Taxation Laws Amendment Bills, 2011

STANDING COMMITTEE ON FINANCE PRESENTATION
7 September 2011

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Process

- Draft released on 2 June 2011
- Initial briefing to Standing Committee on Finance on 15 June 2011
- Hearings held on 21 and 22 June 2011
- Written responses to National Treasury/SARS due by 11 July 2011
- Responses amounted to over 500 pages provided by approximately 60 organisations
- Workshops were conducted with interested stakeholders
- Accelerated consultation process on section 45 and related matters announced on 29 June 2011
  - One-on-one meetings held, covering more than 50 transactions
  - Revised proposal on section 45 and related matters released on 3 August 2011
  - Comments on revised legislation due by 17 August 2011 and workshop held on 31 August 2011

MEDICAL SCHEME CREDIT

Medical Scheme contributions and other medical expenses - past reforms

- **2005/06**: An employer could contribute up to two-thirds of the member's contribution as a tax-free fringe benefit
- **2006/07**: 2/3rds tax-free provision was replaced by a monthly monetary cap (to encourage broader medical scheme coverage, extend tax benefit to self-employed individuals & achieve a more equitable tax treatment)
  - Medical scheme contributions paid by taxpayers tax deductible (tax-free if the employer pays) subject to monthly caps(R500 first two beneficiaries & R300 for all other beneficiaries)
- **2007/08, 2008/09 & 2009/10**: monthly caps increased: R530 & R320, and R570 & R345 and R625 & R380
- The tax-free fringe benefit for employer contributions was removed. However, employees can claim deduction for medical scheme contributions, whether made by employee or by employer on behalf of employee up to the cap.
- **2010/11** & **2011/12**: monthly caps: R670 & R410, and R720 & R440

Conversion of Medical Deductions to Medical Tax Credits: Comparison: Deductions vs. Credit

Deduction	Tax credit
A reduction from taxable income of capped medical scheme contributions & qualifying medical expenses, potentially resulting in the taxpayer being in a lower income tax bracket	**A reduction in the tax liability / tax payable**
The **value** of a deduction will depend on the taxpayer's **applicable marginal rate** (between 18% and 40%) – the higher a taxpayer's marginal rate, the more valuable the given deduction.	The **value** of the tax credit will be **equitable** across income groups (tax credit will be calculated at the same rate for all taxpayers)

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Deductions vs. Credit – illustration of the higher "subsidy" for individuals with higher marginal rate under the deduction regime

Annual	Monthly	18%	20%	25%	30%	40%
Deduction		Monthly Credit				
5 280	440	79	88	110	132	176
8 640	720	130	144	180	216	288
17 280	1 440	259	288	360	432	576
22 560	1 880	338	376	470	564	752
27 840	2 320	418	464	580	696	928
36 000	3 000	540	600	750	900	1 200
41 460	3 455	622	691	864	1 037	1 382
48 000	4 000	720	800	1 000	1 200	1 600

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Original proposed medical tax credits (2012/13)

- **Medical scheme contribution credit**
  - Available to taxpayers who are medical scheme members
  - **R216 pm** each for taxpayer and first dependant
  - **R144 pm** for each additional beneficiary
- **Supplementary medical scheme contribution credit**
  - Available to medical scheme members (taxpayers) and dependants aged 65 and above, and members or dependants with a disability
  - **R216 pm**
  - A taxpayer aged 65 / above with a disability will not receive a double benefit

Revised proposal for 2012/13

Under 65 years	65 years and older
<u>Medical scheme contributions</u> -**R216 monthly tax credit** each for taxpayer and first dependant -**R144 monthly tax credit** for each additional beneficiary - Supplementary credit for disabled dropped <u>Out of Pocket expenses</u> -Medical scheme contributions in excess **of 4 times the tax credit**, plus -Other "out-of-pocket" medical expenses -Deductible if more than **7.5% of taxable income** -Approved expenses (lists) fully deductible if disabled or disable dependant	<u>Medical Scheme contributions</u> - Contributions (on behalf of retirement employees) by ex-employer (or insurance company) a taxable fringe benefit -All contributions fully remain deductible, taxpayer in a tax neutral position -Supplementary credit dropped <u>Out of pocket expenses</u> All expenses fully deductible

A more equitable system

Beneficiaries	Monthly Tax Credit	Annual Tax Credit	Annual Cumulative Tax Credit	18%	25%	30%	40%
				"Equivalent deduction"			
1st	216	2 592	2 592	14 400	10 368	8 640	6 480
2nd	216	2 592	5 184	28 800	20 736	17 280	12 960
3rd	144	1 728	6 912	38 400	27 648	23 040	17 280
4th	144	1 728	8 640	48 000	34 560	28 800	21 600
5th	144	1 728	10 368	57 600	41 472	34 560	25 920

