-traded over-the-counter investments should be permitted.

Accepted. Over-the-counter investments will be permitted. Instruments of this kind must be readily available to the general public. As a practical matter, instruments of this kind are offered by financial intermediaries (e.g. banks, brokers and dealers).

*Comment:* Funds of this nature often utilise government debt as part of the investment package. The current version of the legislation does not cater for this functionality.

Accepted. Government issued instruments will be permitted. More specifically, instruments (e.g. debt) issued by national, provincial and municipal government will be viewed as permissible investments.

#### 9.10 Revised currency rules for intra-group exchange items

(Main reference: Section 24I(7A) and (10))

*Comment:* The adoption of International Financial Reporting Standard (IFRS) rules in respect of exchange differences on net investments in foreign subsidiaries is overly complex. It is proposed that the current deferral rules in respect of intra-group exchange items should be retained, subject to the exclusion for short-term items.

*Response:* Accepted. The net investment in foreign subsidiary test will be replaced by a test based on unhedged non-current assets or liabilities between group members or connected persons. The meaning of current assets or current liabilities will follow the meaning provided by IFRS. The revised regime will trigger mark-to-market treatment for foreign currency debts hedged by derivatives and back-to-back loan funding stemming from parties outside the group.

9.11 Removal of foreign currency deferral for pre-production activities

(Main reference: Section 24I(7))

*Comment:* The current system of deferring the recognition of exchange differences in respect of pre-production assets should be retained. Imposition of mark-to-market taxation for loans used to acquire large assets (e.g. plant and machinery) will cause liquidity problems.

*Response:* Accepted. The proposed amendment will be deleted. Future consideration will be given to the possible alignment of the provision to the general tax treatment of pre-trade expenses.

9.12 Capital gain currency rules

(Main reference: Paragraph 43 of the Eighth Schedule)

*Comment:* The amendment to the capital gain currency rules will result in an overlap with the ordinary revenue mark-to-market system. In particular, currency monetary items may be subject to a capital gains charge in addition to the mark-to-market system.

*Response:* Monetary items of the kind falling within the mark-to-market system will be specifically excluded from the capital gains currency conversion rules.

9.13 Closure of dividend conversion schemes

(Main reference: Section 64EB)

*Comment:* The proposed taxation of share derivatives is impractical. In the case of many share derivatives, the deemed dividend charge is often impossible to administer because the identity of the counter-party is generally unknown and because the current system does not allow for easy tracing of identities.

*Response:* Accepted. Imposition of the Dividends Tax in respect of share derivatives will be withdrawn for further consideration. However, deep concerns exist that this omission from Dividends Tax treatment creates a permanent bias in favour of share derivatives vis-a-vis shares.



This issue will have to be revisited to protect the long-term viability of the Dividends Tax in respect of foreign shareholders.

*Comment:* Imposition of the charge as a dividend *in specie* is overly burdensome for the local payor because a direct charge on the local payor will distort the pricing formula. It is unclear why the standard Dividends Tax withholding system cannot prevent the avoidance of concern, especially since the shareholder is the cause of the avoidance.

*Response:* Accepted. The dividend *in specie* concept will be dropped. To ensure the administrative viability of the charge, it is proposed that the anti-avoidance rule create a withholding obligation on the payor of the dividend ceded or forming part of a repurchase agreement and of the manufactured dividend in the case of a share lending arrangement. This version of the test should not impact the pricing formula.

*Comment:* The anti-avoidance rules are too narrow. The exempt party acquiring dividends by way of cession could come in other forms besides that of a domestic company. For instance, pension funds can be used to achieve the same result.

*Response:* Accepted. The anti-avoidance rule will be expanded. The revised rule will cover all persons that are exempt from Dividends Tax.

*Comment:* The anti-avoidance rule should not create a deemed charge in respect of the manufactured dividend payment (or other dividend substitute). Instead, the artificial transfer (e.g. the dividend cession) should be deemed not occur. More specifically, the Dividends Tax should apply to the transaction as if the transaction did not occur.

*Response:* Partially accepted. The transaction will be effectively disregarded as suggested for dividend cessions and repurchase agreements. However in the case of share lending arrangements the exempt lender cannot be deemed to remain the beneficial owner of the actual dividend as the borrower would have delivered the borrowed share in the market to the actual beneficial owner of the dividend.

*Comment:* The effective date is impractical given the short notice. The parties involved cannot stop a transaction mid-stream on the day of Government announcement. Systems are also not in place to impose a deemed dividend charge with immediate effect. Taxpayers accordingly seek more time to properly manage the process.

*Response:* Accepted. The proposed amendments will no longer apply to amounts paid on or after 31 August 2012. Instead, the new regime will apply to transactions entered into on or after 1 September 2012 and to amounts paid on or after 1 October 2012 if the transaction was entered into before 1 September 2012.

