NATIONAL
TREASURY

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAXATION LAWS AMENDMENT BILL, 2012

12 November 2012

DRAFT

[W.P. –- '12]

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EXPLANATION OF MAIN AMENDMENTS

1. INCOME TAX: INDIVIDUALS, SAVINGS AND EMPLOYMENT

1.1. ADDITIONAL MEDICAL EXPENSES CONVERTED TO MEDICAL TAX CREDITS

[Applicable provisions of the Income Tax Act: Amend section 6A, insert section 6B, delete section 18]

I. Background

A. Medical scheme contributions made by individual taxpayers

Taxpayers of 65 years of age and above are entitled to a monthly "deduction" against taxable income in respect of all medical scheme contributions made for the benefit of themselves and their dependants. As of 1 March 2012, taxpayers below 65 years of age are entitled to a monthly "tax rebate" (i.e. credit) in respect of any medical scheme contributions made for the benefit of themselves and their dependants. The above monthly tax credits will be adjusted annually. Medical credits are non-refundable (i.e. cannot be used as the basis for a refund) and cannot be carried over to the next year of assessment.

B. Additional (e.g. out-of-pocket) medical expenses incurred by individual taxpayers

All additional medical (e.g. out-of-pocket) expenses potentially qualify for deductions (as opposed to credits). These medical costs include a variety of out-of-pocket costs, such as doctor fees, ancillary services (e.g. nursing costs) and medicines.

Currently, taxpayers of 65 years of age and above are entitled to a full deduction against taxable income in respect of any qualifying medical expenses. Taxpayers below 65 years of age who have a disability or whose spouse or child has a disability, fall into a special category. These taxpayers are entitled to a deduction of all qualifying medical expenses as well as the value of the medical scheme contributions that in aggregate exceed 4 x the credit allowed for medical scheme contributions.

However, taxpayers under the age of 65 (who fall outside the above category) are subject to a floor. More specifically, the taxpayer is entitled to a deduction equal to the aggregate of qualifying medical expenses and the medical scheme contributions in excess of 4 x the allowed credit that exceeds 7.5 per cent of the taxpayer's taxable income (excluding any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit).

II. Reasons for change

In 2011, the system of deductions for medical scheme contributions was converted to credits in an attempt to improve the equity of the tax system. This conversion was based on the notion that medical tax credits provide a more equitable form of relief than medical deductions because the relative value of the relief does not increase with higher income levels. The proposed amendments encompass phase two of the changes.

III. Proposal

A. Overview

It is proposed that the remaining aspects of the deduction system for medical expenses be replaced with the tax credit system in respect of all medical scheme contributions and qualifying medical expenses for all taxpayers. Under this system, a set level of credits will be allowed for medical aid contributions (with annual upward adjustments), with certain excess contributions and out-of-pocket expenses also eligible for tax credits (instead of deductions). All credits will remain non-refundable. Like the current system for deductions, application of the tax credit system will fall into three categories: (i) taxpayers of age 65 and above, (ii) taxpayers with a disability factor under age 65 and (iii) all remaining taxpayers.

B. Taxpayers of 65 years of age and above

It is proposed that taxpayers of 65 years of age and above will become entitled to medical expenses tax credits in lieu of the current deduction system for all medical-related items. Other than the standard monthly medical scheme credits, the further credits will be set at a 33.3 per cent level. More specifically, the medical credits will be calculated as follows:

- The standard monthly medical scheme credits for the taxpayer, spouse and dependants;
- 33.3 per cent credits for medical scheme fees that exceed three times the standard medical scheme credits; and
- 33.3 per cent credits for all qualifying medical expenses (other than medical scheme contributions).

Example 1
Facts: (For the purposes of the examples, the monthly medical scheme credits as at 1 March 2012 will be used.) Mr X is 65 years old. For the year of assessment commencing on 1 March 2014, he made contributions to a medical scheme of R2 000 per month on behalf of himself and his wife. By 28 February 2015, he had incurred R20 000 in qualifying medical expenses.

Results:

Type of deduction	**Expense**	**Calculation**	**Value of credit**
Standard monthly medical scheme credits	R2 000 p.m. x 12 = R24 000 p.a.	(R230 + R230) = R460 p.m. R460 x 12	R5 520 p.a.
Excess medical scheme fees		(R24 000 – (3 x R5 520)) = R7 440 R7 440 x 33.3%	R2 478 p.a.
All qualifying medical expenses	R20 000	R20 000 x 33.3%	R6 660 p.a.
Total	R44 000		R14 658 p.a.

Therefore, Mr X’s tax liability for the 2014/2015 tax year would be reduced by R14 658.

C. Taxpayers below 65 years of age (with a disability factor)

Like current law, a separate calculation exists for taxpayers below 65 years of age if the taxpayer, his/her spouse or child is a person with a disability. Other than the standard monthly medical scheme credits, the credits will generally be set at a 33.3 per cent level. More specifically, the medical credits will be calculated as follows:

- The standard monthly medical scheme credits for the taxpayer, spouse, and dependants;
- 33.3 per cent credits for medical scheme fees that exceed three times the standard medical scheme credits; and
- 33.3 per cent credits for all qualifying medical expenses (other than medical scheme contributions).

Example 2
Facts: Ms Y is 31 years old. For the year of assessment commencing on 1 March 2014 she made contributions to a medical scheme of R2 000 per month on behalf of herself and her two children. Her son has a disability. By 28 February 2015, she had incurred R20 000 in qualifying medical expenses.

Results:

Type of deduction	Expense	Calculation	Value of credit
Standard monthly medical scheme credits	R2 000 p.m. x 12 = R24 000 p.a.	(R230 + R230 + R154) = R614 p.m. R614 x 12	R7 368 p.a.
Excess medical scheme fees		(R24 000 – (3 x R7 368)) = R1 896 R1 896 x 33.3%	R631 p.a.
All qualifying medical expenses	R20 000	R20 000 x 33.3%	R6 660 p.a.
Total	R44 000		R14 659 p.a.

Ms Y’s tax liability for the 2014/2015 tax year would be reduced by R14 659.

D. Taxpayers below 65 years of age (in the residual category)

Like current law, a separate calculation exists for taxpayers below 65 years of age in the residual category (if the taxpayer, spouse or children are not persons with a disability). These credits will generally be set at a 25 per cent level.

More specifically, these medical credits will be calculated as follows:

- The standard monthly medical scheme credits for the taxpayer, spouse, and dependants; and

- 25 per cent credits of the value of the amount by which the aggregate of the medical scheme fees that exceed four times the standard medical scheme credits, and all qualifying medical expenses (other than medical scheme contributions), exceed 7.5 per cent of the taxpayer's taxable income (excluding any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit).

Example 3
Facts: Mr Z is 30 years old. For the year of assessment commencing on 1 March 2014, he made contributions to a medical scheme of R2 000 per month on behalf of himself, his wife, and their child. By 28 February 2015, he had incurred R20 000 in qualifying medical expenses. Mr Z's taxable income for the 2015 year of assessment is R200 000.

Results:

<table>
<tr><th>Type of deduction</th><th>Expense</th><th>Calculation</th><th>Value of credit</th></tr>
<tr><td>Standard monthly medical scheme credits</td><td rowspan="2">R2 000 p.m. x 12
= R24 000 p.a.</td><td>(R230 + R230 + R154)
= R614 p.m.
R614 x 12</td><td>R7 368 p.a.</td></tr>
<tr><td>Excess medical scheme fees</td><td rowspan="2">(R24 000 – (4 x R7 368))
= – R5 472
No excess carried = R0
(R0 + R20 000)
= R20 000
(7.5% x R200 000)
= R15 000
R20 000 – R15 000
= R5 000
R5 000 x 25%</td><td rowspan="2">R1 250 p.a.</td></tr>
<tr><td>All qualifying medical expenses</td><td>R20 000</td></tr>
<tr><td>Total</td><td>R44 000</td><td></td><td>R8 618 p.a.</td></tr>
</table>

Mr Z's tax liability for the 2014/2015 tax year would be reduced by R8 618. If Mr Z's taxable income was R300 000 for the 2015 year of assessment, he would not be able to claim an additional credit, since 7.5% of his taxable income (R22 500) would exceed his qualifying medical expenses.

IV. Effective date

The proposed amendments will be effective in respect of any contributions made or other medical expenses incurred in years of assessment commencing on or after 1 March 2014.

1.2. EXEMPTION FOR COMPULSORY ANNUITY INCOME STEMMING FROM NON-DEDUCTIBLE RETIREMENT CONTRIBUTIONS

[Applicable provisions: Insert section 10C; amend section 11(n); amend paragraphs 5(1) and 6(1)(b) of the Second Schedule]

I. Background

As a general matter, at least 2/3rds of the value of all retirement fund interests must be applied by retirement fund members to provide or acquire a compulsory annuity. More specifically, this 2/3rds rule applies to retirement interests in respect of pension funds, pension preservation funds, and retirement annuity funds (as opposed to provident funds or provident preservation funds). There are two basic annuity options available – a traditional guaranteed life annuity and a living annuity.

To the extent a retirement fund member elects to receive a portion of his or her retirement fund interest in the form of a lump sum upon retirement (or a pre-retirement withdrawal), that lump sum is subject to tax as per the retirement lump sum tax table (or the retirement lump sum withdrawal tax table). In calculating the tax due on the lump sum, the former member is afforded an exemption to the extent the member has made non-deductible contributions to retirement funds. This exemption applies in respect of retirement and pre-retirement withdrawals.

The South African Revenue Service (SARS) keeps record of non-deductible contributions made by individuals to retirement funds (e.g. a contribution to a pension fund by a member to the extent that exceeds the 7.5% contribution limit). When a the retirement fund applies for a tax directive, the law provides that the taxable lump sum should be reduced to the value of all prior non-deductible contributions made by that individual. This relief is applied across retirement funds on a 'first-come, first-serve' basis.

However, if retirement fund interest is applied to provide/acquire annuities, the annuity payments are fully subject to normal income tax. No relief is currently available in respect of non-deductible retirement contributions against annuities received even if the individual's non-deductible contributions exceed all lump sums.

II. Reasons for change

The exemption for retirement and pre-retirement lump sums in respect of non-deductible contributions to retirement funds prevents potential double taxation. In other words, after-tax contributions should not be taxed a second time upon withdrawal. No policy reason exists for this relief not to apply in the case of receipts and accruals by way of compulsory annuities.

III. Proposal

In view of the above, all non-deductible contributions are aggregated in respect of an individual. Restated, all non-deductible contributions to retirement funds are pooled irrespective of the retirement fund to which the contributions were made. However, any non-deductible contributions made throughout the year of assessment will only be added upon assessment to the value of the available aggregated non-deductible contributions.

Further, the available aggregated non-deductible contributions can be applied against a person's retirement interest (in the form of a compulsory annuity or a lump sum), regardless of the fund from which that retirement interest originated. However, the non-deductible contributions will only be applied to a compulsory annuity acquired by a person after that person's retirement, and not where the compulsory annuity is held by any subsequent holders. The available aggregated non-deductible contributions will be applied on a first-come-first served basis in respect of any lump sums and compulsory annuities.

Example
Facts: Mr X belongs to a pension fund. He has R200 000 in non-deductible contributions accumulated when he retires from the fund. He decides not to take a lump sum, and acquires a guaranteed life annuity with the R1 000 000 retirement interest at retirement.

Results: The first R200 000 received in annuity payments from the living annuity will be exempt from income tax.

IV. Effective date

The proposed amendments are effective for receipts and accruals as from 1 March 2014.

1.3. COMPLETION OF THE "CLEAN BREAK PRINCIPLE" WHEN DIVIDING RETIREMENT INTEREST IN DIVORCE

[Main provisions: Delete the definition of "formula C" in paragraph 1; amend paragraphs 2(1)(b)(iA); 2A and 2B of the Second Schedule]

I. Background

A. Current policy

It is Government's policy to promote the "clean-break" principle in respect of the taxation of all amounts assigned in terms of divorce orders. Under this principle, each party to a divorce order should be subject to tax on the portion of the retirement interest that each party ultimately withdraws. The net effect is to divide the tax between the divorcing parties in accordance with the division of retirement interest. This principle stands in contrast with historic rules that often taxed the member of a retirement fund for savings ultimately assigned to the member's ex-spouse.

B. Current position for private sector funds

The "clean-break" principle has largely been entrenched in private sector funds through the application of the Pension Funds Act and the Income Tax Act. Therefore, in most cases, the non-member ex-spouse is taxed when withdrawing his or her retirement interest. However, certain exceptions remain that keep ex-spouses tied to one another in tax terms.
More specifically, an anomaly arises if a non-member ex-spouse fails to claim prompt payment of the divorce award from a retirement fund (through failure to exercise a timeous election as per the Pension Funds Act) prior to the member ex-spouse exiting the fund.

Under these circumstances, the member ex-spouse will remain liable for the tax on the portion of the retirement interest assigned to the non-member ex-spouse. After paying the tax, the member retains a right of recovery from the ex-spouse for the tax.

C. Current position for the Government Employees Pension Fund (GEPF) and other public sector funds

As of February 2012, the GEPF (and other Government pension funds) have not implemented the "clean-break" principle. Therefore, the result for the non-member was as follows:

- The non-member ex-spouse had to wait until the member ex-spouse exited (as a result of resignation, retiring, or death) the fund in order to have access to the retirement interest assigned in terms of the divorce order; and

- The non-member ex-spouse was not afforded any growth or interest on the amount assigned in terms of the divorce order.

From a tax point of view, the member ex-spouse was taxed both on the amount that he/she received upon exit from the fund as well as the portion that was assigned to the non-member ex-spouse in terms of the divorce order. However, the member ex-spouse could recover the tax paid from the non-member ex-spouse.

Nevertheless, because the member ex-spouse was the taxpayer in respect of both amounts, the non-member ex-spouse continued to enjoy the benefit of the exemption applicable in the case of public sector funds (known as "formula C"). The formula effectively provides an exemption from tax, in respect of pension earning for years of Government service prior to 01 March 1998.

D. Divorce orders issued before 13 September 2007

During the process of implementing the "clean-break" principle for private sector funds, transitional rules were enacted to exempt from tax, amounts payable to a non-member ex-spouse in respect of divorce orders issued before 13 September 2007. However, the exemption applied only if the non-member ex-spouse claimed the benefit on or after 01 March 2009 (if claimed prior to the member ex-spouse exiting the retirement fund). The purpose of the exemption was to shield non-member ex-spouses from unanticipated tax consequences that would result if the non-member ex-spouse was suddenly subject to tax on his/her portion of the lump sum benefit (because the initial divorce agreement was set on the basis that the tax would fall on the member, not on the non-member ex-spouse).

II. Reasons for change

A. Private sector funds

No policy reason exists to deviate from the "clean-break principle" in the case of private sector funds. Taxpayers should not be tied together merely because certain ex-spouses fail to make timeous elections.

B. The GEPF and other public sector funds

The GEPF will introduce the "clean-break" principle for the monetary division of pension benefits in March 2012. It is also expected that other public sector funds will soon follow. Given these regulatory changes, retirement fund taxation should effectively place all public sector fund members on equal footing with private sector fund members as regards to the application of the "clean-break" principle.

III. Proposal

A. Private sector funds

The "clean-break principle" will be applied in full to private sector funds. Tax will be divided in accordance with amounts assigned in divorce. Deviations from this principle for failure to make timeous elections and other causes will no longer cause a departure from the "clean-break principle".

B. The GEPF and other public sector funds

Given the changed regulatory environment for public sector funds, it is proposed that all public sector fund members be placed on an equal footing with private sector fund members in tax terms, thereby fully implementing the "clean-break principle." Both ex-spouses will now be taxed in accordance with their own economic interests. Furthermore, it is proposed that the exemption for pre-1998 years of service be fully retained by both ex-spouses. Hence, both the member and the member's ex-spouse will retain the relief to the extent the retirement fund pay-out relates to pre-1998 years of service.