Proposals under consideration for 2013/14

- Below 65 years - convert deductible "out of pocket" expenses into a credit at 25%, with 7.5% threshold
- Disabled taxpayers or taxpayers with disabled dependants – convert "out of pocket" expenses into a tax credit – at a rate to be determined
- 65 years and above – convert out of pocket expenses into a tax credit at a rate to be determined

SECTION 45 AND RELATED MATTERS

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11

Initial Proposal (2 June 2011)

- Section 45
  - National Treasury initially announced the temporarily suspension of section 45 intra-group rollover relief from 3 June 2011 until 1 January 2013
  - Issue: Use of tax-free reorganisations to substantially increase deductible debt in the target
  - The 18-month period was intended to provide Government with time to protect the fiscus while examining debt/share issues (estimated loss of R3-5 billion annually)
- Hybrid shares
  - The minimum share redemption period was moved from 3 years to 10 years (section 8E); hybrid shares deemed to give rise to ordinary income
  - New rules were added to treat dividends from 3rd party backed (secured) shares as ordinary revenue without regard to the 3 year minimum (no stock in underlying company
  - Objective: Closure of CIS and funnel schemes

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1

Process: Round 1 (June/July)

- Contended adverse commercial impact
- Section 45 suspension
  - Closure of pure intra-group transfers
  - Closure of BEE intra-group leveraged transfers
  - Closure of merger and acquisitions (e.g. private equity) as well as special project financing
- Ordinary treatment for hybrid share dividends
  - Closure of BEE preference share funding
  - Closure of general preference share funding to make share acquisitions (overcomes inability to obtain interest deductions for debt to acquire shares)
- Factual meetings
- Over 50 transactions were discussed
- Many "very safe" transactions raised but key information gained

Process: Round 2 (August/September)

- Revised proposals (3 August)
  - Section 45 suspension lifted
  - No deduction for interest to facilitate section 44, 45 and 47 reorganisations unless approval (regulations)
  - Removal of the 10 year rule for hybrid shares
  - Third party guarantees permissible if the share funding is used to acquire equity shares
- Further comment period
  - Comments period ended 17 August
  - Workshop on 31 August
  - Response document informal hearing on 7 September
  - Further funding workshop proposed (plus revised regulation release)

Basic Tax Mathematics

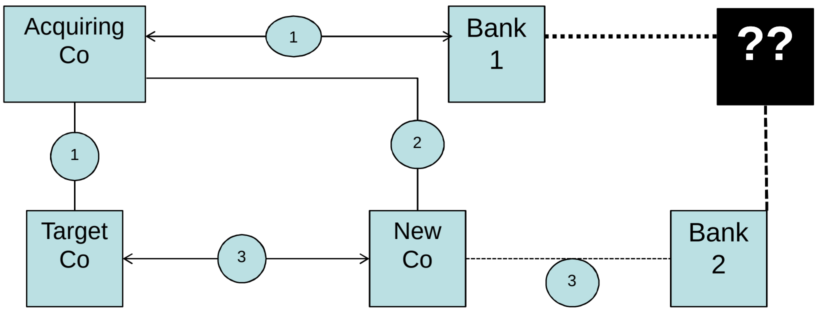
	Payor	Payee
Interest	(-)	(+)
Dividends	(0)	(0)
Tax planner's target	(-)	(0)
Trapped	(0)	(+)

SECTION 45 ISSUES: EXCESSIVE DEBT

Reorganisations and Leveraged Buyouts

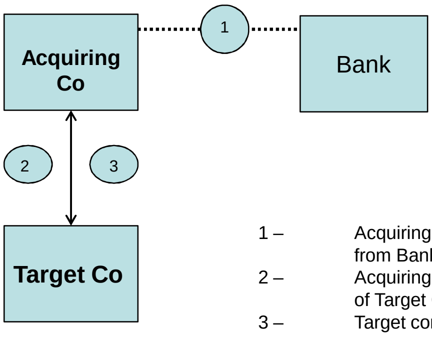
- Concern:
  - Use of tax-free reorganisations to connect deductible debt to share acquisitions
  - Reorganisations: Mainly section 45; also sections 47 and 44
- Key features:
  - Excessive debt
  - Debt with share-like terms
  - Interest paid to exempt parties
    - Foreign bond holders
    - Foreign paid-in-kind notes
    - Four funds formula (exempt fund)
    - Pension funds (domestic and foreign)

Intra-group LBO Transactions (i.e. section 45)