## 10. INCOME TAX: TECHNICAL CORRECTIONS

### 10.1 Dividend Issues

*Comment: (Reference: Section 10B).* It is proposed that the foreign dividend exemption for listed shares does not apply if the dividend is deductible. However, these dividends are already subject to the Dividends Tax. The net result is unfair double taxation.

*Response: Accepted.* The denial of the exemption in respect of deductible foreign dividends should not apply to foreign dividends derived from JSE listed shares. These foreign dividends on listed shares are generally subject to the Dividends Tax in any event, thereby eliminating the arbitrage of concern (i.e. a deduction for the payor with total exemption for the payee).

*Comment: (Reference: Section 10B).* Foreign scrip distributions are now excluded from the foreign dividend definition (like the domestic dividend definition). However, this form of exclusion does not apply to foreign capital distributions even though domestic scrip distributions are fully excluded from the domestic return of capital definition. No reason exists for this deviation.

*Response: Accepted.* Foreign return of capital distributions should exclude scrip distributions. This exclusion will match the exclusion for domestic capital distributions.

*Comment: (Reference: Section 10B(5)).* Section 10B(5) provides that the exemptions from tax provided by section 10B do not extend to any payments out of any foreign dividend received by or accrued to any person. On a strict reading of the wording, if a dividend is paid through a chain of foreign subsidiaries, and the dividends are funded by the foreign dividend, the foreign dividend received by the ultimate South African shareholder may possibly lose the exemption. The net effect of this language is to undo the participation exemption when a South African company owns a chain of foreign subsidiaries. This result could not have been intended.

*Response: Accepted.* Section 10B(5) is merely intended to match section 10(3). The purpose of section 10(3) is mainly to prevent the exemption for annuities. Section 10B(5) will accordingly be reworded.

*Comment: (Reference: Section 10B(4)).* The denial of the participation exemption for deductible circular flows is overly broad. While the relief for trading stock purchases from this anti-avoidance rule is appreciated, further relief is required for the purchase of allowance assets.

*Response: Comment misplaced.* The denial of the exemption for deductible circular flows does not currently apply to purchases of allowance assets. The denial applies only for deductible payments. The deduction for allowance assets is only notional (by way of depreciation

allowance); the deduction for allowance assets does not constitute a payment.

*Comment:* (References: Sections 8E, 8EA and 64F). Income yields from hybrid equity instruments and third-party backed shares inclusions should not be taxed again under the Dividends Tax. Double tax relief should exist to prevent the Dividends Tax from applying to amounts already subject to the hybrid equity and third party backed share rules.

*Response:* Comment misplaced. An exemption from Dividends Tax is already proposed for amounts subject to normal tax. The language will be changed to exclude amounts that “constitute income.”

*Comment* (Reference: Sections 8C and 64F). An inclusion under Section 8C in respect of restricted (employee) equity instruments potentially overlaps with the Dividends Tax. Double tax relief should exist to prevent the Dividends Tax from applying to amounts already subject to section 8C.

*Response:* Comment misplaced: The rules already prevent double taxation as discussed above. Further facts may be required to clarify the issue of concern.

*Comment:* (Reference: Section 64FA). Clarity should be provided on how to address dividends paid to *en commandite* partnerships so that the partners can obtain the appropriate exemption/tax treaty relief as intended. The current tracing method of linking the beneficial owner of a dividend is complex and notification by the partnership of the owners forfeits *en commandite* status.

*Response:* Not accepted. SARS requires information to determine whether a beneficiary is entitled to an exemption. SARS cannot be expected to exempt persons without having the ability to obtain proof of the exemption.

*Comment:* (Reference: Section 64E). Certain interest-free loans will give rise to Dividends Tax on an annual basis to the extent that the interest yield is too low. This charge exists even though the underlying loan corpus may have been subject to the Secondary tax on Companies under the former deemed dividend rules. This indirect double tax charge should be eliminated.

*Response:* Comment misplaced. Proposed section 64E(4)(e) prevents duplication to the extent that the underlying loan was viewed as a deemed dividend subject to Secondary Tax on Companies.

*Comment:* (Reference: Section 64J). Under the law in existence as of 1 April 2012, it appears that companies paying dividends can rely on STC credits in respect of intra-group dividends received even though those dividends were never subject to the Secondary Tax on Companies. While the amendment correcting this mismatch is theoretically sound, the proposed legislation is retroactive. The timing of the correction should be effectively only from the date that the legislation was publicly released – 6 July 2012 (not 1 April 2012).

*Response: Not Accepted.* While retroactivity is to be avoided, there is no constitutional bar against retroactivity in the context of tax legislation. Commonwealth norms of taxation do allow for retroactivity in particular instances. In this instance, the missing references were an obvious omission, especially given the clear indication of policy as stated in the explanatory memorandum. Moreover, almost all of the back-dated technical corrections proposed are seeking to assist taxpayers as requested. Taxpayers cannot expect retroactive technical corrections in their favour whilst the fiscus stands vulnerable for the same type of obvious errors working to the Government's detriment.