Example

Facts: Mr A joins Government in 1990. He remains in service until 2014. In 1992 he marries Ms D. They get divorced in 2008. According to the divorce order, Ms D is entitled to 40 per cent of Mr A's retirement interest as at the date of divorce. On the date of divorce, Mr A's retirement interest is valued at R2 000 000. Ms D is therefore entitled to R800 000. In 2012, Ms D elects to receive the benefit, and the retirement fund pays Ms D R800 000 less any tax liability.

Results: With regards to the application of the relief in respect of pre-1998 years, the calculation of the taxable amount will be:

Completed years of service of the member post-1998 as at date of the lump sum becoming payable (1998 – 2012)	14 years
Total completed years of service of the member as at date of the lump sum becoming payable (1990 – 2012)	22 years
Value of lump sum becoming payable	R800 000

$$\frac{14 \text{ years}}{22 \text{ years}} \times \text{R800 000}$$

= R509 091 (taxable lump sum)

C. Divorce orders issued before 13 September 2007

Transitional relief for pre-13 September 2007 divorce orders will be extended so as to eliminate anomalies. All payments to a member's ex-spouse in respect of these divorce orders will now be exempt. It is proposed that any amount that becomes due and payable on or after 01 March 2012 in terms of a divorce order that was issued before 13 September 2007 will be free from tax.

IV. Effective dates

The proposed amendments will be effective in respect of any amounts that become payable by a retirement fund on or after 1 March 2012.

1.4. STREAMLINED TIMING FOR CERTAIN FORMS OF VARIABLE CASH REMUNERATION

[Applicable provisions: Insert section 7B; substitute section 23E]

I. Background

A. Receipts and accruals as gross income

Gross income includes all income "received or accrued". Hence, gross income includes income received or accrued in respect of employment, and more specifically, "remuneration" paid by employers to employees. "Remuneration" is an expansive concept, covering salary, overtime pay, leave pay commission and bonuses, benefits-in-kind, amongst other employment-related income.

B. Employer deductions

Under the general deduction formula, an employer carrying on a trade is entitled to a deduction in respect of "remuneration" expenditure incurred in the production of income. No direct linkage exists between most employer deductions and employee income.

However, section 23E limits an employer's general deduction in respect of leave pay. Under this limitation, deductions are limited to the extent that the amount is actually paid or becomes due and payable by the employer. Employee income is deemed accrued on the same date, thereby ensuring a timely matching of employer deductions and employee income.

C. Monthly withholding of employee remuneration

Amounts included by an employee under "remuneration" are subject to employees' tax (known as the pay-as-you-earn system of taxation). Pay-as-you-earn taxation is based on the "remuneration" that the employer "pays or becomes liable to pay" to an employee in certain month. Pay-as-you-earn taxation requires the employer to withhold on a monthly basis with the employer required to transmit the tax to SARS within seven days after the end of each month.

II. Reasons for change

For the most part, the accrual of a salary-related amount in respect of an employee and the actual payment by the employer occurs within the same month (e.g. basic salary and wages). However, in the case of variable "remuneration" (e.g. commissions, bonuses and overtime pay), it appears that interpretation problems regarding the timing of accrual frequently arise. For instance, variable "remuneration" often accrues prior to payment because the amount is often left undetermined by close of the month. The delayed determination is often due to a lack of time (payroll cut-off) or internal controls.

Further, certain forms of accrual are arguably subject to a suspensive condition. This question may arise in respect of a bonus that contains discretionary aspects under the sole control of the employer. The determination of whether the bonus contains a suspensive element can only be determined by closely examining the facts of each case (including the employment agreement). An erroneous taxpayer-finding that a suspensive condition exists (where no suspensive condition actually exists) could easily result in an under-declaration of pay-as-you-earn taxation.

Regardless of the reason, the net result is a differential between payment and accrual that may be separated by a few weeks/months. While employers should theoretically go back and correct the prior monthly withholding, this form of correction is difficult (if not impossible) as a practical matter:

- Firstly, most employers make use of a payroll system that calculates pay-as-you-earn taxation on a cash-payment assumption. Only employers with specific capacity (expertise) would be able to make adjustments after the fact.

- Secondly, monthly adjustments are time-consuming and costly from both an employer and a SARS point of view, particularly in the case of large employers with thousands of employees. The necessary adjustments can typically be made only during the annual payroll reconciliation process, thereby leading to additional penalties and interest for employers.

III. Proposal

From a policy perspective, it is preferable to have a tax system that allows for the timely matching of:

- The withholding obligation and the inclusion in income of certain income (e.g. the employees' tax liability of the employer with a simultaneous inclusion of income for the employee); and
- Employee-income and employer-deductions for employment-related income.

It is accordingly proposed that employee "gross income", required pay-as-you-earn withholding and employer deductions be aligned as much as possible. Rather than adjust core principles and create unintended and unnecessary consequences, this alignment will be required only for items that have a history of causing recurring problems, namely: Leave pay, over-time pay, commission, bonuses and travel reimbursement.

Under the revised framework, the timing of the listed items will shift to a payment basis. Restated, the tax events for these items will be deemed to occur only when the underlying amount is paid by the employer to the employee for purposes of determining: (i) employee gross income, (ii) pay-as-you-earn withholding, and (iii) employer deductions.

Mere accruals and incurrals will be disregarded. From a practical perspective, this change should alleviate the need for complex interpretation (thereby reducing the number of unintended SARS-taxpayer disputes) and pay-as-you-earn mismatches without violating the integrity of the tax system overall.

IV. Effective date

The proposed amendments will be effective in respect of "variable remuneration" that accrue to employees or are incurred by employers, or that become due and payable by employers, on or after 1 March 2013.

1.5. FRINGE BENEFIT VALUATION IN RESPECT OF RENTED EMPLOYER-PROVIDED VEHICLES

[Applicable provision: Amend paragraph 7 of the Seventh Schedule]

I. Background

Employers often provide employees with the use of company-owned vehicles that employees are allowed to use for private purposes in conjunction with business use. This private use of employer-provided vehicles translates into a taxable employment fringe benefit that is subject to monthly employees' tax (pay-as-you-earn) withholding.

Calculation of the taxable fringe benefit is equal to the *"determined value"* multiplied by a factor. This *"determined value"* equals the original acquisition cost or retail market value (when the right of use was first obtained) of the vehicle to the employer. The fringe benefit value may be reduced under two sets of circumstances upon assessment if accurate records of distances travelled for business use have been kept. This reduction occurs as follows:

1. By the ratio of actual proven business kilometers travelled over total kilometers travelled during the year; and

2. In the case where the employee bears the full cost of the license, insurance, maintenance or fuel for the private use of the vehicle, by the ratio of actual proven business kilometers travelled over total kilometers travelled during the year multiplied by these cost amounts.

II. Reason for change

In light of the global economic climate along with increases in the security and collateral requirements required for financing, employers have increasingly begun to rely on rental vehicles for business purposes as opposed to direct ownership (or finance leases). These rented vehicles are provided to employees for business and incidental private use.

Nonetheless, as illustrated above, the tax calculation in respect of the value of the private use of a vehicle assumes that the employer is relying on purchased (i.e. owned) vehicles. The calculation is not appropriate if the employer rents the vehicle pursuant to an operating lease.

III. Proposal

When employers provide employees with a vehicle for business use, it is proposed that the on-going rental value be utilised as the starting point for the calculation of the fringe benefit if: (i) that vehicle is acquired by the employer under an 'operating lease'; and (iii) that 'operating lease' was concluded by parties transacting at arm's length and that are not connected persons in relation to each other.

This fringe benefit calculation is limited to rentals under an operating lease as opposed to a finance lease (i.e. in substance ownership). In order for the vehicle rental arrangement to be viewed as an operating lease (see the definition of "operating lease" contained within the section 23A ring-fencing provisions relating to finance leases (so as to be excluded), the lease arrangement must contain the following elements:

- The employer must rent the vehicle from a lessor in the ordinary course of the lessor's business (other than banking, financial services business or insurance business);
- The vehicle may be leased by the general public for a period of less than a month;

- The costs of maintaining the vehicle must be borne by the lessor (including any repairs to the vehicle necessary due to normal wear and tear); and

- The risk of loss or destruction of the vehicle must not be assumed by the lessee.

> **Example**
> ***Facts:*** An employer calculates that it would be more cost-effective to provide rented vehicles to employees as company cars. After getting quotes, the employer enters into a contract with a vehicle rental company to lease a fleet of 200 vehicles for a period of three years inclusive of maintenance, licence fees, and insurance.
>
> ***Results:*** The contract will qualify as an operating lease if vehicles are also leased to the general public.

In order to place the proposed fringe benefit calculation on par with the existing calculation, the monthly value of the rental vehicle will be based on the actual costs incurred by the employer under the operating lease as well as the cost of fuel in respect of that vehicle. The value of the fringe benefit can be reduced upon assessment for proven business use (i.e. using business-use-over-total-use formula based on the distances travelled).

The cost of fuel in respect of the vehicle pertains to direct spend on fuel for the vehicle in cash or through a fuel card linked specifically to that vehicle. Where an employee has an unlinked fuel card (i.e. a fuel card not linked exclusively to a particular vehicle), the taxable benefit that results must be reflected separately as a travel allowance. Lastly, it must be noted that where the maintenance, license, and insurance in respect of the vehicle has been split from the main rental agreement, the provision of those services to the employee by the employer would result in different fringe benefit that has to be valued separately.

IV. Effective date

The proposed amendments are effective in respect of years of assessment commencing on or after 1 March 2013.

1.6. CO-ORDINATION OF DEDUCTION AND EXEMPTION RULES IN RESPECT OF EMPLOYER-OWNED EMPLOYEE-RELATED INSURANCE POLICIES

[Applicable provisions: Amend sections 10(1)(gH); 11(w); and 23B(5)]

I. Background

A. General

In terms of the Income Tax Act, one segment of "employer-owned insurance policies" encompasses insurance policies relating to the death, disability, or severe illness of an employee. These employer-owned insurance policies are entered into for:

- The direct protection of the employer against the risk of loss due to adverse events impacting employees; or

- The benefit of an employee, and/or his/her dependents or beneficiaries (hereafter only referred to as the "employee").

When designing the tax regime pertaining to employer-owned insurance policies, the following paradigm was sought:

- If premiums were funded with post-tax contributions, policy proceeds should be tax-free; and

- If the premiums were funded with pre-tax contributions, policy proceeds should be taxable.

Further, the revised tax regime was specifically designed to disregard inclusions and deductions occurring prior to 1 March 2012. The purpose of this effective date cut-off was to allow for all the relevant parties to go cleanly forward without being fettered by the past (and to avoid the potential churning of policies as the only practical means of eliminating the past).

B. Employer deduction of premiums

1. <u>Section 11(w) qualifying policies</u>

Section 11(w) specifically sets several requirements that must be met before an employer can deduct premiums incurred in respect of employer-owned insurance policies. Certain employer-owned insurance policies will therefore fall outside the ambit of section 11(w). Further, section 23B(5) disallows deductions under section 11(a) in respect of any premiums incurred under a policy of insurance contemplated in section 11(w).

2. <u>Examples of non-qualifying policies</u>

Examples of policies that fall outside the ambit of section 11(w) include:

- A policy of insurance solely against work-related accidents as defined in section 1 of the Compensation for Occupational Injuries and Diseases Act;

- Pre-existing employer-owned 'keyperson' policies containing investment features (i.e. having a cash value or surrender value breach); and

- Any endowment policy (other than a sinking fund policy that has no life insured, e.g. used for guaranteed plans) that an employer takes out for its own savings purposes (loss breached).

C. Policy pay-outs for the benefit of the employer

Policy pay-outs to employers will generally be included in income unless an employer chose not to claim a deduction for plans that could otherwise qualify for premium deductions. Employers exercise the choice of not claiming through silence (i.e. by not stating their intention to claim deductions within the relevant insurance policy contract).

II. Reasons for change

A. Deduction limitation for employer premiums

1. Interaction between sections 11(a) and 11(w)

The limitation on employers seeking a general deduction for payments in respect of employer-owned insurance policies is unclear. It was intended that the sole provision for deducting premiums in respect of these policies would be section 11(w), being the more specific provision relating to premium deductions [rather than the general deduction formula of section 11(a)]. However, the rules literally appear to state that section 11(a) deductions are disallowed only if the premiums were eligible for deduction under section 11(w). This deduction limitation is far narrower than intended.

2. Employment-related policies

Section 11(w) currently excludes a policy of insurance solely against an accident as defined in section 1 of the Compensation for Occupational Injuries and Diseases Act. The effect is that these premiums are potentially deductible in terms of section 11(a). However, it appears that the scope of the exclusion is too limited because the exclusion does not extend to all policies that relate to the death, disability, or injury of an employee arising out of and in the course of employment (e.g. general work-related accident plans, and travel insurance taken out by an employer in respect of employee work-related travel). The intention is that the premiums in respect of employment-related policies be deductible in terms of section 11(a).

Further, the ambit of paragraph 2(k) of the Seventh Schedule is arguably wide enough to encompass premiums paid by employers in respect of employment related policies. It is not the intention that these policies result in a fringe benefit for the employee.

B. Taxable linkage for policy pay-outs for the benefit of employers

While the initial paradigm was intended to create a clear linkage between premium deductions and policy pay-out inclusions, the literal language lacks this clear linkage. The exemption for policy pay-outs to employers appears to apply solely when the employer fails to state the intention of deducting premiums. Employer-owned insurance policies that simply fail to meet the required premium deduction criteria appear to fall outside the policy pay-out exemption. No reason exists for this disparity.

III. Proposal

A. Deduction in respect of employer premiums

1. <u>General rule</u>

The general deduction limitation for employer-owned insurance policies will be clarified. If an employer pays premiums in respect of insurance policies relating to the death, disability or severe illness of an employee the only avenue for claiming a deduction will be section 11(w) (but for employment-related policies). Employers will not be allowed to claim a general deduction for policies of this kind, even if these policies fall outside the technical ambit of section 11(w) (e.g. a policy intending to benefit the employer containing an investment element).

2. <u>Exception - employment-related policies</u>

It is proposed to extend the exclusion in section 11(w) to specifically exclude a policy of insurance related to the death, disablement or severe illness of an employee or director arising out of and in the course of employment. The corollary is that the premiums in respect of these policies will be eligible for a general deduction.

Travel insurance for business purposes ordinarily covers a number of different risks. Specific protection/cover offered is often in respect of personal accident, medical assistance, general assistance (e.g. repatriation of remains etc.), trip cancellation, luggage and personal effects, personal liability, and hijack, kidnap, and wrongful detention. Whereas the personal accident portion of the policy does indeed relate to the death, disability or severe illness of an employee, the fact that the cover is limited to an event that arises out of and in the course of employment will ensure that the policy will not fall within the ambit of section 11(w), but may instead qualify for a general deduction in respect of premiums.

It is intended that that no fringe benefit be generated in the case of employer-held employment-related insurance policies (e.g. work accident policies). As a result, a specific exclusion will be inserted so that no fringe benefit will occur if the insured event as per the policy can only occur out of and in the course of employment of the employee. However, pay-outs from these policies will be taxable for the employee upon pay-out.

B. Taxable linkage for policy pay-outs to employers

1. <u>General rule</u>

Under the general rule pertaining to employer-owned insurance policies where premiums were funded with post-tax contributions, policy proceeds should be tax-free; on the other hand, where the policy premiums are funded with pre-tax contributions, the policy proceeds should be taxable. The relationship between taxable pay-outs and deductible premiums will be realigned with the general rule. In future, the proceeds in respect of an insurance policy held by the employer relating to the death, disability or severe illness of an employee will be exempt if no deduction was previously available in respect of premiums paid or incurred.

2. <u>Transitional rule</u>

The new regime for employer-owned key-person policies came into effect from 01 March 2012. The key-person insurance regime change was part of the larger regime change around employer-owned insurance policies. One of the aims of the regime change was to close the deduction for premiums paid or incurred by employers in respect of employee-benefitting deferred compensation plans (containing an investment element). Therefore, a significant number of these and other plans may have been eligible for deductible premiums prior to 01 March 2012, but will fail to satisfy the deduction requirements of section 11(w) going forward.