1 – Acquiring Co obtains a bridging loan from Bank 1 uses the loan proceeds to acquire all the Target Co shares
2 – Acquiring Co sets up New Co
3 – New Co obtains a long-term interest bearing loan from Bank 2 to acquire the assets of Target Co with the proceeds used to pay off the bridging loan (for which New Co obtains interest deductions because the debt is connected to assets; see case ITC 1625)
4 – Risk: bank offloads the loan to exempt parties or channels funds to exempt parties via back-to-back loans

Liquidation LBO Transactions
(i.e. section 47)



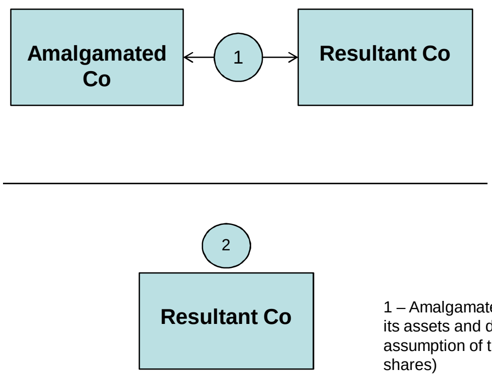
1 – Acquiring Co obtains an interest bearing loan from Bank

2 – Acquiring Co uses loan proceeds to purchase all of Target Co shares

3 – Target company distributes all of its assets to Acquiring Co and liquidates (i.e. liquidation dividend)

- Acquiring Co claims an interest deduction on the loan as the proceeds are arguably used to acquire (**indirectly**) assets (the target company must have a complementary business to the acquiring company)

Amalgamation transactions
(i.e. section 44)



1 – Amalgamated Co has existing interest bearing debt used to fund its assets and disposes of all its assets in exchange for the assumption of the debts by Resultant Co (plus Resultant Co shares)

2 – The existence of Amalgamated Co is terminated

- Resultant Co claims a deduction of the interest expenses on the debt it assumed in terms of 2 above
- The shareholders of Amalgamated Co acquire Resultant Co shares

New Proposals

- Denial of interest deduction for section 45 and section 47 transactions where approval is not granted
- Prohibit the deduction of interest on existing debt in section 44 transactions
- Approval process for interest deduction (regulation)
  - No Minister's consultation required
  - Industry consultation window opened
  - Decision subject to appeal and objection
- Main leakage:
  - Debtor getting deduction and financier (Bank) offloading debt instrument to exempt person (e.g. foreigner or pension fund)
- No approval, no deduction
  - Group companies: no deduction no inclusion
  - Banks: deduction by Bank if there's an inclusion (but an interest offset by the bank)
  - Exempt persons: no deduction no inclusion

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21

Narrowed Discretion

- Factors taken into account in exercising the discretion:
  - the potential tax leakage associated with the debt issued to facilitate the reorganisation
  - the level of debt to the total equity of the debtor company,
  - the estimated interest expenses in relation to the estimated income after the reorganisation
  - the debt versus equity features of the so-called debt instrument and
  - the ownership relationship between debtor versus the creditor (i.e. whether the creditor is a shareholder in the debtor)

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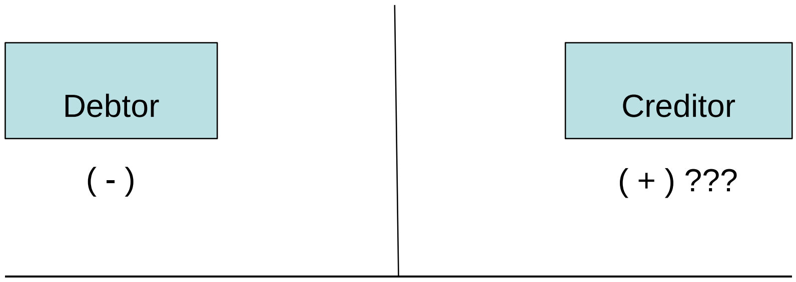
22

Creditor Offloading



- **What happens if the Creditor unilaterally offloads the debt instrument to exempt parties?**
- **Debtor’s interest deductions are at risk**

SECTION 8EA AND 8E: HYBRID SHARES

Overall Theory

- **Substance questions**
  - Key Question: Are the shares really disguised debt?
  - Key feature of debt #1: Perpetual versus required capital repayment by issuer or third party (IFRS)
  - Key feature of debt #2:
    - Interest in profits versus fixed repayment
    - Look to the funds of the issuer versus outside parties
- **Aggregate Theory**
  - Preference shares should be respected if the system is neutral (0 – 0)
  - Assumes all parties are taxpayers
  - Lowering the cost of funding