*Comment: (Reference: Section 64J).* If the Dividends Tax is understated because the company payor claims STC credits, the various recipients of these dividends with inflated STC credits should not be liable for any Dividends Tax ultimately due. These recipients (i.e. regulated intermediaries and beneficial owner of dividends) cannot be held responsible for tax understatements beyond their control.

*Response: Accepted.* Any liability for the overstatement of STC credits should be the sole responsibility of the company payor because only the company payor has the information to make the calculation. Regulated intermediaries and beneficial owners of dividends should be free from any primary or residual responsibility.

*Comment: (References: Section 64E and paragraph 75 to the Eighth Schedule).* If a company distributes listed shares of another company in an unbundling, special valuation problems arise in respect of the listed unbundled shares subject to the Dividends Tax or taxable as a capital distribution. The value of the listed unbundling shares is often volatile (i.e. even changing on a daily or hourly basis). Under current law, the valuation date for determining the value of *in specie* assets is the date of payment, but this date is unrealistic because this date is simply too late. Taxpayers must be able to rely on a valuation date that reasonably precedes the dividend payment date in order to avoid under-valuations or over-valuations.

*Response: Accepted.* In the case of a taxable unbundling of listed shares, the valuation date of the shares will be set at a date before payment. More specifically, the date will be the last date to register (i.e. the date that the amount is due and payable).

*Comment: (References: Section 64E and paragraph 2 of the Seventh Schedule).* Company loans made to employers trigger fringe benefit tax to the extent that the interest-yield falls below market value. A similar charge exists under the Dividends tax for below-market interest loans made to shareholders. This dual charge should be eliminated.

*Response: Comment misplaced.* Section 64E(4) deems a dividend to exist in respect of low-interest loans if the loan is granted by virtue of a share. The fringe benefit tax can only arise if the loan was granted by virtue of employment.

*Comment: (Reference: Section 64E).* Profits derived from dividends paid by South African subsidiaries to JSE listed foreign companies are effectively double taxed when the listed company ultimately distributes the profits to South African shareholders. This form of dividend loop is quite common and merits double tax relief.

*Response: Not accepted.* These tiered distributions are impossible to trace. In addition, loop structures are largely to be avoided as a matter of Exchange Control policy.

*Comment: (Reference: Section 64K).* Under current law, reporting under the Dividends Tax is limited to payments when the Dividends Tax is due. The proposal to extend reporting to all dividend payments (even when no potential Dividends Tax is ultimately due) is administratively burdensome.

*Response: Not accepted.* SARS needs to be able to track all STC credits, the utilisation of exemptions and all other dividends paid to determine whether tax is fully or partially due. Hence, the potential tax base at stake must be reported in full, not just dividend amounts subject to tax as determined solely by the withholding agent. Process issues should be discussed directly with SARS.

*Comment: (Reference: Section 64N).* Under current law, a company or regulated intermediary required to withhold Dividends Tax must obtain proof of any foreign tax paid for purposes of claiming foreign tax rebates. This requirement is very onerous, especially for regulated intermediaries who often make payment to thousands of foreign beneficiaries.

*Response: Not accepted.* The need for proof of foreign tax paid has long been understood. SARS cannot be expected to allow relief merely on *prima facie* statements.

*Comment: (Reference: Section 64L).* The JSE Derivatives Fund and the JSE Guarantee Fund are exempt from income tax. However, this same exemption does not apply in respect of the Dividends Tax. No reason exists for this disparity.

*Response: Accepted.* It is agreed that the Dividends Tax exemption and the normal tax exemption should match in this instance. An exemption will accordingly be added for the Dividends Tax in respect of fidelity and indemnity funds.

*Comment: (Reference: Paragraph (ee) of the Proviso to Section 10(1)(k)(i)).* In 2011, dividend income was to be treated as (non-exempt) ordinary revenue if derived by way of cession or in consequence of cession. Read literally, this wording meant that all dividends would no longer enjoy any exemption because all shares are transferred by way of cession. The new wording to correct this concern gives rise to new problems by requiring a beneficial ownership interest in the underlying shares. In particular, the holder of the dividends does not always hold a beneficial interest in the underlying share. The shares may be held by

way of a collective investment scheme or a trust. No reason exists to deny the dividend exemption in these circumstances.

*Response:* Partially accepted. The denial of the exemption will be amended to deal with the areas of concern. The rule will therefore apply to:

- dividends that are ceded to a company; and
- dividends that are vested in a company by a discretionary trust,

unless those dividends are acquired along with the underlying shares. The prior amendment will be deleted retrospectively, and the revised amendment will take effect as of 1 January 2013 to avoid any retroactive consequences.