In order to accommodate these circumstances, and to prevent the need for policy churning (so as to create a pragmatic 1 March 2012 cut-off), it is proposed that the general rule be effective only in respect of premiums paid on or after 1 March 2012. In other words, deductible premiums will only prevent policy pay-outs from being tax-free if those deductible premiums arise on or after 1 March 2012. Deductible premiums before this date can be disregarded.

IV. Effective date

The proposed amendments are to be effective in respect of premiums paid or incurred on or after 1 March 2012.

1.7. CESSION OF EMPLOYER-OWNED INSURANCE POLICIES (WITH INVESTMENT VALUES) TO RETIREMENT FUNDS

[Applicable provision: Paragraph (d)(iii)(cc) of the definition of “gross income” in section 1]

I. Background

A. Employer contributions to retirement funds

Employers can claim a deduction for contributions to an employer-affiliated retirement fund if made for the benefit of an employee (but this deduction is limited to a specified percentage cap). However, no corresponding inclusion of the value of these contributions exists in the “taxable income” of the employee.

The tax treatment of an employer contribution to an employee’s retirement annuity fund (being a self-standing fund) differs from the outcome described above. In the first instance, the amount that an employer can deduct for tax purposes is unlimited. Secondly, the employer contribution also results in a taxable fringe benefit for the employee equal to the value of the contribution. However, the value of the taxable benefit is deemed to be a contribution made by the individual to the retirement annuity fund (thereby being deductible within the R1 750 or 7.5 per cent limits).

B. Deferred compensation policies

In 2010 and 2011, a policy decision was taken to discourage new deferred compensation policies because these policies offered unfair tax advantages to select key employees. However, a legislative exit-strategy was created for an employer to transfer the value of a policy to an employee once the policy was paid-up (i.e. when the employer ceases contributing to the policy). The aim was to assist employers seeking an exit strategy by allowing for employers to exit on a tax neutral basis.

To achieve this exit, the employer could either: (i) elect to receive the proceeds from the policy and thereupon pay those proceeds over to the employee, or (ii) cede the policy to the employee or to a retirement fund for the benefit of the employee.

- *Paid-up proceeds:* If the employer receives and transfers the insurance proceeds, the employer will be in a tax neutral position with an inclusion and a deduction in respect of these proceeds. Although the payout from the policy to the employer would constitute a disposal, the proceeds will be exempt from capital gains tax because the employer would be the first beneficial owner of the policy. At the employee level, the employee will be taxed on the proceeds received from the employer with these amounts included within pay-as-you-earn withholding.

- *Policy cessions:* If the employer cedes the policy (either to the employee or to a retirement fund for the benefit of the employee), the cession would constitute a disposal, but the cession is exempt from capital gains taxation because the employer would be the first beneficial owner of the policy. At the employee level, the value of the policy will be included in the income of the employee as a taxable fringe benefit, including pay-as-you-earn withholding.

II. Reasons for change

It has come to light that certain individuals have been using deferred compensation schemes as a form of retirement. Instead of contributing to a retirement fund, employers have been contributing funds to a deferred compensation insurance scheme. Under the current legislation, these individuals will be discouraged from policy cessions as an exit strategy because these cessions now trigger ordinary revenue for employees without offset (if contributed to a pension or provident fund as opposed to a retirement annuity fund). Instead, the preferred exit strategy will be the transmission of paid-up proceeds. This latter exit strategy will often result in the cashing out of policies without any re-contribution to a retirement-type vehicle.

III. Proposal

A. Cession to pension or provident funds

It is proposed to amend the legislation to allow for a cession of employer-owned insurance policies (despite any investment element) to a pension or provident fund without triggering tax for employees. This ability to cede policies tax-free will assist employees who seek to preserve the value of their policies until their retirement. From a policy point of view, no issues arise because this transfer will shift the policy from a less restrictive environment to a more restrictive environment. This freedom from employees' tax makes the tax treatment comparable to that of cash contributions to pension and provident funds (which also arise free from employees' tax).

B. Cession to a retirement annuity fund

It should be noted that an initial cash contribution made by an employer to a retirement annuity fund leads to a taxable fringe benefit and therefore operates differently than employer contributions to pension and provident funds. Therefore, in instances where an employer cedes the policy to a retirement annuity fund that is individually associated with an employee, standard principles should apply (i.e. the explicit inclusion in the employee's income will be removed). Employee fringe benefit treatment would apply as in pre-existing law. It follows that the employer contribution will be deemed to be made by the individual to the retirement annuity fund (again, as under pre-existing law). The net result is a corresponding deduction (thereby being deductible within the R1 750, R3 500 or 15 per cent limits).

C. General policy

As a general policy matter, it should be noted that above changes should not be viewed as a policy shift - deferred compensation schemes will continue to be discouraged going forward. Employer contributions to an employer-owned insurance policy for the benefit of an employee will remain a taxable benefit for the employee (under general principles). The above proposal merely facilitates an easier exit.

IV. Effective date

The proposed amendment is effective as from 1 March 2012.

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2. INCOME TAX: BUSINESS (GENERAL)

2.1. REVISED "SHARE" DEFINITION

[Applicable provisions: Section 1]

I. Background

The 2011 legislation introduced a new definition of the term “share”. The insertion of the definition of “share” was intended to clarify that the term “share” includes “similar” equity interests in a company (mainly to take into account ownership interests in certain foreign entities and non-standard companies).

II. Reasons for change

The revised “share” definition is unclear. It is also circular in its reference to “share” and “equity interest”.

III. Proposal

The definition of share will be revised to eliminate the circularity just described. In the main, the definition will be more closely aligned with the most recent company law definition (see section 1 of the Companies Act, 2008). Hence, a share will now be defined to mean any share or similar proprietary interest in which a (domestic or foreign) company is divided

IV. Effective date

Definition applies with effect from 1 January 2013.

2.2. REVISED VERSION OF THE HYBRID EQUITY AND THIRD-PARTY BACKED SHARE PROPOSALS

[Key provisions: section 8E and section 8EA]

I. Background

A. *Debt versus shares*

Debt and share instruments have a number of differences in their features and their consequences.

- In commercial terms, debt represents a claim on a specified stream of cash flows. In its purest form, this claim comes in the form of interest that is payable despite the financial performance of the debtor. Shares, on the other hand, represent a contingent claim by shareholders on dividends that are directly or indirectly based on company profits.

- In tax terms, debt payments are typically deductible by the payer with the same payments being includible as income by the payee. With the advent of the Dividends Tax, dividend payments in respect of shares are not deductible by the payer but are potentially subject to a 15 per cent charge falling on the payee (subject to exemptions). Depending on the circumstances, a tax incentive may exist for a taxpayer to attach a label to a debt or a share instrument that differs from the underlying substance.

B. *Legislative background*

1. Pre-2011 legislation

Prior to 2011 (and setting aside the potential impact of tax and commercial jurisprudence), two sets of legislative tax rules existed that sought to address differences in respect of debt or share instruments when the label of those instruments differs from their substance. Stated dividends in respect of shares were deemed to generate interest income if instruments labeled as shares contained certain debt features. Conversely, stated interest in respect of debt instruments was not deductible if instruments labeled as debt contained certain share features. The legislative rules contained one major limitation however. Many of the features tainting the instrument at issue have an impact only if these features apply three years from the date of issue. Therefore, many taxpayers simply delay the triggering event for tainted features beyond the three-year period.

2. Legislation in 2011

The 2011 legislation sought to strengthen the anti-avoidance rules if share instruments (typically preferred shares) were loaded with debt-like features. These anti-avoidance rules came in two forms. Firstly, the legislation targeted share issues where the dividends in respect of those shares were guaranteed by unrelated third parties. These third party guarantees effectively meant that the holder of the share had no direct or indirect meaningful stake in the risks associated with the issuer. Secondly, the legislation targeted share issues where the dividends in respect of those shares were fully secured by financial instruments (i.e. the secured financial instrument served as the basis for the dividend yield as opposed to a mix of assets associated with the issuing company as a whole).

II. Reasons for change

A. *Hybrid Equity Instruments*

Under the 2011 proposal, treatment of certain shares as tainted hybrid equity instruments due to the use of secured debt-based instruments remains appropriate theoretically. As discussed above, these preference shares merely operate as a conduit for underlying debt instruments with the holder looking solely to the debt as collateral. Nonetheless, concerns have been raised that the initial amendment is overly broad. Firstly, the amendment does not provide any caveat for preference shares issued as a financing tool to acquire substantial interests in a target operating company (in the context of black economic empowerment and otherwise). This limitation effectively overrides the relief contained in the anti-avoidance rules for third-party backed shares. The rule prohibiting “indirect” securities (and even the definition of a prohibited financial instrument) is too wide, thereby creating uncertainty for many standard commercial practices that pose little risk to the fiscus.

B. *Third-party-backed shares*

Under the 2011 proposal, treatment of certain shares as tainted shares due to guarantees by third parties is theoretically sound. The initial amendment also recognises the need for an exception in the case of preference shares issued as a financing tool to acquire substantial share interests in a target operating company (in the context of black economic empowerment and otherwise). That said, the nature of the relief appears too narrow, failing to account for a variety of transactions. The rules specifically catering for multi-tier preference share schemes also failed to reach the technical relief initially desired. Lastly, adjustments were required to cover certain emerging avoidance gaps.

III. Proposal

A. Overview

The current three year rule in respect of redeemable shares will be retained. In addition, two new set of rules will apply. These two new set of rules essentially aim at the same concern – holders of debt-like shares that rely on third-party balance sheets wholly unrelated to the issuer. The first aims at share issues where the dividends in respect of those shares are fully secured by financial instruments (i.e. the secured financial instrument served as the basis for the dividend yield as opposed to a mix of assets associated with the issuing company as a whole). The second aims at holders of debt-like shares that rely on third-party balance sheets wholly unrelated to the issuer.

In the case of security arrangements, the holder of the debt-like share (typically labeled as a preference share) is looking to one or more debt-bearing financial instruments of a third-party to indirectly support the preference dividend yield of the issuer. In the case of third-party backed shares, the holder of a debt-like share (again typically labeled as a preference share) is looking to the credit of a third-party guarantee (or obligation) to indirectly support the preference dividend yield of the issuer.

Holders of instruments receiving dividend yields in respect of either set of tainted shares must treat the dividend yield as income (with the yield falling outside of the Dividends Tax regime). Both provisions also contain an exception for preference share schemes where the funding received for the preference share issue is ultimately applied to directly or indirectly acquire a pure equity stake in an active operating company (i.e. a qualifying purpose as defined). These exceptions mean that preference share funding can continue as a means for acquiring the shares of active operating companies (including black economic empowerment transactions).

B. Hybrid shares secured by interest-bearing instruments

1. Basic anti-avoidance rule

The anti-avoidance rule for hybrid shares secured by interest-bearing instruments has a two-pronged trigger. Under the first prong, the dividend yield must be derived from a preference share. For this purpose, a preference share is either a non-equity share (a share other than an equity share as defined in section 1) or a share with a yield that is calculated directly or indirectly with reference to a specified rate of interest or the time value of money. Under the second prong, the share must be secured by a financial instrument (i.e. an interest-bearing instrument or one determined with reference to specified rate of interest or time-value of money principles). Alternatively, the second prong will be satisfied by a negative pledge that achieves the same effect as a direct security (i.e. an arrangement preventing disposal of the financial instrument).

If either of the prongs of the anti-avoidance rule described above is satisfied, the dividend yield is deemed to qualify as income. The anti-avoidance rule equally applies to domestic and foreign dividends. The purpose of this rule is to prevent intervening hybrid share conduits that act as a means of converting interest income into a dividend yield at the holder level. Concerns also exist that the holder of the preference share is really looking to the credit of a third-party issuer of the underlying debt and not the issuer itself (i.e. not having any meaningful interest in the issuer of the share).

Example 1
Facts: Holder Company subscribes for preference shares from Issuer Company. The preference shares are redeemable in five years by Holder Company, and the dividend yield on the shares is based on JIBAR. The only assets held by Issuer Company are bonds. The Bank has a security interest in the bonds.

Result: The redeemable preference shares are subject to the anti-avoidance rule. The dividends payable are based on a JIBAR rate, and the shares are secured by interest bearing arrangements. Therefore any dividends generated by the preference shares are treated as income by Holder Company.

2. Exceptions

As stated above, hybrid shares secured by debt-like financial instruments may avoid the anti-avoidance rule if the consideration is used for a qualifying purpose (e.g. if the consideration is applied directly or indirectly for the purpose of acquiring operating company shares). This exception recognises the need for preference share financing in respect of share acquisitions because South African tax law does not generally allow for deductible interest when debt is employed to finance a share acquisition.

At its core, the qualifying purpose exceptions to the anti-avoidance rule require that the consideration for the share issue somehow relate to the acquisition of equity shares (e.g. ordinary shares) in an active operating company.

- Under the first exception, the consideration for the hybrid shares issued may be directly or indirectly applied to acquire equity shares in an operating company. (Note: No relief from the anti-avoidance rule exists if the holder of the preference share acquires shares in an operating company that is part of the same group of companies as the holder. This limitation is meant to avoid cash injections to a related member of the group posing as an artificial acquisition.)

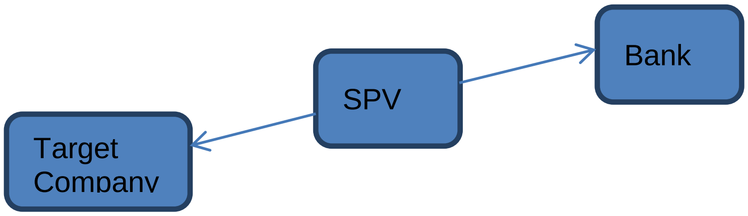
- Under the second exception, the consideration may be used for retiring bridging loans initially used for the same purpose.

- Under the third exception, the consideration may be used for refinancing hybrid shares if the initial hybrid shares were used directly or indirectly to finance the acquisition of equity shares in an operating company. In the case of this refinancing arrangement, the consideration for the newly issued hybrid shares cannot exceed the balance outstanding in respect of the original shares (as well as the accrued interest thereon).

- Under the fourth exception, the consideration may be used for the payment of dividends in respect of a redeemed preference share issued for the any other qualifying purpose.

The above exceptions also allow for the funding of transaction costs attendant with those qualifying purposes.

Example 1



Facts: A special purpose vehicle (SPV) issues preference shares to Bank in exchange for R50 million. The term of the preference share issue is five (5) years. The return on the preference shares is calculated with reference to JIBAR plus 2 per cent. SPV applies the consideration from the preference shares issue to acquire ordinary shares in Target Company. Target Company is actively engaged in the manufacturing sector. Target Company's ordinary shares serve as security for the bank in respect of the preference share yield. The dividends in respect of Target Company's ordinary shares are paid into SPV's interest-deposit account. As part of the Bank's conditions for the arrangement, the SPV's interest-deposit account funds are also secured in favour of Bank.

Result: The use of ordinary shares as security does not taint the SPV preference share issue because the ordinary shares do not qualify as a debt-bearing financial instrument or a financial instrument with a time-value of money yield. On the other hand, the use of the interest-deposit account as security may be problematic because the bank account generates a debt-like yield. Nonetheless, this use of a bank account as security does not taint the preference share issue because the consideration for the preference shares was used to acquire equity shares in an active operating company.

Example 2

Facts: Assume the same facts as Example 1, except that five years have passed. At this point, the preference shares have a face value of R30 million outstanding. Given the large balance outstanding, the parties agree to refinance the initial five-year arrangement. New preference shares are issued to Bank for R30 million with SPV paying the R50 million to redeem the initial preference share issue. Bank again requires the preference share issue to be secured by the ordinary shares of Target Company plus the bank account that collects the ordinary share dividend proceeds (plus the interest thereon).