South African Paradigm

- Limit on interest deductions
  - Interest on debt used to acquire shares is not deductible (most countries so allow)
  - BEE vehicles do not have any income to be absorbed by interest deductions
  - No group taxation
  - Strong need for funding
- Problems of multi-person audits
  - The auditor needs to know the tax position of the fundee to know the impact of hybrid shares by the funder
  - Each taxpayer must be audited separately, taxpayers can take different positions in regard to the same transaction, and taxpayers are not responsible for the tax owed by other parties

Revised Proposal

- Section 8E (third party backed shares)
  - Safe harbour added for funding to acquire ordinary shares
  - Group member of issuing preference share company can provide guarantee
  - Group member of target company can provide guarantee
- Section 8E (hybrid shares)
  - 10 year rule dropped
  - Dividends cannot be derived directly or indirectly mainly from interest

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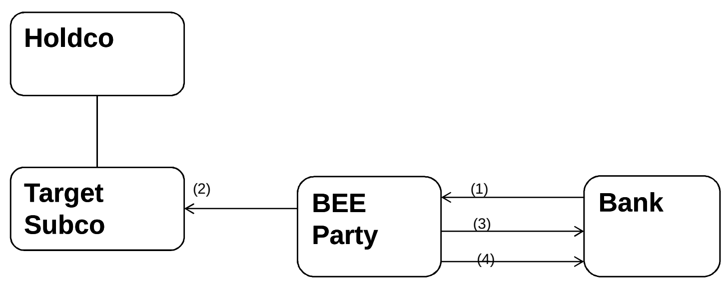
27

Acquisition and Pledge of Ordinary Shares



1. Bank funds BEE Party
2. BEE Party purchases Target Ordinary Shares
3. BEE Party issues Preference Shares to the funding Bank
4. As security to the funding arrangement, BEE Party Pledges Target Ordinary Shares in favour of the Bank

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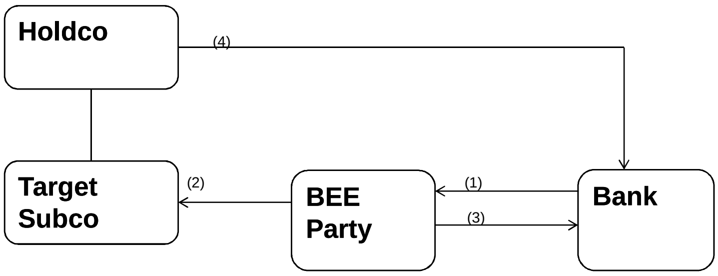
1

Acquisition and Pledge of Ordinary Shares



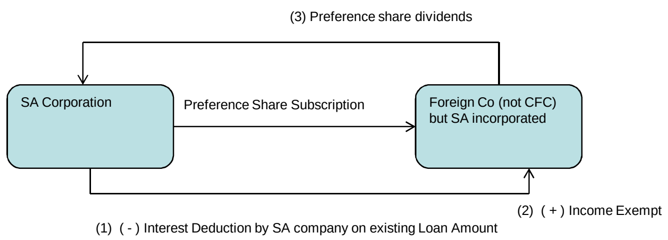
1. Bank funds BEE Party
2. BEE Party purchases Target Ordinary Shares
3. BEE Party issues Preference Shares to the funding Bank

4. As security to the funding arrangement, Holdco issues a Guarantee exercisable upon default by the BEE Party (or Holdco can acquire shares from bank)

Proposed Revisions to Third Party Backed Financing

- Uses
  - The use of preference shares will remain limited to securing the bank's funding for ordinary share acquisitions of operational target companies (or of holding companies with operational subsidiaries)
  - New option 1: Refinancing initial preference funding
  - New option 2: Back-to-back preference shares for ultimate ordinary shares
  - New option 3: Funding can be used to acquire foreign shares
- Guarantees
  - The 3rd party guarantee is permissible if the 3rd party has 20% or more of equity share in the funded party issuing preference shares or target company
  - Once the preference share loses the guarantee or pledge, the preference share is no longer tainted, and the proposed rule no longer applies
- Effective date: Deferred to 1 October 2012

Section 8E Funnel Problem



Basic Preference Share Revisions

- Initial proposal
  - 10-year rule dropped
- 3 August proposal
  - Preference shares dividend must not be directly or indirectly derived "mainly" from interest
  - Tracing problem?
  - Banks/insurers unintentionally impacted in respect of all preference share issues
- Proposed revisions
  - The tracing rule will be eliminated
  - Problem will instead arise for shares guarantees, pledged of otherwise secured by financial instruments other than shares