## 10.2 Miscellaneous Issues

*Comment (section 9D(9A)):* The current controlled foreign company rules impose tax on rentals paid by a resident to the controlled foreign company unless the rental is paid in respect of an operating lease or a lease that constitutes a financial instrument. An operating lease is specifically defined to exclude finance leases. The current wording of this diversionary rule incorrectly assumes that a finance lease is a financial instrument.

*Response:* Comment misplaced. A finance lease is a financial instrument as defined. More specifically, a finance lease constitutes an interest-bearing arrangement or a financial arrangement based on or determined with reference time value of money, cash flow or the exchange or the transfer of an asset. Hence, the term financial instrument covers financial leases (with the potential relief being the same applicable to other financial instruments).

*Comment: (Reference: Section 12E):* Companies eligible for small business relief should be allowed to invest in a local portfolio of a collective investment scheme in securities because this type of investment is merely a passive form of investment and cannot be used as a form of income splitting.

*Response:* Comment misplaced. The exclusion of local collective investment schemes in securities exists because collective investment schemes of this nature are no longer “companies” in a tax sense. Therefore, ownership in these schemes will continue to be excluded from the income splitting rules.

*Comment: (Reference: Section 22B):* The need for the current anti-avoidance rules designed to convert sales proceeds into pre-sale dividends funded by loans from a purchaser are understood. However, the wording is too wide. Under the literal terms of the anti-avoidance rules, any redemption funded by loans will now fall under the anti-avoidance rules even if no outside purchaser is involved.

*Response:* Noted. This issue will be considered in the next legislative cycle. Resolution of this issue will not be simple because pre-sale redemptions can be used as an acquisition tool.

*Comment: (Reference: Section 45(3A)):* The Taxation Laws Amendment Act of 2011 introduced new anti-avoidance rules applicable in respect of intra-group rollover transactions involving loans and preference shares. These rules prevent tax cost manipulation by limiting the tax cost of the newly issued debt (or preference shares) to zero. While the proposed amendment applies only to new transactions, certain transactions were unintentionally impacted because the agreement was concluded before the effective date with the suspensive conditions being fulfilled only afterwards. This application of the effective date is unfair since the suspensive conditions are outside the control of the parties involved.

*Response:* Accepted. Fully finalised transactions subject to suspensive conditions will be excluded. Stated differently, transactions entered into before the effective date will not be subject to the new anti-avoidance rules merely because suspensive conditions were fulfilled afterwards.

*Comment: (Reference: Section 45(3A)):* The rule deeming a nil base cost for debt instruments and equity shares issued in an intra-group rollover needs to account for debt cancellations. This form of debt cancellation should not give rise to additional tax as long as the debt remains wholly within the group.

*Response:* Comment misplaced. Section 45(3A) deals with the holder, not the issuer. The debt cancellation rules focus on the issuer. It should also be noted that relief currently exists for debt cancellations between connected persons.

*Comment: (Reference: Section 47(1)):* The liquidation roll-over provisions should cover all disposals of assets of a company in the course of liquidation as opposed to only distributions. Assets in liquidation are often disposed of to cancel shareholder loans and this form of disposal is technically not a distribution.

*Response:* Accepted. The definition of a “liquidation distribution” will be amended to cover disposals in the course of liquidation.

*Comment: (Reference: Sections 44 and 47):* The 18-month required liquidation period for amalgamation and liquidation rollovers is too short. The elimination of liabilities and the transfer of property registration often take longer due to factors outside the taxpayer’s control.

*Response:* Accepted. The 18-month period will be extended to 36 months. This extended period should make the liquidation and amalgamation rollover provisions far more accessible.

## **11. VALUE-ADDED TAX**

11.1 Amendment of section 12 – Relief for political parties  
(Main reference: Section 12(1)(m))

*Comment:* The proposal to exempt from VAT the membership income of political parties and donations made to political parties raises the question of how these political parties will be treated during the period prior to the amendment becoming effective. The proposed relief for political parties must be on par with the relief previously given to fixed property developers in Taxation Laws Amendment Act 24 of 2011 (i.e. the relief given to developers was not retrospective and was applicable only as of promulgation)

*Response: Accepted:* The current relief proposed for political parties is prospective, coming into operation only from 1 January 2013. Political parties that are currently on register for VAT (insofar as VAT registration relates to the ambit of the proposed amendment), will be permitted to de-register with no exit charge. Further, political parties that have charged VAT on supplies made will not be refunded. These transition rules are consistent with the transition rules found elsewhere in the VAT Act.