Result: The new preference shares issue is exempt for the same reasons as the initial share issue. The use of ordinary shares as security does not taint the SPV preference share issue because the ordinary shares do not qualify as a debt-bearing financial instrument or a financial instrument with a time-value of money yield. This use of a bank account as security does not taint the preference share issue because of the purpose test (the consideration for the preference shares was used to retire preference shares with the initial preference share issue dedicated to acquiring equity shares in an active operating company).

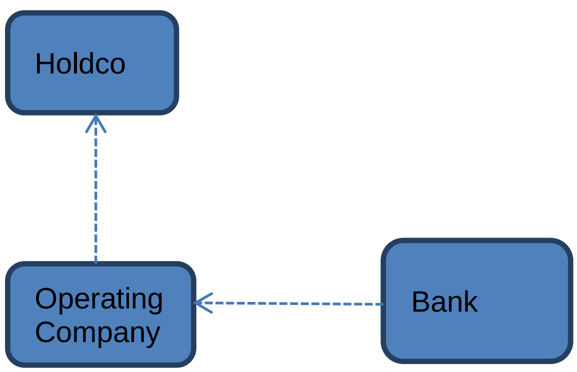
C. Shares backed by third-party guarantees

1. Basic anti-avoidance rule

The anti-avoidance rule for shares backed by third-party guarantees/obligations has a two-pronged trigger. Under the first prong, the share must be subject to an enforcement right or an enforcement obligation in respect of a third-party. Under the second prong, this enforcement right or obligation must be triggered upon the failure to pay a dividend or upon the failure to pay a return of capital distribution. The enforcement right or obligation at issue must essentially require another party (i.e. a person other than the issuer of the share) to directly or indirectly guarantee dividends or return of capital distributions to be paid to the holder in respect of the share at issue.

If both prongs of the anti-avoidance rule described above are satisfied, the dividend yield is deemed to qualify as income. This rule equally applies to domestic and foreign dividends. The purpose of this anti-avoidance rule is to ensure that the credit-worthiness of the issuer has a bearing on the holder versus complete reliance on the creditworthiness of a wholly unrelated entity.

Example 1



Facts: Holding Company owns all the shares of Operating Company (as well as other various subsidiaries). Bank and Operating Company enter into a financing arrangement through the use of preference shares issued by Operating Company with a JIBAR yield. The consideration received for the preference shares is used by the Operating Company to reinvest in business operations and to distribute dividends. In order to enhance Bank's stake in the preference shares from a risk point of view, Holding Company guarantees to purchase the preference shares from Bank if the preference share yield falls below JIBAR.

Result: The arrangement triggers the anti-avoidance rule. The preference shares are backed by a third-party guarantee, and the guarantee relates to the preference share yield. The dividends in respect of the preference shares accordingly generate ordinary revenue.

2. Exceptions

Shares guaranteed by third-parties may avoid the anti-avoidance rule if the consideration for the issue of the shares is applied directly or indirectly for the purpose of acquiring equity shares of an operating company. This exception recognises the need for (preference) share financing in the case of share acquisitions because South African tax law does not generally allow for deductible interest if the debt is employed to finance a share acquisition.

At its core, the qualifying purpose exceptions to the anti-avoidance rule require that the consideration for the share issue somehow relate to the acquisition of equity shares (e.g. ordinary shares) in an active operating company.

- Under the first exception, the consideration for the hybrid shares issued may be directly or indirectly applied to acquire equity shares in an operating company. (Note: No relief from the anti-avoidance rule exists if the holder of the preference share acquires shares in an operating company that is part of the same group of companies as the holder. This limitation is meant to avoid cash injections to a related member of the group posing as an artificial acquisition.)

- Under the second exception, the consideration may be used for retiring bridging loans initially used for the same purpose.

- Under the third exception, the consideration may be used for refinancing hybrid shares if the initial hybrid shares were used directly or indirectly to finance the acquisition of equity shares in an operating company. In the case of this refinancing arrangement, the consideration for the newly issued hybrid shares cannot exceed the balance outstanding in respect of the original shares (as well as the accrued interest thereon).

- Under the fourth exception, the consideration may be used for the payment of dividends in respect of a redeemed preference share issued for the any other qualifying purpose.

The above exceptions also allow for the funding of transaction costs attendant with those qualifying purposes.

If the exceptions apply, the exceptions allow for a variety of third party guarantees/obligations. These guarantees/obligations can come from:

- the acquired operating company (that is the object of the financing);

- the initial issuer of the preference share issued where the consideration is applied for the purpose of the direct or indirect acquisition of the operating company;

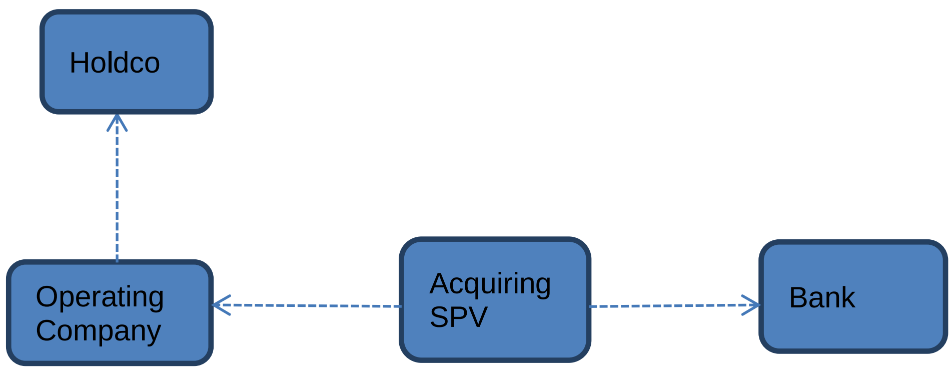
- an intermediary of the initial share issuer where the consideration is applied for the purpose of the direct or indirect acquisition of the operating company;

- any person that directly or indirectly holds at least 20 per cent of the equity shares of the acquired operating company, the initial issuer of the preference share or an intermediary issuer as contemplated above; or

- a company that forms part of the same group of companies as the acquired operating company, the initial issuer of the preference share or an intermediary issuer as contemplated above.

The guarantees above are allowed because the parties have a direct or indirect stake in the target company that is the object consideration used for the acquisition. In addition, guarantees/obligations from natural persons and non-profit companies (e.g. community trusts) are wholly allowed irrespective of their shareholding in the acquired operating company. These parties typically will not provide guarantees unless they have an indirect stake in the target company.

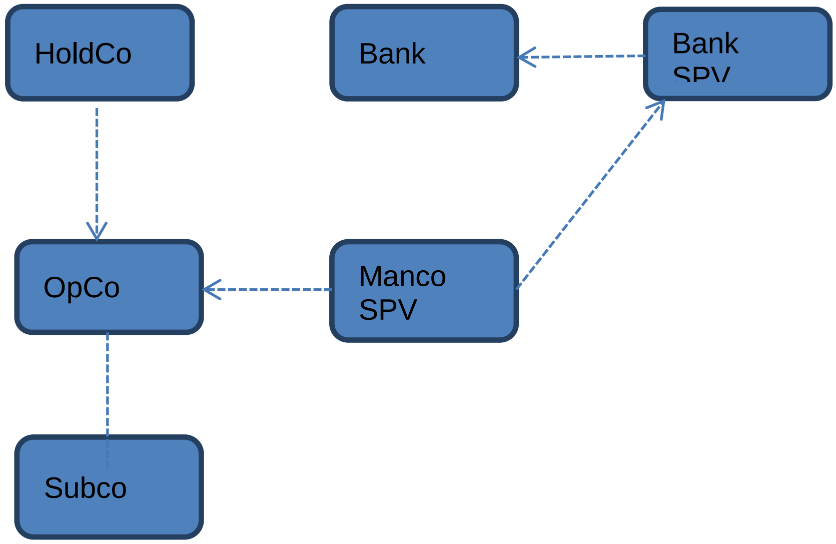
Example 1:



Facts: Holdco owns all the shares of Operating Company. Holdco wants to shift some of its ownership in Operating Company to existing operating company managers. The managers accordingly form Acquiring SPV for financing purposes. Bank agrees to provide Acquiring SPV with R20 million in cash to Acquiring SPV in exchange for preference shares issued by Acquiring SPV. The preference shares are redeemable after five years by Bank and generate a yield equal to JIBAR plus one per cent. Acquiring SPV then uses the funds to acquire 20 per cent of the ordinary shares of Operating Company. Bank requires a guarantee from Holdco and Operating Company that Bank can sell the Acquiring SPV preference shares to Holdco or Operating Company if insufficient funds exist to pay the required dividends.

Results*:* As an initial matter, the guarantees by Holdco and Operating Company could give rise to ordinary revenue in respect of the preference share yield. However, because the funds are used to acquire equity shares in an operating company, the exceptions apply (thereby allowing the parties to disregard both sets of guarantees).

Example 2:



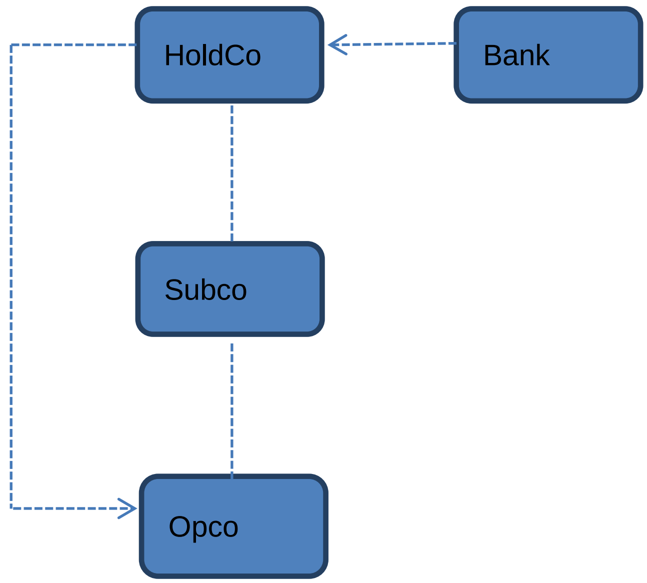
Facts: HoldCo owns all the shares of OpCo (an operating mining company), and Opco owns all the shares of Subco. A management committee SPV (formed as Manco SPV) comprises of senior management in OpCo. Manco SPV seeks to acquire 20 per cent of the ordinary shares in OpCo. In order to raise the necessary funds, Manco SPV enters into a back-to-back arrangement with Bank so as to obtain funding from outside investors.

- To facilitate this arrangement, Bank forms a wholly-owned SPV. Bank SPV issues preference shares and receives R15 million in exchange as consideration. The Bank SPV preference shares generate dividends of prime plus three per cent. Bank must repurchase the preference shares at the conclusion of Year 5. Manco SPV and Bank guarantee the preference share dividend yield if the preference shares fail to provide the prime plus three per cent dividend yield promised (with the investors first looking to the Manco guarantee).

- Bank SPV then transfers these funds to Manco SPV in exchange for Manco SPV shares. The preference shares generate dividends of prime plus three per cent. Manco SPV must repurchase the preference shares at the conclusion of Year 5. Holdco, Opco and Subco guarantee the preference share dividend yield if the preference shares fail to provide the prime plus five per cent dividend yield.

Results: At the outside, the preference shares issued by Bank SPV may be adversely impacted by the anti-avoidance rule because of the multiplicity of third party guarantees (by Bank, Manco SPV, Holdco, Opco and Subco). However, because the consideration was ultimately used for the share acquisition of a certain percentage of Opco's ordinary shares, the exceptions apply. This relief allows the parties to disregard Manco SPV's guarantee (the other issuer) and the Opco guarantee (the operating company). Holdco (holder of Opco) and Bank (holder of issuer) are qualifying holders so these entities can also be disregarded. Lastly, Subco can be disregarded because Subco is a controlled company for Opco.

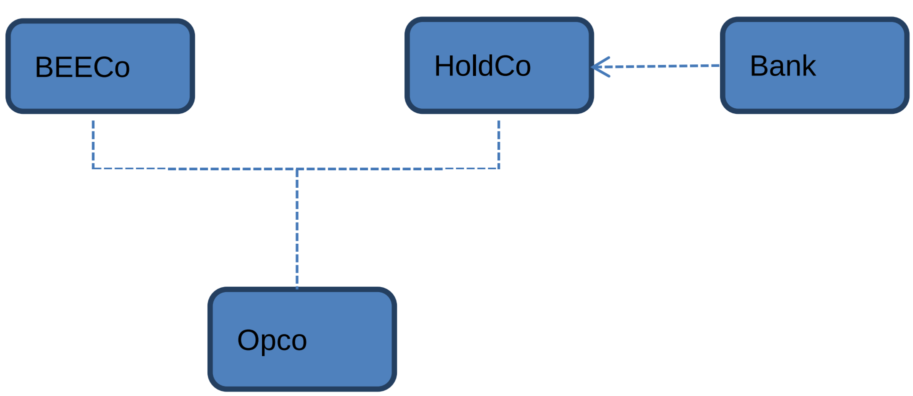
Example 3:



Facts: Holding Company owns all the shares of Subsidiary Company, which in turn holds all the shares of Operating Company. Bank and Holding Company enter into a financing arrangement through the use of preference shares issued by Holding Company with a JIBAR yield. The consideration received for the preference shares is used by the Holding Company to acquire shares in Operating Company. In order to enhance Bank's stake in the preference shares from a risk point of view, Subsidiary Company and Operating Company guarantee to purchase the preference shares from Bank if the preference share yield falls below JIBAR.

Results: The preference share yield will be deemed to generate ordinary revenue. The funding is not used for a qualifying purpose because Holding Companies is acquiring shares that are part of the same group of companies.

Example 4:



Facts: Holding Company owns 74 per cent of the shares of Operating Company, while BEECo owns 26 per cent of the shares of Operating Company. Bank and Holding Company enter into a financing arrangement through the use of preference shares issued by Holding Company with a JIBAR yield. The consideration received for the preference shares is used by the Holding Company to acquire shares in Operating Company that are held by BEECo. In order to protect Bank's stake in the preference shares from a risk point of view, Operating Company guarantees to purchase the preference shares from Bank if the preference share yield falls below JIBAR.

Results: The guarantees by Subsidiary Company and Operating Company would be allowed in respect of the preference share yield because the funds are used to acquire equity shares in an Operating company from a party outside the group. The preference share yield will be respected as dividends (and not treated as ordinary revenue).

IV. Effective date

The proposed amendments apply to dividends (or foreign dividends) received or accrued on or after 1 January 2013 in respect of years of assessment commencing on or after 1 January 2013. However, dividends (and foreign dividends) received on or after 1 January 2013 will only be subject to the new rules if the dividends (and foreign dividends) at issue accrue on or after 1 April 2012 and are received three months after the date of accrual. The latter set of rules prevents taxpayers from accelerating accruals to avoid the new anti-avoidance regime.

2.3. "DEBT" TERMINOLOGY CONSISTENCY

[Applicable provisions: Throughout the Income Tax Act]

I. Background

Debt encompasses a sum owed by one party (the debtor) to another party (the creditor). Typically, a debt is created when the creditor lends a sum of money to a debtor. The debt is granted with expected repayments that may (or may not) include interest for the use of the sums loaned. Debt can come in many forms, including a personal loan, an advance (e.g. on salary), a note, a bond, a debenture, a bank deposit or any other claim of money requiring repayment. Debt may be held privately or publicly traded.

II. Reasons for change

Various provisions within the Income Tax Act deal with the concept of debt and seek to encompass the various ways in which a debtor/creditor relationship may be created. The result is a variety of cumbersome formulations that can be viewed as creating unnecessary inconsistencies and uncertainty. The use of the term "debt" (like that of shares) is critical, often being the defining feature of how a transaction is be to treated under the Income Tax Act.

III. Proposal

It is proposed that all the various concepts utilising the term debt (e.g. debt instruments, loans and advances) be unified within a single term. Under the revised formulation, the term "debt" will be used throughout the Income Tax Act. All other related terms will be dropped. The term "debt" will bear its ordinary meaning.

IV. Effective date

The amendment will be effective on or after 1 January 2013.