11.2 Amendment of section 21 – Debit and credit notes  
(Main reference: Section 21(1)(f))

*Comment:* Although there is agreement that a credit note or debit note should be issued to correct a previously issued tax invoice, the proposed amendment is too lenient. More specifically, there must be a reasonable tax invoice to start with. A tax invoice should have at least a few particulars that make the invoice qualify as a valid tax invoice (i.e. the words “tax invoice”, the name, address and VAT registration number of the supplier, and an individual serialised number and the date of issue of the tax invoice). If a tax invoice is devoid of the stated bare minimum requirements, taxpayers should not be allowed to issue a correcting credit or debit note.

*Response: Accepted:* The scenario under which a credit or debit note can be issued for information missing on a tax invoice will be narrowed. A credit or debit note is merely an extension of a tax invoice, the latter of which must satisfy a minimum standard (i.e. containing the word “tax invoice” as well as the name, address and VAT registration number of the supplier). It follows that a credit or a debit note cannot be issued to correct core deficiencies in respect of an invoice. Further, to assist SARS in VAT audits, a credit or debit note cannot be issued where the information pertaining to the individualised serial number and date of tax invoice is missing.

## 12. SECURITIES TRANSFER TAX

12.1 Temporary adjustment to the broker-member exemption  
(Main reference: Section 8(1)(q))

*Comment:* While the proposed relief is welcome, the permissible stock accounts to be added are too numerous. Brokers will not be able to constantly allocate (and reallocate) shares between the “unrestricted stock account”, “security



restricted share loan stock account” and “security restricted cash loan stock account”. Brokers should be allowed to hold a single account but reflect the different levels of status within that single account.

*Response:* Accepted. Brokers will be allowed to hold a single restricted account for non-bank clients. Changes in status will be reflected as suggested.

*Comment:* In order to eliminate any further disputes on this matter in respect of prior years, the provisions clarifying the exemption for brokers should be dated back to 1995 (i.e. when the exemption was initially added).

*Response:* Partially accepted. The revised exemption will be back-dated to 1 July 2008; the date when the Securities Transfer Tax became effective. Prior dates relate only to the now defunct Uncertificated Securities Tax.

12.2 Securities transfer tax on dividend cessions  
(Main reference: *Repeal of section 145 of Act 24 of 2011*)

*Comment:* In 2011, imposition of the Securities Transfer Tax in respect of dividend cessions was repealed because dividend cessions became taxable as ordinary revenue. However, the proposed legislation reverses this repeal even though dividend cessions are still taxable as ordinary revenue. No seeming reason exists for this repeal.

*Response:* Accepted. Dividend cessions will remain free from Securities Transfer Tax. The proposed repeal of the relief will be withdrawn.

## 13 ADMINISTRATION

13.1 Incorporation of international agreements for combined border control posts  
(Main reference: *Clause 1*)

*Comment:* It is inappropriate to include principal legislation in amendment Acts. This provision should be inserted in the Customs and Excise Act, 1964.

*Response:* Not accepted. The proposal extends beyond the Customs and Excise Act, 1964, to other border control legislation. The proposed location of the provision has been cleared with the State Law Adviser.

13.2 Penalty on inadequate estimate of second provisional tax payment for taxpayers with a taxable income in excess of R1 million  
(Main reference: *Clause 15; Amend paragraph 20*)

*Comment:* The proposal is that these penalties will automatically be levied at a fixed percentage (20 per cent). It is also not clear why the penalty which was previously capped at a maximum of 20 per cent must now automatically be levied

at the maximum. It is recommended that the existing system be retained, (i.e. the penalty may be levied if SARS is not satisfied that it was seriously calculated and will not automatically be levied at 20 per cent).

*Response:* Not accepted. The proposal ensures that all provisional taxpayers are treated in the same way. As part of the proposal paragraph 20(2) has been amended to permit SARS to waive part or all of the penalty imposed if satisfied that the estimate was seriously calculated and not deliberately or negligently understated.

*Comment:* There is no opportunity for the taxpayer to request remission of the penalty. The discretion to remit the penalty should be extended.

*Response:* Comment misplaced. Clause 15(c) of the draft Bill extends the discretion, as proposed by the commentator.

*Comment:* Once the 20 per cent margin for error has been exceeded the automatic imposition of a penalty will result in the need to object and appeal, which will drive up costs. A turnover of R30 million, the threshold for monthly VAT payments, should, therefore, be used in place of the R1 million taxable income threshold currently used.

*Response:* Not accepted. Whether SARS exercises its discretion before or after the imposition of the penalty, a taxpayer is required to provide sufficient information to satisfy SARS that its estimate was “seriously calculated with due regard to the factors having a bearing thereon and was not deliberately or negligently understated.” It is thus a question of the timing of the provision of the information, rather than the need to provide it. Using a VAT threshold would have anomalous results for taxpayers who are not registered for VAT, who have differing profit margins from the norm or who would fall under this provision despite having an assessed loss.

### 13.3 Effective date for new research and development rules (Main reference: Clause 22; Amend section 1)

*Comment:* The effective date for the new rules changed from 1 April 2012 (or a later date determined by the Minister) to 1 October 2012. Confirmation is required that the necessary Committee and forms are finalised.

*Response:* The Committee has been duly constituted, has sat and is already considering applications. The application forms have also been finalised and are available from the Department of Science and

Technology website at <http://www.dst.gov.za/index.php/services/the-rad-tax-incentives-programme>.

13.4 Definition of a SARS official  
(Main reference: Clause 23; Amend section 1)

*Comment:* Is “(c) a person “contracted or engaged by SARS for purposes of the administration of a tax Act and who carries out the provisions of a tax Act under the control, direction or supervision of the Commissioner” not an employee under the Fourth Schedule to the Income Tax Act?

*Response:* Employees are covered by “(b) an employee of SARS”. The amendment is intended to include persons from other organs of state whose services are obtained by SARS but with whom a commercial contract is not concluded. Their inclusion ensures that their engagement by SARS is fully regulated by the Tax Administration Act, 2011, for purposes of the secrecy provisions, amongst others.

13.5 Extension of time to respond to a query  
(Main reference: Clause 32; Amend section 46)

*Comment:* Why is this decision for the extension of time to submit relevant material not subject to objection and appeal, while the decision for the extension of time for objection and appeals is?

*Response:* A failure to submit relevant material within the original period specified may result in an administrative penalty in the future. (Administrative penalties are not yet in force in this regard.) If an administrative penalty were to be imposed the taxpayer would be able to request remission of the penalty, as well as object and appeal if it were not granted. In addition, an unreasonable refusal by a SARS official to extend the period could be brought to the attention of management and the Tax Ombud, On the other hand, a failure to submit an objection or appeal within the period specified by law disqualifies the objection or appeal. As a result of its final impact, the decision not to extend the period is itself made subject to objection and, if necessary, appeal.

13.6 Estimated assessments  
(Main reference: Clause 39; Amend section 95)

*Comment:* Estimated assessments are not subject to assessment or appeal unless a taxpayer submits a return and no reduced or additional assessment is raised. If there is no basis for the assessment, how do you complete the return?

*Response:* The only assessments based on an estimate that are not subject to objection or appeal under this rule are those issued because taxpayers have failed to submit their returns. The return should be completed on the same basis that it would have been completed if it had been submitted as required. If SARS does not revise its assessment to take account of the return submitted, the taxpayer is then entitled to object and, if necessary, appeal the decision. The burden is on SARS to justify its estimate in the face of the facts provided by the taxpayer.

13.7 Remission of understatement penalty  
(Main reference: Clause 48; Amend section 223(3))

*Comment:* The remission is only for a reportable arrangement. Why is advice on any other dispute not covered?

*Response:* The commentator has overlooked the distinction between an “arrangement” and a “reportable arrangement”. The section refers to an arrangement, which is widely defined and addresses the concern raised.

13.8 Phase I of regulation of tax practitioners  
(Main references: Clauses 57 and 58; Amend section 240 and insert section 240A)

*Comment:* There is a risk that there may be a period where there are no bodies that can specifically be recognised and that the statutory bodies mentioned in section 240A cannot allow persons who are only tax practitioners as members of their organisations, as these individuals would not meet the entrance requirements.

*Response:* Accepted. Although bodies may begin engaging with SARS on an informal basis for recognition as soon as the legislation has been introduced, a window period after promulgation must be allowed for their formal recognition. Tax practitioners who do not fall under a recognised controlling body will also have to find a recognised controlling body with which to register. It is therefore proposed that the requirement to register with a recognised controlling body only come into effect on 1 April 2013.

*Comment:* The proposed date of 1 April 2013 is too early and 1 July 2013 or later would be preferable.

*Response:* Not accepted. SARS has begun engaging with bodies, as suggested above, on the steps to be taken for recognition if the legislation is adopted. While there is no doubt that the deadline is tight, the

recognition of bodies early in 2013 should be achievable, so that tax practitioners are in a position to join recognised bodies by 1 April 2013.

*Comment:* A person may not be registered as a tax practitioner if he or she has “(a) during the preceding five years been removed from a related profession by a ‘controlling body’ for serious misconduct.” The term “related profession” is not defined and should be replaced by “tax profession.” The term “serious” should be defined to bring it in line with the disqualification criteria to hold office as a director under the Companies Act, 2008.

*Response:* Not accepted. The wording of the draft Bill recognises that the tax profession is supported by and overlaps with a number of related fields such as the internal and external audit profession, accounting profession and valuation profession. It is unclear why a person who has been removed from such a profession should be entitled to be registered as a tax practitioner. Removal from a profession either occurs because of failure to pay the required fees or as the most serious sanction available to the profession for misconduct. The amendment proposed in the Bill clarifies that it is only the second reason for removal that acts as a bar to registration as a tax practitioner. The amendment proposed by the commentator is likely to be inconsistent with the various professions’ rules and overlaps with the disqualification criteria prescribed in section 240(3)(b).