2.4. CLOSURE OF DIVIDEND CONVERSION SCHEMES

[Applicable provisions: Section 64EB of the Income Tax Act]

I. Background

The Dividends Tax came into effect on 1 April 2012 at a rate of 15 per cent and is designed to replace the former Secondary Tax on Companies. The Secondary Tax on Companies applied at the company level, leaving the combined company rate above 30 per cent (a rate above the international norm). The Dividends Tax accordingly applies to dividends at the shareholder level so as to avoid this concern. This shift to the shareholder level conforms to modern international trends.

One consequence of the change is the differing rates applicable depending on the shareholder involved. As a result, dividends paid to pension funds are now exempt, and dividends paid to domestic companies are also generally exempt on the basis that the dividends will be taxed once the profits are eventually paid via further dividends to other types of shareholders (e.g. natural persons). Lastly, dividends paid to certain foreign shareholders may now be eligible for tax treaty relief for the first time.

II. Reason for change

A tax scheme has emerged for the benefit of foreign shareholders that arguably reduces the Dividends Tax rate to zero (without any reliance on a tax treaty). These schemes essentially seek to convert the taxable payment of dividends into exempt compensation, gains or income upon disposal. This conversion is arguably accomplished in a number of ways on the alleged basis that the scheme allows for the conversion of Rand denominated dividends into amounts denominated in a foreign currency (even though this currency conversion could occur through other means). These conversion schemes come in a variety of forms, the most notable of which are described below.

Example 1

Facts: Listed Company declares dividends to its shareholders. After declaration but before payment, Foreign Shareholder expects to receive R100 000 of dividends from Listed Company. Foreign Shareholder sells the right to these dividends to Independent South African Company in exchange for a foreign currency equivalent (less a fee). The stated purpose of the transaction is to convert the Rand dividend amount to foreign currency, but the real purpose of the transaction is to eliminate Dividends Tax.

Alleged result: If form fully governs, the sale of dividend rights by Foreign Shareholder is viewed as foreign source income (outside South African taxing jurisdiction). The acquisition of dividends by way of cession is included in the income of Independent South African Company, but the repayment of the equivalent amount (as a manufactured dividend) allegedly qualifies for an offsetting deduction.

Example 2

Facts: Listed Company declares dividends to its shareholders. After declaration but before payment, Foreign shareholder expects to receive R800 000 in dividends from Listed Company. Foreign Shareholder lends the shares (including the implicit dividend expectation) to Independent South African Company. During the lending period, Independent South African Company receives R800 000 of dividends on the borrowed shares but must repay the corresponding foreign currency equivalent to Foreign Shareholder (less a fee). This repayment is in the form of manufactured dividends. The stated purpose of the transaction is to convert the Rand dividend amount to foreign currency, but the real purpose of the transaction is to eliminate Dividends Tax.

Alleged result: If form fully governs, the share loan by Foreign Shareholder is either viewed as a non-taxable loan or as a foreign source disposition (outside South African taxing jurisdiction). The receipt of dividends by South African Company is included in the income of South African Company, but the repayment of the amount (as a manufactured dividend) allegedly qualifies for an offsetting deduction.

Example 3

Facts: Listed Company declares dividends to its shareholders. After declaration but before payment, Foreign shareholder expects to receive R800 000 in dividends from Listed Company. Foreign Shareholder sells the shares *cum dividend* to Independent South African company for $1 million. Foreign Shareholder then repurchases the same shares for $970 000 (after the dividend is paid to Independent South African Company and after subtracting the fee). The stated purpose of the transaction is to convert the Rand dividend amount to foreign currency, but the real purpose of the transaction is to eliminate Dividends Tax.

Alleged result: If form fully governs, the sale of the shares by Foreign Shareholder is viewed as foreign source income (outside South African taxing jurisdiction). The receipt of dividends by South African Company after the sale is allegedly viewed as an exempt company-to-company dividend.

III. Proposal

While the above transactions could arguably be attacked under the General Anti-avoidance Rule (and under common law substance-over-form principles), the ongoing risk to the fiscus stemming from these schemes is too high to ignore. The above schemes are accordingly being closed via explicit statutory mandate. The nature of this closure will depend upon the scheme involved.

- Firstly, if a person (e.g. a person exempt from dividends tax such as a company or a pension fund) acquires a dividend by way of cession from another party after the distributing company declares or publicly announces the dividend, the payee of the dividend will be recharacterised. More specifically, the dividend is deemed paid to the party ceding the dividend (as if the cession did not occur). The net result is to treat the cessionary (e.g. the foreign transferor in the schemes of concern) as the ongoing beneficiary of the dividend.

- Secondly, if a domestic company acquires the share by way of loan and pays a manufactured dividend in respect of dividends arising from that share loan, so much of the manufactured dividend (as does not exceed the amount of the dividends received by the domestic company) stemming from the loan will be treated as a dividend paid for the benefit of the share lender. In essence, the net effect is treat the share lender as if the share lender (e.g. the foreign person in the schemes of concern) still receives the dividend with the dividend now coming from the share borrower. It should be noted that the Dividends Tax rules must still be applied to the actual dividend.

- Lastly, if a domestic company acquires a share after a dividend declaration or a public announcement and resells that share to the seller of the share (or any other company forming part of the same group of companies as the seller of that share), that dividend will be treated as having been paid for the benefit of the seller of that share. The net result is to treat the initial seller (e.g. the foreign transferor in the schemes of concern) as the ongoing beneficiary of the dividend.

Example 1

Facts: Listed Company declares dividends to its shareholders. After declaration or announcement of the dividend but before payment, Foreign Shareholder expects to receive R100 000 of dividends from Listed Company. Foreign Shareholder sells the right to these dividends by way of cession to Independent South African Company in exchange for a foreign currency equivalent.

Proposed result: The R100 000 dividends paid by Listed Company are deemed paid directly to Foreign Shareholder. The cession of dividends is ignored. The dividends will accordingly be subject to the Dividends Tax (with possible relief should the scope of a tax treaty cover the payment).

Example 2
Facts: Listed Company declares dividends to its shareholders. After declaration but before payment, Foreign Shareholder expects to receive R100 000 in dividends from Listed Company. Foreign Shareholder lends the shares (including the implicit dividend expectation) to Independent South African Company. During the lending period, Independent South African Company receives R100 000 of dividends on the borrowed shares but must repay the corresponding foreign currency equivalent to Foreign Shareholder (less a fee).

Proposed result: The receipt of dividends by South African Company is included in the income of South African Company, but the repayment of the amount (as a manufactured dividend) allegedly qualifies for an offsetting deduction. However, the manufactured dividend is also deemed to be a dividend, thereby triggering the Dividends Tax. The R100 000 amount (less the fee retained) will accordingly be subject to the Dividends Tax (with possible relief should the scope of a tax treaty cover the payment). It should be noted that the actual dividend stemming from the shares outstanding on loan may also trigger a Dividends Tax, depending upon the beneficiary of the dividend.

Example 3
Facts: Listed Company declares dividends to its shareholders. After declaration but before payment, Foreign shareholder expects to receive R100 000 in dividends from Listed Company. Foreign Shareholder sells the shares *cum dividend* to Independent South African company for $500 000. Foreign Shareholder then repurchases the same shares for $450 000 (after the dividend is paid to Independent South African Company and after subtracting the fee).

Proposed result: The R100 000 dividends paid by Listed Company are deemed paid directly to Foreign Shareholder. The initial sale is ignored for purposes of determining the Dividends Tax. The dividends will accordingly be subject to the Dividends Tax (with possible relief should the scope of a tax treaty cover the payment).

IV. Effective date

The proposed amendment will be effective on 1 September 2012 in respect of transactions entered into on or after that date and to amounts paid on or after 1 October 2012 in respect of transactions entered into before 1 September 2012.

2.5. QUALIFYING INTERESTS IN ASSET-FOR-SHARE REORGANISATIONS

[Applicable provisions: Sections 42 and 44]

I. Background

As a mechanism to encourage corporate restructuring, section 42 of the Income Tax Act provides roll-over relief when built-in gain assets are transferred for shares issued by a company. In order to enjoy this form of roll-over relief, the transferor of the asset must hold a qualifying interest in the transferee company immediately after the transfer. In the case of unlisted companies, a qualifying interest generally requires a minimum holding of at least 20 per cent of the equity shares and voting rights in the transferee company immediately after the transfer (or a similar group of company relationship).

II. Reasons for change

The 2011 Taxation Laws Amendment Act amended the threshold in respect of the participation exemption (which provides tax exemptions in respect dividends and capital gains derived from foreign company shares if minimum threshold percentage is held in those companies). More specifically, the minimum threshold was reduced from 20 per cent down to 10 per cent in order to align the threshold with international norms and other ownership thresholds in the Act.

III. Proposal

The 20 per cent threshold for asset-for-share transactions is now out of line with the participation exemption for cross-border dividends and share disposals. The 20 per cent threshold for asset-for-share transactions (e.g. company formations) is also relatively high by international standards. This higher standard is especially problematic given the fact that asset-for-share transactions are now being fully extended to cross-border rollovers (inbound transfers and transfers to controlled foreign companies – see note on REVISED ROLLOVER REGIME FOR CROSS-BORDER REORGANISATIONS). Given these changes, it is now proposed that the minimum qualifying interest in respect of an unlisted asset-for-share rollover be reduced from 20 per cent down to 10 per cent.

IV. Effective date

The proposed amendment will be effective in respect of transactions entered into on or after 1 January 2013.

2.6. SHARE-FOR-SHARE RECAPITALISATIONS

[Applicable provisions: Section 43]

I. Background

Company restructurings come in a variety of forms. Company reorganisations involve formations, acquisitions, amalgamations, unbundlings and liquidations.. Reorganisation transactions of this nature are often eligible for rollover relief (i.e. deferral of gains and losses) under Part III (i.e. section 41 through 47) of the Income Tax Act.

Companies may also enter into share-for-share recapitalisations that involve a single company. In a recapitalisation, the shareholders of a company surrender all (or some) of the shares held in exchange for the issue of new shares by the same company. This action typically entails a share split, share consolidation or a share conversion.

The capital gain provisions currently provide roll-over treatment (i.e. deferral of gain or loss) for shares surrendered in a recapitalisation (plus certain limited forms of conversions). This relief is limited to capital gains (as opposed to relief from ordinary revenue). This rollover treatment is predicated on the receipt of certain shares in exchange for shares surrendered. Receipt of other consideration as part of the recapitalisation triggers gain.

II. Reasons for change

Current rollover relief for recapitalisations is too narrow and out of sync with the reorganisation rules. Firstly, the relief applies only in respect of shares held as capital gains as opposed to shares held as trading stock. Secondly, the types of permissible share consideration are too narrow (simple share splits, consolidations or conversions). The need for increased flexibility in this regard has now taken higher priority given recent changes to company law. These changes include the need for the conversion of par value shares into no par value shares.

III. Proposal

A. Share recapitalisations

It is proposed that the capital gain rules applicable to share-for-share recapitalisations be replaced in favour of a new regime. Under the revised regime, rollover treatment will apply when a shareholder surrenders shares in a company for other shares in that same company. More specifically –

- a swap of equity shares for other equity shares;
- the subdivision and consolidation of a non-equity shares for other non-equity shares; and
- a swap of a property linked unit (i.e. dual linked share-debenture debenture in a REIT or a controlled property company – see note on CREATION OF A UNIFIED SYSTEM

OF TAXING REAL ESTATE INVESTMENT TRUSTS FOR PROPERTY INVESTMENT SCHEMES).

However, to the extent that any party to the share-for-share transaction receives consideration other than shares (e.g. cash and debt), this other consideration will be taxable. In the main, the new recapitalisation rules will otherwise fall within the same paradigm as the pre-existing reorganisation rules (e.g. being subject to the same restraints as the proposed anti-avoidance share mismatch rules – see note on VALUE MISMATCHES INVOLVING SHARE ISSUES).

B. Note on conversions

The revised recapitalisation rules will automatically incorporate share-for-share transactions associated with the conversion of a close corporation to a company and the conversion of a co-operative to a company (as did the prior recapitalisation rules). In addition, where a share block company is converted into an ordinary company, this proposal will also automatically apply to the share swap.

IV. Effective date

Revised rollover relief for recapitalisations applies in respect of transactions arising on or after 1 January 2013.

2.7. VALUE MISMATCHES INVOLVING SHARE ISSUES

[Applicable provisions: Section 24B, 24BA and 41(2); paragraph 1 ("value shifting arrangement" definition), paragraph 11(1)(g), paragraph 13(1)(f) of the Eighth Schedule, and paragraph 23(b)(ii) of the Eighth Schedule].

I. Background

A. The issue of shares for assets

Companies can finance the acquisition of assets through the issue of their own shares. This issue is tax-free from the perspective of the company issuer. On the other hand, taxpayers disposing of assets to a company in exchange for a share issue generally realise capital gain or loss in respect of capital assets (and ordinary revenue or loss in the case of trading stock assets).

Prior to the introduction of section 24B, companies issuing shares in exchange for assets did not receive any tax cost in respect of the assets acquired because judicial precedent does not view the issue of shares as expenditure incurred. Application of these general principles created a significant hindrance to company formations and other forms of share-financed asset acquisitions. Zero tax cost treatment also falls completely outside of international tax norms.

Section 24B was introduced to eliminate this hindrance. More specifically, section 24B deems the issuing company to have acquired the asset for an amount equal to the lesser of: (i) the market value of that asset immediately after the acquisition, or (ii) the market value of the shares immediately after the acquisition. On the other side of the transaction, the transferor is deemed to have disposed of the asset for an amount equal to the market value of the shares after the acquisition.

B. Value shifting anti-avoidance rules

The Eighth Schedule also contains rules dealing with value shifting arrangements. The primary purpose of these rules is to prevent the shifting of value between shareholders (as well as beneficial owners of trusts and partnerships) without constituting a disposal for CGT purposes. These anti-value shifting rules are restricted to arrangements between connected persons so as to exclude bona fide commercial transactions.

II. Reasons for change

As a matter of principle, the provisions of section 24B generally assume that asset-for-share transactions are performed on a value-for-value basis. However, schemes with uneven exchanges allegedly allow for value to be transferred without triggering the appropriate tax due.

It is also recognised that the value shifting anti-avoidance rules contained in the Eighth Schedule have proven to be ineffective in regards to companies. One reason for this ineffectiveness stems from the fact that a formal “connected person” relationship is often lacking in many anti-avoidance transactions of this nature.

III. Proposal

A. *Share issue mismatches*

1. Tax charge stemming from share issue mismatches

It is proposed that the value-for-value principle applicable in respect of all asset-for-share exchanges should be clarified by legislation. In this regard, value mismatches involving shares will explicitly give rise to tax in the hands of the party receiving a benefit regardless of whether or not connected persons are involved. The trigger is a share-for-consideration transaction with the terms of the transaction differing from independent persons dealing at an arm’s length (when viewed in isolation from other related or unrelated transactions, operations, etc… Under the new anti-avoidance rules for non-arm’s length terms:

- If the market value of the asset disposed of by the taxpayer exceeds the market value of the shares issued, the company issuer will be subject to an additional level of gain. The character of this additional gain will be capital in nature.

- If the company issues shares that have a market value that exceeds the assets received in the exchange, this excess amount will be deemed to give rise to a deemed *in specie* dividend (generally subject to the Dividends Tax).

It should be noted that these anti-avoidance rules do not apply if transactions occurring between companies within the same (section 1) group. Group transactions of this nature typically occur at book value (this transfer at book value were one of the key reasons for the intra-group rollover regime).

2. Tax cost of shares involved in a share issue mismatch

If a transferor disposes of assets for shares as part of a share issue transaction, the shares will generally have a tax cost (i.e. are viewed as having an expenditure incurred) equal to the value of the assets disposed of. On the other hand, if the share issue is part of a Part III rollover transaction, the shares will generally have a tax cost in the hands of the transferor equal to the tax cost of the assets that existed previously in the hands of the transferor.