*Comment:* The proposal provides that the Commissioner must recognise as "a statutory body" the Independent Regulatory Board for Auditors (IRBA), South African Legal Practice Council (SALPC) and certain other statutory bodies. It is not clear if these bodies are intended to be the ultimate controlling bodies. The proposed section then provides that SARS "may" recognise other bodies, if such bodies meet the requirements as set out in section 240A(2). It is recommended that existing bodies that meet the requirements must also be approved by the Commissioner. If the Commissioner requires amendments to the existing bodies’ constitutions, these amendments can be addressed before the approval is granted.

*Response:* Comment misplaced. The statutory bodies listed have the same status as other recognised controlling bodies. The only difference is that they are automatically recognised. The use of the word “may” serves to indicate that it is the Commissioner who has the discretion to determine whether the requirements set out in section 240A(2) have been met. If amendments are required to meet the requirements, this will form part of the engagement between bodies seeking recognition and SARS.

*Comment:* It is our understanding that the Auditing Professions Act, 2005, limits the powers of IRBA to the regulation of auditors. The proposal appears to be a significant policy departure from that envisaged when the Act was enacted and clarity on this matter would be welcomed.

*Response:* The proposal does not expand the mandate of IRBA beyond the regulation of auditors; it merely recognises the role that IRBA has in this regard. A review of disciplinary reports published by IRBA indicates that IRBA has taken action against auditors involved in misconduct in tax matters. See, for example, page 34 of IRBA's annual report for 2012, which was tabled in Parliament in September 2012.

*Comment:* The Legal Practice Bill has not yet been enacted. The Bill contemplates a "transitional SALPC" initially and an actual SALPC could be operational only up to three years later. The reference to the SALPC should be removed until the Legal Practice Act is effective.

*Response:* Accepted. The reference to the SALPC has been removed and replaced with references to a Law Society established in terms of Chapter 3 of the Attorneys Act, 1979, and the General Council of the Bar of South Africa, a Bar Council and a Society of Advocates referred to in section 7 of the Admission of Advocates Act, 1964.

*Comment:* The words "providing advice with respect to the application of a tax Act or completing returns as a 'recognised controlling body'" are confusing.

*Response:* Accepted. The proposed introductory wording of section 240A(2) has been rephrased.

*Comment:* With regard to the minimum qualification and experience requirements as well as the continuing professional education (CPE) requirement, it is recommended that it is specifically stated that these requirements must be within the field of taxation.

*Response:* Comment misplaced. The opening requirement in the proposed section 240A(2)(a) is that the minimum qualification and experience requirements, as well as continuing professional education, be "relevant and effective". The question of relevance must be judged in the context of this provision appearing in the Tax Administration Act, 2011, and being administered by the Commissioner.

*Comment:* The Minister may appoint a panel of retired judges (or persons of similar stature and competence) to deal with disciplinary matters. There is some

concern as to whether this will be appropriate as smaller bodies may not be able to afford their share of the costs of such a panel.

*Response:* Accepted. It will be made clear that the Minister will only appoint a panel at the request of the recognised controlling body or where the Minister is satisfied that a recognised body's disciplinary process is ineffective. Furthermore, one or more of the panel members will be permitted to hear complaints, which should reduce the costs involved if a matter is not so complex as to require more than one member.

*Comment:* The regulation of the tax profession should include SARS officials.

*Response:* Not accepted. SARS and its officials are already subject to several oversight mechanisms that do not apply to tax practitioners. These mechanisms range from the newly established Tax Ombud, to the Public Protector, to overall oversight by this Committee and Parliament.

*Comment:* In the same way that SARS may report unprofessional conduct to a controlling body, so a formal basis of reporting unprofessional acts of SARS officials with the Commissioner should be established in legislation.

*Response:* Comment misplaced. SARS is a creature of statute and requires empowering legislation to fulfil its functions. This is not the case for taxpayers and tax practitioners, who are free to lodge a complaint with SARS without such legislation. If a complainant is not satisfied with SARS's response, the existing oversight mechanisms may be used.

### 13.9 Issues not forming part of the Bill

*Comment:* There are a number of countries in which a limited statutory privilege is extended to tax advice provided by tax advisers who are not lawyers, including Germany, New Zealand, the UK and USA. In view of the fact that tax practitioners are now being regulated by law, such a limited statutory privilege should be granted in the Tax Administration Amendment Bill, 2012.

*Response:* Not accepted. The response when similar comments were made in respect of the Tax Administration Bill remains appropriate, since Phase I of the regulation of tax practitioners still relies to a large extent on regulation by self-constituted professional bodies.

"It is recommended that the comment be held over for consideration together with a future Regulation of Tax Practitioners Bill. Legal professional privilege (LPP) is a near absolute common law right that originated in the UK in the sixteenth century. It protects communications

between lawyers and their clients while obtaining legal assistance. No similar privilege exists for communications with accountants, doctors, priests and others. Where privilege is extended outside the legal profession, even on a limited basis, this is done by statute. Commentators draw on Germany, New Zealand and the USA as examples of foreign jurisdictions that offer a limited privilege in respect of non-lawyers who give tax advice.

The matter is currently under review by the Australian Treasury, which issued a discussion paper in April 2011. After setting out the case for the extension of privilege the discussion paper notes the arguments against it. These include the increased scope of documents that would be covered by privilege, the unique duties lawyers have to the law and the courts, the role of the courts in supervising lawyers, the potential for delay and abuse, the “floodgate” argument for other professionals and the potential for difficulties in the international and inter-agency context. The period for public comment has now closed, but a decision has not been communicated. Canada does not offer a similar privilege to non-lawyers. The UK limits HMRC’s right to request opinions from tax advisers, but not from their clients or others who may hold them. The question of a broader privilege in the UK has recently been litigated up to the Court of Appeal. The Court denied it to accountants after noting that;

“Thus, not only has Parliament not created any statutory extension of LPP to legal advice sought from and given by accountants on tax matters, but this position has been reached after consideration of the position by several responsible bodies, making diverging recommendations on the point, including two committees, some of whose recommendations did lead to legislation. Parliament’s failure to change the law in this respect is not an accident.”

*(Prudential Plc & Anor, R (on the application of) v Special Commissioner of Income Tax & Ors [2010] EWCA Civ 1094. The ruling is currently on appeal to the Supreme Court.)*

While the issue of a level playing field between lawyers and other professionals with respect to privilege is acknowledged,<sup>1</sup> the following comment by the Australian Financial Services Minister, Bill Shorten, is instructive; “The (admittedly receding) lawyer in me would argue that the lawyer-client privilege is one safeguarded by the additional duties incumbent upon lawyers as officers of the court, and that the absence of such a duty among accountants is fatal to your profession’s claim.” At least in Australia, however, tax practitioners are subject to statutory regulation.



The question of a limited privilege for tax advice by non-lawyers is a contentious one internationally. SARS's view is that just as is the case in Germany, the USA and (if a limited privilege is extended in that country) Australia, a prerequisite for considering the extension of privilege in tax matters to non-lawyers is that the tax practitioners are regulated, not by self-constituted professional bodies, but by law.

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<sup>1</sup> The Court of first instance in the *Prudential* case suggested that one way in which the issue of a level playing field could be addressed is by reducing the scope of LPP in the tax arena. These comments were not supported by the Court of Appeal. In the USA, Mark Everson, an ex-Commissioner of the IRS has gone a step further by suggesting that; "Congress should take a hard look at the doctrine of attorney-client privilege as it applies to corporations. Communications pertaining to patents, or threatened or actual litigation, should remain protected. But communications about, say, commercial transactions and financing and even government-mandated filings and disclosures might not." ("Lawyers and Accountants Once Put Integrity First" *New York Times* 18 June 2011)"

To update two examples given in the response to comments on the Tax Administration Bill, the Australian discussion paper closed for comment over a year ago in July 2011 and no decision to extend privilege to tax advisers who are not lawyers has been communicated to date. In the United Kingdom the appeal on extending privilege to tax advisers who are not lawyers commenced before the Supreme Court on 5 November 2012.

Reviewing the benchmark countries for the Tax Administration Bill and SARS's discussion paper on regulating tax practitioners, the situation may be summarised as follows according to SARS's information.

	Statutory Regulator	Limited Statutory Privilege
Australia	Yes	No*†
Botswana	No	No
Canada	No	No
Malaysia	Yes	No
New Zealand	No‡	Yes
UK	No**	No††
USA	Yes	Yes†

\* Administrative arrangement.

† Does not extend to aggressive tax planning (GAAR)/tax shelter advice.

‡ Registration with tax administration required.

\*\* HMRC has indicated that it intends to "consult further during 2012 on standards, oversight of the paid agent community and independent input to HMRC decisions on sanctions."

†† Restriction on request from tax practitioner, information may be requested from taxpayer and others.

*Comment:* It is noted that SARS can recover costs that it may incur in recovering debts from taxpayers, but taxpayers have no recourse to recover costs from SARS.

*Response:* Comment misplaced. While draft versions of the Tax Administration Bill made provision for SARS to recover costs in recovering debt, the Bill that was introduced and the Act do not. As to the question of costs more generally, the response on pages 13 and 14 of the response to comments on the Tax Administration Bill remains appropriate.