If a share issue mismatch is involved, the tax cost of the shares may have to be adjusted. More specifically, if the value of the assets exceeds the value of the shares (i.e. capital gain is triggered in respect of the excess), the excess will be applied to otherwise existing tax cost in the shares received. No adjustment to the tax cost of the shares will arise where the value of the shares exceeds the value of the assets transferred (i.e. where there is a deemed dividend in specie).

3. Examples

Provided below are examples of how the value mismatch anti-avoidance rules apply in respect of gains/deemed dividends and adjustments to tax cost.

Example 1
Facts: Individual X transfers capital assets with a market value of R2 million (and a base cost of R1 350 000) to Company ABC. As consideration for these assets, Company ABC issues shares with a total value of R1 400 000 to Individual X. These assets will be held as capital assets in the hands of Company ABC. The transaction would not have occurred in isolated between independent persons at arm's length (e.g. was motivated by tax considerations).

Result:
Tax charge*:* The market value of the assets disposed of by Individual X exceeds the market value of the shares issued by Company ABC. Company ABC will realise capital gain of R600 000 (i.e. difference between the R2 million market value of assets transferred and the R1 400 000 share value received) in addition to R50 000 (R1 400 000 share value received less R1 350 000 base cost) if rollover relief is not utilised.

Tax cost for shares: The base cost of the shares received by Individual X will be reduced by the R600 000 of excess.

Example 2
Facts: Individual Y transfers capital assets with a market value of R1 million to Company DEF. As consideration for these assets, DEF issues shares with a total market value of R1.2 million to Individual Y. The assets will be held as capital assets in the hands of Company DEF. The transaction would not have occurred in isolated between independent persons at arm's length (e.g. was motivated by tax considerations).

Result:
Tax charge: The market value of the assets disposed of by Individual Y is lower than the market value of the shares issued by Company DEF. Company DEF will be deemed to distribute an *in specie* dividend of R200 000 (i.e. the difference R200 000 between the R1 million market value of assets transferred and the R1.2 million value of shares received).

Tax costs: The base cost of the shares received by Individual Y will not be adjusted because of the deemed dividend.

B. *Expenditure incurred in respect of asset for share or debt issues*

If a company issues shares for assets, the expenditure incurred for those assets will equal the market value of the shares issued in exchange (with the value determined after the transaction). It should be noted that this expenditure incurred is not subject to adjust by the share value mismatch rules. If a company issues debt for assets, the expenditure incurred for those assets will equal the amount of the debt issued in exchange.

C. Continuation of the value shifting anti-avoidance rules

In light of the new anti-avoidance rules to prevent share mismatches, the current value shifting anti-avoidance rules probably can be narrowed. From 1 January 2014, the value shifting rules will no longer apply in respect of companies but will continue in respect of trusts and partnerships. The effective date of the proposal is delayed by one year so the proposal can be studied further to ensure that the change does not give rise to avoidance.

IV. Effective date

The share value mismatch rules and the tax cost rules for company share/debt issues come into effect on 1 January 2013 and will be applicable in respect of transactions/acquisitions on or after that date.

2.8. DEBT-FINANCED ACQUISITIONS OF CONTROLLING SHARE INTERESTS

[Applicable provisions: Section 24O]

I. Background

A. General deduction formula

A business can be acquired by either purchasing the business assets of a target company or by purchasing the shares of the target company. The acquisition can be funded in a variety of ways, one of which is through interest-bearing debt.

The Income Tax Act allows for the deduction of interest expenses only if these expenses are incurred in the production of income. Interest expenses incurred when using debt to finance the acquisition of business assets are generally deductible because the business assets should produce income. However, because shares largely produce exempt dividend income, interest expenses associated with debt-financed share acquisitions are not deductible (subject to a few case law exceptions, such as those described in CIR v Drakensberg Garden Hotel (Pty) Ltd and ITC 1604).

B. Indirect share acquisitions

Despite the above, interest deductions associated with share acquisitions can be achieved indirectly through the use of the section 45 rollover provisions (i.e. hereinafter referred to as indirect share acquisitions). This result is achieved through a simple three-step process. In step one, an acquiring company typically purchases all of the shares of a target company with debt-financing obtained via a temporary bridging loan. In step two, the target company enters into a tax-deferred sale of assets to a newly formed subsidiary of the acquiring company via a section 45 intra-group transaction.

The subsidiary acquires these target assets via long-term debt-financing. These long-term debt proceeds are then distributed to the acquiring company so as to repay the bridging loan. The interest on the long-term debt is deductible against target company income because the debt is used to acquire income-producing assets from the target company.

II. Reasons for change

Under the current paradigm, a practical dichotomy exists. Interest deductions associated with debt-financing of direct share acquisitions are not deductible while indirect debt-financing via sections 45 and 47 are allowed if the financing meets the requirements of section 23K. Therefore, these indirect share acquisitions have been formally accepted in the tax system under certain limited circumstances. No reason exists to deny interest-deductions associated with direct share acquisitions occurring under similar limited circumstances. To force an indirect share acquisition in all instances is to effectively add unnecessary transaction costs.

III. Proposal

A. Overview

A special deduction will be added for interest incurred if that interest is associated with debt used to acquire controlling share interests in operating companies, and the acquisition is comparable to those indirectly allowed for indirect share acquisitions. This special deduction will apply without regard to the "production of income" and trade requirements of section 11(a). Instead, the target company acquired must be an operating company. In order for a company to qualify as an operating company, the company must continuously carry on business by providing goods and services for consideration (or the target company is a company that is a controlling group company in relation to the target company described above).

In essence, these interest deductions will be allowed against acquiring company income when the underlying debt is used to acquire controlling share interests (i.e. equity shares) in an operating company. Control will be defined within the context of the section 41 "controlled group of companies" definition. These deductions will be allowed as long as the target company remains within the same section 41 group of companies as the acquiring company and as long at the target company remains an operating company. The proposed regime applies to wholly domestic acquisitions (i.e. is limited to section 41 groups) because the current indirect route is allowed only within the domestic context.

The net impact of this regime will leave taxpayers with two options when acquiring controlling share interests in an operating company. The parties can continue to utilise the indirect share acquisition technique for debt-financing or the newly added regime for direct debt-financing. The indirect option continues to allow for interest to be deducted against target company income. The direct option will now allow for interest to be alternatively deducted against acquiring company income.

B. Anti-avoidance limits

As discussed, interest deductions associated with indirect share acquisitions are contained. More specifically, interest deductions associated with indirect share acquisitions are now disallowed to the extent that the overall transaction results in significant tax leakage. The new provisions associated with direct share acquisitions will be subject to the same limitations.

IV. Effective date

The amendment will be effective in respect of acquisitions undertaken on or after 1 January 2013.

2.9. DEBT REDUCTIONS FOR LESS THAN FULL CONSIDERATION

[Applicable provisions: Sections 8(4)(m), proviso to section 20(1)(a); paragraphs 3(b)(ii), 12(5), 13(1)(g), 20(3)(b), 40(2) and 56(2) of the Eighth Schedule]

I. Background

A. General

The tax treatment of debt reductions or cancellations depends on the underlying cause of the reduction or discharge. Reductions or cancellations can thus result in ordinary income (including fringe benefit income), capital gain or even be viewed as a donation/estate transfer. One unique category of debt reduction or cancellation stems from the debtor's inability to pay.

B. Ordinary revenue

Debt reductions or cancellations caused by an inability to pay within the ordinary revenue system can trigger one of two effects – reduction of excess losses or ordinary revenue as a recoupment.

- As an initial matter, the Income Tax Act provides for a reduction of the balance of assessed losses to the extent that a debtor benefits from a compromise or concession of a liability by a creditor. However, this result applies only if the amounts advanced by the creditor were utilised to fund expenditure (or an asset) and a deduction (or allowance) was previously allowed in respect thereto.

- As a secondary matter (i.e. if the debt relief does not trigger a reduction in losses), the Income Tax Act provides for a recoupment or a recovery equal to an amount by which an obligation to make payment is wholly or partially relieved. As with the rule for loss reductions, this result applies only if the obligation gave rise to an expenditure or allowance that was previously allowed as a deduction.

C. Capital Gains Tax

Debt reductions or cancellations caused by an inability to pay within the capital gains system can trigger one of two effects – reduction of expenditure in respect of capital assets (i.e. base cost) or capital gain. It should be noted that these rules are residual rules (i.e. applying only to the extent that the reduction or discharge did not already give rise to ordinary revenue).

- Debt reductions or cancellations in respect of capital assets acquired can have one of two effects. If the asset is still held by the debtor and the debt (i.e. expenditure) has been reduced, the base cost of the asset must be reduced. If the asset is no longer held, the reduction triggers immediate capital gain.

- In respect of reductions or cancellations falling outside the primary rule just outlined above, a slightly different set of rules apply. If a debt owed by a debtor in this category has been reduced or cancelled for no consideration or for consideration that is less than the face value of the debt, the debtor essentially realises gain equal to the amount of the reduction or cancellation. This secondary trigger does not apply if: (i) the debtor and the creditor are members of the same group of companies, or (ii) the debtor is being liquidated and the creditor is a connected person (with the connected person simultaneously being denied the loss).

II. Reasons for change

Debtors in distress seeking relief are a recurring economic concern. With the recent global financial crisis, an unusually large number of companies are experiencing financial distress. Relief for these companies is essential if local economic recovery is to occur.

The tax system unfortunately acts as an added impediment to the recovery of companies and other parties in financial distress. In particular, the potential tax imposed upon parties receiving the benefit of debt relief effectively undermines the economic benefit of the relief (with Government partially reversing the relief by claiming a proportionate share of tax). Most problematic is that tax debt forgiven by SARS due to a taxpayer's inability to pay also gives rise to capital gain (i.e. retriggering a portion of the tax just relieved).

III. Proposal

A. Dual system overview

A uniform system is proposed that will address debt relief (i.e. debt reductions or cancellations for less than full value consideration). This uniform system will cover both the rules relating to ordinary revenue and the rules relating to capital gains. Ordering rules will also be added for debt relief potentially treated as a donation, estate transfer or as a fringe benefit.

B. Ordering rules

1. Current paradigm

Debt can be reduced or cancelled for a variety of reasons. As under prior law, the causal link lies at the core for determining the tax treatment. If debt is reduced or cancelled for full consideration, the reduction or cancellation should be viewed as an indirect form of cash payment under current tax principles. For instance, a taxpayer could perform services in exchange for a debt reduction or cancellation, thereby generating ordinary revenue. Alternatively, a taxpayer could transfer a capital asset in exchange for the reduction or cancellation of a debt, thereby generating capital gain or loss in respect of the disposed of asset.

At issue is debt owed by a debtor that is reduced or cancelled for less than full consideration. Debt reductions or cancellations of this nature can be treated as a donation (potentially subject to the Donations Tax), as part of the bequest from an estate (potentially subject to the Estate Duty) or as disguised salary. Debt reductions or cancellations outside this arena will fall into the ordinary or capital gain landscape of the Income Tax, depending on how the borrowed funds were applied.

- If the debt was used to fund a deductible expenditure or an allowance (e.g. depreciation), the debt reduction or discharge will be taken into account in terms of the ordinary revenue rules.

- The rules for capital gains apply as a residual category (i.e. in scenarios where no deductions or allowances were previously claimed).

As a practical matter, the ordinary debt relief system will typically apply in respect of debts stemming from unpaid deductible operating expenses, from unpaid interest incurred or from unpaid trading stock. The capital gain relief system will typically apply in respect of debts stemming from previously acquired non-depreciable capital assets. If the previously acquired assets are depreciable, the ordinary and/or capital gain system may potentially apply.

2. Proposed ordering rules

The proposed rules will roughly follow the same implicit ordering rules of current law while providing an explicit set of demarcations. This ordering will be as follows:

- Firstly, if the debt reduction or cancellation constitutes property of an estate and that debt reduction or cancellation is reduced or cancelled in favour of an heir or legatee by virtue of a bequest, the estate duty potentially applies. If the debt reduction or cancellation qualifies as donation under the donations tax, the donations tax potentially applies (as opposed to the income tax). Lastly, if the debt reduction or cancellation stems from an employer or employee relationship, the amount is generally viewed as taxable salary subject to pay-as-you-earn withholding.

- To the extent that the debt reduction or cancellation falls outside the above paradigm (i.e. is not a bequest, a donation or a taxable employer-employee fringe benefit), the debt reduction or cancellation will be taken into account in terms of the ordinary revenue rules if the debt proceeds were used to fund deductible expenditures or allowances.

- To the extent that the debt reduction or cancellation falls outside of all of the above paradigms (i.e. is not a bequest or a donation, nor a taxable employer-employee fringe benefit nor an amount within the ordinary paradigm), the debt reduction or cancellation will be taken into account in terms of the capital gain rules.

It should be noted that the new paradigm will apply whenever debt is reduced or cancelled for less than full consideration. This debt reduction or cancellation can occur within insolvency, business rescue, similar statutory proceedings or informal workouts. The reduction or cancellation also need not explicitly result from the inability to pay.

3. Debt previously incurred in respect of depreciable assets

An issue of allocation arises when determining the impact of a debt reduction or cancellation in respect of debt applied to fund depreciable assets. At issue is whether the funding should first be allocated to depreciation deductions previously taken or whether the debt should first be allocated to the capital portion of the asset still held. In other words, if R100 of debt is used to acquire a depreciable asset and depreciation of R5 was taken against that asset, what happens if the debt is reduced by R5? Is the reduction viewed as an ordinary recoupment of R5 or allocated against the R95 capital residual?

Under the proposal, this question will be explicitly resolved in favour of the taxpayer. More specifically, if debt was used to fund the acquisition of a depreciable/allowance asset, the reduction or discharge will initially be viewed as funding the capital expenditure to the extent of the remaining base cost of the depreciable asset so held. The residual (i.e. any amount of debt reduction or cancellation exceeding base cost) will be viewed as having funded the depreciation allowances so taken. As a general matter, the net effect will be to initially reduce the base cost of depreciable assets so held (see C. "Capital" debt relief). If the base cost is fully depleted, the reduction or cancellation will then trigger ordinary revenue (see D. "Ordinary" debt relief).

Example 1
Facts: Company X borrows R3.5 million. Company X applies all of the borrowed funds to acquire a plant. Company X depreciates the plant by R800 000, leaving R2.7 million of base cost (R3.5 million less the R800 000 of depreciation). The lender subsequently cancels R2 million of the debt.

Result: The R2 million of the cancelled debt will be applied towards the capital portion (reducing the base cost of the plant to R2.7 million to R700 000). None of the reduction will be viewed as having been applied against the previously depreciated portion.

Example 2
Facts: Company Y borrows R3.5 million. Company Y applies all of the borrowed funds to acquire a plant. Company Y depreciates the plant by

R3 million, leaving R500 000 of base cost (R3.5 million less the R3 million of depreciation). The lender subsequently cancels R3 million of the debt.

Result: The R3 million of the cancelled debt will initially be applied towards the capital portion (reducing the base cost of the plant to R500 000 to zero). The remaining R2.5 million will be viewed as having been applied against the previously depreciated portion (resulting in ordinary revenue of R2 million).

C. "Capital" debt relief

1. Two-tier system

As discussed above, proposed "capital" treatment for debt reductions and cancellations is a residual category, applying as long as the other regimes outlined above do not apply. Hence, the regime does not apply if the funds stemming from the debt are not viewed as a donation, a bequest or a fringe benefit). Secondly, the amount must not fall within the ordinary revenue paradigm (being an amount used to fund expenditure other than a deductible expenditure or an allowance, or being an amount used to fund an allowance asset). Capital treatment will have the following two-tier impact:

- <u>Base cost reduction</u>: If the debt reduction is viewed as falling within a capital paradigm, the debt reduction or cancellation will firstly reduce the base cost of the capital assets so held by the debtor. However, this base cost reduction will apply only to the extent to which the borrowed funds were used to acquire those capital assets still held by the debtor and only to the extent that the capital assets have any remaining base cost.

- <u>Reduction of assessed capital losses</u>: If the debt reduction or cancellation is viewed as falling within a capital paradigm and the amount cannot be traced to an asset so held (or the base cost in the asset is fully depleted to zero), the excess reduction or cancellation will be applied against any assessed capital losses that the debtor may have.

If the "capital" debt reduction or cancellation falls outside the above parameters, the debt reduction or cancellation generally has no further impact. In other words, if the debtor's base cost and assessed losses are fully reduced in accordance with the above, no capital gains arise. Immediate taxable capital gain treatment for debt reductions or cancellations (as under current law) will no longer apply. However, if the asset is an allowance asset, the excess reduction could potentially trigger a recoupment.

Example
Facts: Debtor borrowed R5 million to acquire two vacant lots. Vacant Lot 1 was purchased for R3 million, and Vacant Lot 2 was purchased for R2 million. Vacant Lot 2 was sold for R1.2 million, generating an R800 000 capital loss. Due to circumstances outside Debtor's control, Vacant Lot 1 is has significantly declined in value. Debtor also used the R1.2 million of proceeds from Vacant Lot 1 for personal consumption. In order to alleviate Debtor's circumstances, the lender of the debts cancels R3 million of those debts. Of this amount, R2 million of the debt reduction is

attributable to formerly held Vacant Lot 2, and R1 million of the debt reduction is attributable to Vacant Lot 1.

Result: The R1 million amount of debt cancelled that is attributable to Vacant Lot 1 reduces the base cost in that lot from R3 million down to R2 million. The other R2 million cancelled cannot be applied against Vacant Lot 1 because the debt was not initially applied to acquire that lot. Instead, the R2 million is applied to eliminate the R800 000 of assessed capital losses. No further impact arises (i.e. the R1.2 million of unallocated debt reduction does not give rise to capital gain).

2. Pre-effective date assets

In applying the proposed rules, particularly in respect of base cost reductions, special rules are required for determining the base cost of pre-CGT effective date assets (i.e. assets held before 1 October 2001). The value of these pre-CGT effective date assets is determined based on one of three methods (as determined by the taxpayer):

- The market value method;
- The time-apportionment method; and
- The 20 per cent proceeds method.

Determination of which method applies (and how each method applies) can only be made upon disposal of the relevant asset. Hence, where there is reduction of a debt used to fund the acquisition of a pre-valuation date asset, a disposal of that pre-valuation date asset will be deemed to be made solely for purposes of determining base cost and timing rules. The disposal will be deemed to have been made for an amount equal to the market value of that asset immediately before debt is reduced or cancelled. The pre-valuation date asset will also be deemed to be re-acquired at market value thereof (less any capital gain and increased by any capital loss). The resultant amount after applying the above calculation will be treated as the asset's prospective base cost.

3. Special relief for cancelled tax debts

A capital gain should not arise when tax debts are fully or partially cancelled as a policy matter (so as not to undue the intended impact of a tax compromise). Debt cancellations of this kind are accordingly excluded from the base cost/capital loss reduction regime by way of definition (i.e. are excluded from the definition of debt for purposes of the capital debt reduction regime).

4. Pre-existing rules

The current rules triggering capital gain for debt reductions or cancellations (for less or no consideration) will be withdrawn. This form of debt reduction will no longer trigger capital gain as discussed above. However, the relief mechanism in respect of the former capital gain rules (i.e. group relief and liquidation relief) will continue to apply. The net effect of these relief mechanisms is to eliminate the potential loss of base cost or assessed losses in respect of the debtor because these relief mechanisms have their own tax price (reduction of capital losses in respect of the creditor's claim in the debt cancelled).

Two other pre-existing rules will also remain but their application will be limited. Under current law (paragraph 20(3)(b)), the base cost of a capital asset so held is reduced if the underlying expenditure is reduced or recovered. Similarly, this form of recovery will give rise to capital gain if the capital asset is no longer held (paragraph 3(b)(ii). These rules will continue as a general matter, but will no longer apply if the reduction or recoupment of expenditure relates to debt reductions or cancellations for less than full consideration (i.e. are taken into account under the capital debt relief regime).

Example
Facts: Taxpayer purchases intellectual property for R5 million and pays the seller in cash (borrowed from the bank). Due to unforeseen circumstances, the bank needs to reduce the debt by R600 000 as part of a debt work-out.

Result: The R600 000 debt reduction results in a base cost reduction of R600 000 if the intellectual property is held by the debtor at the time of the debt reduction. If Taxpayer sells the intellectual property before the debt reduction, the R600 000 results in the reduction of Taxpayer's assessed capital losses (to the extent Taxpayer has assessed capital losses; otherwise, the reduction has no impact).

D. "Ordinary" debt relief

1. Two-tier system

As discussed above, proposed "ordinary" treatment for debt reductions and cancellations will apply as long as the initial debt was used to finance deductible expenditure or allowances (but only as long as the debt is not viewed as a donation, a bequest or remuneration). These rules will accordingly apply if the debt reduced or cancelled was used to fund trading stock, allowance assets (after full base cost reduction) or other tax deductible expenditure. Ordinary treatment will have the following two-tier impact:

- Cost price reduction: If the debt reduction is viewed as falling within an ordinary paradigm, the debt reduction or cancellation at issue will firstly reduce the cost price of trading stock so held by the debtor. However, this cost price reduction will apply only to the extent to which the borrowed funds were used to acquire the trading stock still held by the debtor and only to the extent that trading stock has any remaining cost price.

- Ordinary revenue or recoupment: If the debt reduction or cancellation is viewed as falling within an ordinary paradigm and the amount falls outside the cost price reduction rules, any residual will be viewed as giving rise to ordinary revenue. Amounts of this nature can be: (i) debt funding related to trading stock where the cost price has already been reduced to zero or where the trading stock is no longer held, (ii) debt funding for allowance assets to the extent of prior depreciation (after base cost is reduced to zero), and (iii) debt related to operating expenses.

The net effect is to ensure that immediate tax arises only as a last resort. This change should assist the parties at issue given the fact that most insolvent debtors will have sufficient cost price in assets so held to eliminate the potential for immediate tax. This (diminished) potential for tax, however, protects the fiscus against schemes seeking to utilise debt cancellations or reductions as a means for artificially reducing tax.

Example 1
Facts: Company X owes debt of R1 million. The trading stock held by Company X has a cost price of R400 000. Company X's creditors discharge all R1 million of the debt owed due to Company X's inability to pay. Of the debt owing, R400 000 stems from trading stock currently held, R150 000 stems from previously held trading stock and R450 000 was used to fund operating expenses.

Result: The amount of the discharged debt (R1 million) will first be applied to reduce the cost price of the trading stock (R400 000) to zero. The remaining amount (R600 000) will be included in the income of Company X as ordinary revenue.

Example 2
Facts: Company Y owes debt of R1 million. Company Y owns an industrial lot with a warehouse with an initial cost of R1.1 million that was funded by the R1 million debt. The lot cost R300 000 and the warehouse structure cost R800 000. To date, Company Y has claimed R420 000 of depreciation in respect of the warehouse, leaving a base cost of R380 000. Company Y's creditors cancel R680 000 of the debt owed as part of an informal debt workout.

Result: In respect of the total debt cancelled, the base cost of both the lot and the warehouse (i.e. remaining base cost R380 000) will be reduced to zero, leaving R300 000 of debt reduction to be accounted for (R680 000 less R380 000). The is excess R300 000 will be included as income.

2. Pre-existing rules

The pre-existing recoupment and reduction of balanced assessed loss provisions will be completely eliminated. The suspension of losses in a sequestrated estate will be eliminated as unnecessary. The law will also be clarified to state that no ordinary recovery or recoupment will arise to the extent amounts have been taken into account as part of the two-tier ordinary debt relief regime.

3. Allowance limitations and exclusions

Going forward, allowances on assets in respect of which a debt was reduced or cancelled may not exceed the aggregate of the expenditure incurred by a taxpayer in respect of an allowance asset, less the sum of (i) the allowances previously claimed on that allowance asset, and (ii) the amount of the debt reduced.

Example

Facts: Company X acquired a machine in respect of which expenditure of R800 000 was incurred. For tax purposes, Company X may claim allowances in respect of the machine on the basis of a 40 per cent allowance in the first year and 20 per cent in each of the subsequent three years. In year 1, Company X accordingly claims an allowance of R320 000. Subsequently, the supplier of the machine, forgives R300 000 of the cost price.

Result: The amount of the discharged debt (R300 000) will be applied to reduce the cost price of the machine. In the subsequent year of assessment, allowance Company X may claim on the machine will be limited to a cost price of R180 000 (R800 000 less R320 000 prior depreciation less R300 000 debt reduction). Of the R180 000 remainder, Company X can claim R160 000 of allowances in Year 2 and the final R20 000 in Year 3.

IV. Effective date

The proposed regime will apply in respect of debts reduced or cancelled on or after 1 January 2013.

2.10. REPEAL OF ANTI-AVOIDANCE FOR CONNECTED PERSON TRANSFERS OF DEPRECIABLE ASSETS

[Applicable provisions: Section 23J of the Income Tax Act]

I. Background

The Income Tax contained a number of identical scattered provisions dealing with the purchase of depreciable property from connected persons. The purpose of these rules (most of which pre-date the introduction of the Capital Gains Tax (“CGT”)) was to prevent tax-free or low-taxed sales between connected persons of depreciable property, followed by increased depreciation against ordinary rates.

Subsequent to the introduction of capital gains taxation, section 23J was introduced to eliminate the previous scattered set of anti-avoidance rules relating to depreciable assets connected person regimes in favour of a single regime. Section 23J limits the depreciable cost of an asset generally purchased from a connected person to the cost incurred by the connected person seller plus (i) all ordinary recoupments, and (ii) the portion of includible capital gains triggered by the seller upon the connected person purchase.

II. Reasons for change

The anti-avoidance rules for connected person sales give rise to anomalies. For instance, if a group member sells property constituting trading stock to another connected person member, the second group member appears to be subject to the anti-avoidance rules when depreciating the property. This result makes little policy sense because the anti-avoidance rules should apply only if the connected person sale is subject to tax at a level lower than ordinary rates.

In view of the recent increase in the CGT inclusion rate (from 50 per cent to 66.6 per cent in the case of companies), the arbitrage opportunity for connected person depreciable asset sales is greatly reduced. Under this revised scenario, the necessity of the anti-avoidance provisions under section 23J becomes questionable.

III. Proposal

It is proposed that the anti-avoidance provisions under section 23J be wholly deleted based on the reasons provided above. It is also noted that the issues raised by section 23J are part of larger problem of inflating untaxed gains (or gains offset by assessed losses) so as to generate future deductions (via inflated depreciation deductions or otherwise). These concerns are probably best addressed through the adoption of domestic transfer pricing principles.

IV. Effective date

The proposed amendment will be effective in respect of assets acquired on or after 1 January 2013.

2.11. PASSIVE HOLDING COMPANIES

[Applicable provisions: Sections 9E of the Income Tax Act]

I. Background

Companies pay income tax at a rate of 28 per cent; whereas, individuals pay tax at a progressive rate of up to 40 per cent. The Secondary Tax on Companies has been replaced by the Dividends Tax. The Dividends Tax is being imposed at a shareholder level and was initially intended to be at a rate of 10 per cent but will now apply at a rate of 15 per cent.

The Passive Holding Companies regime was introduced as an anti-avoidance measure. The main objective of the passive holding company regime was to counter the arbitrage of rates between individuals versus the combined effective rates on corporate earnings (i.e. corporate income tax rate of 28 per cent and the Dividends Tax).

II. Reasons for change

In view of the increase in the rate of tax under the Dividends Tax from 10 per cent to 15 per cent, the arbitrage opportunity between individual rates and combined company rates has been minimised. The combined effective tax rate for company profits (i.e. 28 per cent plus the 15 per cent tax on dividends) is now 38.8 per cent, being very close to the individual rate of 40 per cent. With this differential mostly closed, the necessity of the passive holding company regimes becomes questionable.

III. Proposal

It is proposed that the passive holding company regime be deleted based on the reason provided above. This regime will accordingly never come into effect.

IV. Effective date

The proposed amendment will be effective from the regime's inception.

2.12. CONVERSION OF SHARE BLOCK INTERESTS TO FULL TITLE

[Applicable provisions: Paragraph 67B to the Eighth Schedule; section 9(19) of Transfer Duty; section 8(19) of the Value-added Tax]

I. Background

A. *Role of share block companies*

Share block companies were initially used as a method to sell holiday accommodation in locations where it was legally impossible to subdivide or sectionalise land. In terms of the Share Block Control Act, 1980 (Act No. 59 of 1980), the company is the owner of all of the land and immovable property thereon. The shareholders, by virtue of their shareholding in the share block company, have the right to use an exclusive use area and the common-use areas held by the company.

For various reasons, the share block company is no longer a popular method of holding property. Firstly, it appears that the above legal constraints are no longer a hindrance to subdivision. Secondly, borrowing funds from banks for share acquisitions (even in a share block scheme) is harder to achieve than borrowing for direct interests in immovable property. Sectional title schemes have accordingly become the favoured method for creating a subdivided community neighborhood with common-use areas. In view of the above, many parties to a pre-existing share block company have terminated this legal structure (or are seeking to terminate this legal structure) in favour of more direct forms of immovable property ownership.

B. *Termination of share block companies*

1. Conversion to sectional title scheme

The Share Blocks Control Act, 1980 (Act No. 59 of 1980) provides an explicit method of converting a share block company into a sectional title scheme. If the share block company obtains shareholder approval, the share block company registers the sectional title plan with the registrar of deeds. This registration allows for the division of the underlying property into sectional title units while in share block company hands that will eventually be transferred to the shareholders of the share block company in exchange for their shares. In the initial stages, the shareholders will waive their right of use to the underlying property. The share block company will then transfer title of the units to the shareholders of the share block company. As a final step, the share block company will typically liquidate.

2. Other forms of conversion

If the shareholders want to convert from the share block form of ownership to more direct ownership without utilising the sectional title conversion process, the shareholders can make a special resolution that allows the company to alienate or cede the underlying property (section 8(c)(ii) of the Share Block Control Act). Thereafter, the company may alienate or cede the underlying immovable property like any ordinary company (e.g. either by way of a distribution or by way of a sale of the property to its shareholders). In these instances, the exclusive use areas will often be subdivided before distribution or sale.

In many cases, this procedure could be used to liquidate the company and transfer ownership directly to the shareholders. However, in some cases, common-use areas may not easily be distributed among the shareholders. In these instances, the exclusive use areas are transferred to the shareholders with the common use areas remaining with the company (meaning that the company does not liquidate).

C. *Special tax rule for conversions to sectional title*

As an initial matter, the liquidation of a residential property company typically triggers two levels of capital gain – one level of gain at the company-level upon disposal of company assets and a second level of gain for the shareholders upon surrender of their shares. In order to eliminate this dual level of tax, a special rollover regime was added for conversions of share block companies to sectional title because the ultimate owners are merely transforming their legal claims in respect of the same underlying property.

At the outset, the regime eliminates the potential company capital gain or loss as well as the potential shareholder capital gain or loss that would otherwise exist due to the liquidation of company interests. The potential capital gain or loss for each former shareholder is deferred until the former shareholder actually disposes of the immovable property. This deferral is achieved by providing the former shareholder with the same base cost associated with the former shareholder's total interest in the underlying property. In particular, the former shareholder is treated as having acquired the unit for: (i) the expenditure incurred to acquire the former share in the share block company, plus (ii) the expenditures incurred to undertake improvements in respect of the underlying property.

The acquisition of residential property (via company distribution or otherwise) normally triggers transfer duty. However, this charge is also waived when a share block company is converted into sectional title. Similar relief is also available to ensure that the conversion does not give rise to transfer duty or value-added tax.

II. Reasons for change

Rollover relief for share block company conversions simply envisions conversions to sectional title. This relief does not address the liquidation or distribution of immovable property by a share block companies when shareholders of the share block company seek to obtain full title to the underlying property. The lack of relief in this latter instance is simply an oversight because the conversion to full title was simply not envisioned as a practical option (especially given the focus on conversions to sectional title under the Share Blocks Control Act). No policy reason exists for denying rollover relief in this instance because (like conversions to sectional title) the conversion does not represent any enrichment – merely a transformation of an indirect interest in immovable property into a direct interest.

III. Proposal

It is proposed that rollover relief for sectional title conversion be effectively extended to cover share block company distributions that allow for full title ownership. The only condition is that the right in full title must relate to the same underlying immovable property as the exclusive use right in property previously held by the shareholder. The nature of the rollover relief within the capital gains tax provisions will operate the same as conversions to sectional title. Relief from transfer duty and value-added tax will similarly be extended. The new rule will cover total liquidations of the share block company and distribution of rights where the company will subsequently remain in existence (i.e. still holding the common use areas of the property).

IV. Effective date

The proposed amendments will be effective in respective of disposals, acquisitions and supplies on or after 1 January 2013.

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3. INCOME TAX: BUSINESS (FINANCIAL INSTITUTIONS AND PRODUCTS)

3.1. ANNUAL FAIR VALUE TAXATION OF FINANCIAL INSTRUMENTS IN RESPECT OF FINANCIAL INSTITUTIONS

[Applicable provisions: sections 24J(9); new section 24JB]

I. Background

A. Income taxation of financial instruments

In general, income tax systems impose tax on a realisation basis when calculating gain or loss in respect of asset values. This method requires a realisation event (e.g. a disposal). This reliance on realisation exists because notional gains and losses cannot generally be determined with accuracy (especially from the perspective of revenue enforcement). In essence, realisation brings certainty to notional profits/losses embedded within assets.

However, in recent years, a growing trend exists toward notional realisation in respect of liquid financial instruments (e.g. listed and over-the-counter shares, bonds and derivatives). Unlike other assets, the notional value of these instruments bears a strong correlation with their realisation value in terms of accuracy. The widely-traded nature of these instruments also has the benefit of easy verification for enforcement and compliance purposes. This form of annual notional accounting is commonly referred to as a mark-to-market approach (triggering annual gain and loss based on notional fair market values).

In respect of certain debt instruments (and other arrangements based on time-value-of-money principles) income and expenses are determined on a constant, compounding basis.

Legislation exists that allows for mark-to-market taxation in respect of certain financial instruments (e.g. debt, interest-rate swaps and certain options); otherwise, the overall income tax system remains on a realisation basis.

B. Accounting treatment of financial instruments

Recent International Financial Reporting Standards (IFRS) address the full array of financial instruments (e.g. shares, debt and derivatives) (see IAS 39 and IAS 32, which will soon be transformed to IFRS 9). IFRS classifies financial instruments into four broad categories as described below. The main purpose of this classification is to facilitate a more accurate set of calculations for shareholders.

In achieving this result, IFRS divides financial instruments into four broad categories. These categories are important in determining whether the instruments should be accounted for on a realisation basis or on an annual notional market-to-market basis through profit and loss. These four categories are as follows:

- *Fair value through profit and loss:* These financial instruments are carried at fair value with all annual gains or losses (realised and unrealised) presented in financial statements through profit or loss (and in equity). Fair value through profit and loss has two sub-categories: (a) financial instruments held for trading, and (b) those designated within this category at inception.

    - <u>Held for trading subcategory</u>: Financial instruments that are classified as held for trading must be reported at fair value through profit and loss. Trading generally reflects active and frequent buying and selling. Financial instruments held for trading are generally used with the objective of generating a profit from short-term fluctuations in price or on a dealer's margin. Derivatives are always categorised as held for trading unless accounted for as certain (i.e. cash-flow) hedges.

    - <u>Voluntary designation</u>: IFRS also allows a company to designate financial instruments at fair value through profit or loss if the designation eliminates or significantly reduces a measurement or recognition inconsistency (i.e. reduces an accounting mismatch). For purposes of risk management and investment strategy, a financial institution may also manage a group of assets and liabilities on fair value through profit and loss. This latter option focuses on how that institution manages and evaluates performance rather than on the nature of use associated with the financial asset or liability.

- *Held to maturity:* Financial instruments classified as held to maturity are measured at amortised cost.

- *Loans and receivables:* Loans and receivables have fixed or determinable payments, and are not quoted in an active market. Loans and receivables are measured at amortised cost.

- *Available-for-sale assets:* The available-for-sale category should be viewed as a residual category. Non-derivative assets fall under the available-for-sale classification only after accounting for other categories (e.g. fair value through profit and loss). All gains and losses in this category are recorded in equity and do not impact profit or loss until realisation.

II. Reasons for change

In respect of financial instruments, the rules pertaining to income tax and financial accounting have completely diverged. This divergence has proven to be a challenge for both taxpayers and SARS alike. From a taxpayer compliance standpoint, the resultant divergence has proven costly in terms of systems for financial institutions. The sheer volume of financial transactions for large financial institutions requires expensive systems that require constant adjustment. Tax deviations are often then accounted for manually, thereby being prone to inaccuracies. From a SARS standpoint, the divergence between tax and accounting has become so great that accounting is often no longer a useful benchmark for assessing risk vis-à-vis the accuracy of taxable income.

Admittedly, current law contains a specific rule that allows taxpayers to utilise annual mark-to-market fair value methodology. However, this election in favour of annual fair value methodology is incomplete because this election only caters for specific instruments (e.g. debt), thereby leaving equity and other instruments under the realisation principle. Moreover, this election seemingly focuses solely on financial assets without regard to financial liabilities (thereby resulting in serious mismatches).

III. Proposal

A. Overview

In order to simplify compliance and enforcement, certain companies that operate under IFRS will be required to determine their taxable income in respect of certain financial instruments in accordance with the mark-to-market regime required by IFRS. The main impact of these rules is to annually trigger ordinary revenue or loss for certain financial instruments in respect of changes in fair value.

B. Covered persons

The new IFRS fair value system will be required for covered persons (as opposed to the present elective system). For this purpose, covered persons are persons that are:

- Regulated by the Banks Act, 1990 (Act 94 of 1990) (e.g. local banks and local branches of foreign banks); and
- Authorised members of the JSE (i.e. authorised users) if those members are companies.

C. Annual fair value taxation

Covered persons will be required to directly include in taxable income or loss most of the fair value measurements of IFRS that arise during the same year of assessment. More specifically, covered persons must include in taxable income the aggregate amount of all changes in value that are recognised through profit and loss in respect of financial assets and liabilities as defined and measured by IFRS. However, the following changes in value amounts from the list below will not be taken into account under this new mark-to-market system:

- A share not held for trading;
- An endowment policy;
- an interest held in a collective investment scheme, and
- an interest in a trust.

The above exceptions do not apply if the asset at issue is hedged (because the hedged item is accounted for under the mark-to-market system). The purpose of these exclusions is to prevent liquidity concerns.

Financial assets and liabilities taken into account under the mark-to-market system will not be taken into account as trading stock, as capital assets or in respect of other collateral provisions (so to prevent double counting).

The net effect of this proposal is to shift a large segment of financial assets and liabilities into annual mark-to-market taxation, including certain assets and liabilities viewed as derivatives. On the other hand, it should be noted that many financial assets and liabilities remain outside the IFRS fair value system. (For instance, certain financial instruments are specifically excluded under IFRS, such as group investments, employee share schemes and financial leases).

D. Instruments between consolidated group members

While the new system represents a significant leap forward in terms of SARS enforcement or taxpayer compliance, the new mark-to-market system could potentially be misused to cause tax mismatches. This possibility exists because the majority of taxpayers remain outside the new system. This potential for mismatch is greatest within a consolidated group (multiple legal entities operating as a single economic unit).

In order to protect the fiscus, certain unhedged derivative contracts with consolidated members will fall outside the new mark-to-market system. More specifically, the mark-to-market regime will not apply to a covered person if:

- The financial instrument is a derivative as defined in IFRS
- The counter-party to the derivative is another member of the same consolidated group under IFRS;
- The counter-party is not subject to the proposed mark-to-market regime; and
- The derivative is unhedged by the bank or broker.

Note: For this purpose, the term hedge is broader than the designated hedge rules of IFRS (because parties often indirectly hedge for IFRS purposes by accounting for both the derivative and the other financial instrument at fair value for profit and loss). Instead, the term “hedge” has its ordinary meaning (e.g. a financial instrument that protects against adverse price movements or significantly limits exposures to other risks).

E. Transitional year

Covered persons falling under the new system will be required to shift their method of taxing financial assets and financial liabilities from a trading stock/capital gain approach to an IFRS approach. This shift is made more complicated by the fact that many covered persons have already moved partially into this system for tax purposes (while others remain steadfastly within the realisation system for tax purposes).

In order to accomplish this shift with minimal disruption, it is proposed that covered persons perform a transitional calculation at the end of the year of assessment immediately before the new system goes into effect. Under this transitional calculation, taxpayers entering the new system will have to determine the net value of all financial assets and liabilities subject to fair value reporting as determined above. This aggregate amount will then be compared against the tax cost of all trading stock or capital assets within the financial assets category, reduced by the face value of all financial liabilities.

The above difference between the net IFRS balance sheet calculation and the net tax balance sheet calculation will then be added in, or subtracted from, taxable income. Because these amounts may be large enough so as to create cash-flow problems, the net difference will be added to, or subtracted from, taxable income at a 25 per cent rate over a four year period.

IV. Effective date

The proposed amendment generally applies in respect of years of assessment commencing on or after 1 January 2014. However, the transitional rule will apply at the close of the 2013 year of assessment.

3.2. CAPITAL GAIN/LOSS MARK-TO-MARKET EVENT FOR LONG-TERM INSURER POLICYHOLDER FUNDS

[Applicable provisions: 29B; paragraphs 32(3), (3A) and (3B); 42(1) and (4) of the Eight Schedule]

I. Background

Long-term insurers have four tax funds – one fund that is deemed to be for the benefit of shareholders (known as the corporate fund) and three sets of policyholder funds – the individual policyholder fund, the company policyholder fund and the untaxed policyholder fund. Each fund is largely viewed as a separate taxpayer (this implies that an insurer calculates tax as if the insurer consists of four separate entities). The corporate (shareholder) fund is taxed at a 28 per cent rate like any other company. The individual policyholder fund is subject to a 30 per cent rate, and the company policyholder fund is subject to a 28 per cent rate. The untaxed policyholder fund is wholly exempt. The purpose of the four fund system is for long-term insurers to act as trustees for policyholder investments when determining and collecting income tax in respect of policyholder investments.

Capital gains tax rates are being increased for all taxpayers from 2012 onward. In terms of the individual policyholder funds, the effective capital gains tax rate will increase from 7.5 per cent (i.e. the pre-existing 25 per cent inclusion rate as applied to a tax rate of 30 per cent) to 10 per cent (the new 33.3 per cent inclusion rate as applied to a tax rate of 30 per cent). In terms of the company policyholder funds, the effective capital gains tax rate will increase from 14 per cent (the pre-existing 50 per cent inclusion rate as applied to a tax rate of 28 per cent) to 18.6 per cent (the new 66.6 per cent inclusion rate as applied to a tax rate of 28 per cent). Untaxed policyholder funds remain fully exempt.

II. Reasons for change

A. Realised versus unrealised insurer tax allocations

Income taxation of gains largely applies according to a realisation principle, meaning that gains from asset appreciation are largely taxed (as trading stock or as capital gains) when taxpayers sell or otherwise dispose of investments (with some additional triggers for deemed disposals). The purpose of the realisation principle is to ensure that tax largely applies when cash proceeds are available to pay tax and to avoid the imposition of tax on notional values (which often lack certainty and precision).

As "tax" trustees of policyholder investments, insurers must not only collect income tax in respect of policyholder investments, but insurers must also properly allocate this tax against each policyholder's allocable investments. Insurers achieve this allocation by applying a continual mark-to-market (i.e. a deemed sale and repurchase) approach in respect of investment gains and losses. Under this approach, insurers subtract notional tax from the gain or loss policyholder investments on a continual basis. This notional subtraction means that each policyholder is indirectly taxed on each policyholder's allocable growth without regard to other policyholder interests. Insurers set aside these notional taxes for future payment to SARS via deferred tax reserves.

B. Recent capital gains tax increase

Any change in effective capital gains tax rates for policyholder funds creates complications for insurers as trustees. In particular, if higher rates apply only from a later date, the policyholders notionally affected by the disposal of assets bears the rate of increase not only for the period of that policyholder's notional ownership but also in respect of all prior periods of notional ownership by other policyholders. This problem arises because increased tax applies pursuant to the realisation principle (thereby applying to all gain associated with the instrument while held by the insurer policyholder fund, regardless of any changes in notional policyholder ownership).

Example
Facts: Long-term Insurer purchases Share X for the benefit of Individual Policyholder A on 15 June 2011 at the price of R100. On 20 February 2012, notional ownership of Share X switches from Individual policyholder A whose policy matures to individual Policyholder B when the value of share X is R200. Long-term insurer sells Share X for the benefit of Individual Policyholder B on 10 August 2012 when the value of Share X is R250.

Result: Long-term insurer allocates R92.50 of post-tax gain to Individual Policyholder A on 20 February 2012. This gain is based on the R100 unrealised gain in respect of Share X less reserving of R7.50 for the Capital Gains Tax (i.e. effective rate of 7.5 per cent on the notional gain of R100). Long-term insurer allocates R45 of post-tax gain to Policyholder B on 10 August 2012 (R50 realised gain less the capital gains tax of R5), less a further capital gains tax charge of R2.50 (2.5 per cent on the initial R100 gain which is realised on 10 August 2012).

In essence, because the effective capital gains tax rate is increasing from 7.5 per cent to 10 per cent by the date of disposal, an additional 2.5 per cent charge is due in respect of the R100 prior notional capital gain allocated to individual Policyholder A as shown in the Example. However, this amount cannot be properly charged against Individual Policyholder A as a practical because Individual Policyholder A no longer has any notional connection to Share X. Therefore, the additional 2.5 per cent charge will ultimately have to be borne by Individual Policyholder B because Individual Policyholder B is the only remaining policyholder that is notionally connected to Share X at the time of disposal.

III. Proposal

A. General capital mark-to-market system

In order to ensure subsequent policyholders do not unfairly bear the burden of pre-1 March 2012 capital gains, a mark-to-market event is proposed to lock-in all gains before the capital gains rate increase. Long-term insurers will be required to immediately recognise all unrealised gains and losses arising before the 1 March 2012 effective date in respect of policyholder funds. This recognition will be deemed to have occurred at the close of 29 February 2012. This deemed recognition of pre-1 March 2012 gains and losses is important from a policyholder point of view because this deemed recognition ensures that pre-1 March 2012 capital appreciation will only be taxed at the historic 7.5 per cent. The new higher inclusion capital gain tax rate of 10 per cent will apply only in respect of post-effective date value changes arising from 1 March 2012.

The above capital mark-to-market system will apply to all assets except to the following:

- A debt instrument (i.e. an instrument as defined in section 24J (1));
- An interest rate swap (i.e. an interest rate agreement as defined in section 24 K (1));

- An asset that is calculated with respect to a debt instrument or an interest rate swap (e.g. a derivative in respect of these assets);

- Trading stock; or

- A policy of reinsurance.

Trading stock is exempt because the rates of tax for trading stock remain unchanged. Debt instruments and interest rate swaps (as well as derivatives thereon) are outside the system because these capital gain amounts are largely insignificant. Policies of reinsurance have never been taxed as such and are accordingly outside the system. Domestic policies of reinsurance are not an issue because the underlying assets will be subject to tax under the mark-to-market system in the hands of the domestic reinsurer. However, foreign policies of long-term reinsurance are an issue because these instruments have not historically been subject to appropriate levels of tax. Taxation of these policies will be revisited in 2013.

Assets that are offered by an insurer who has been issued with the certificate from Financial Services Board (FSB) to act as a Category III Financial Services Provider fall outside this mark-to-market event if part of the Category III license. These assets operate differently from other assets held by long-term insurer policyholder funds. Assets of this nature a closely connected to the policyholder so gains and losses associated with these assets (e.g. typically units in a collective investment scheme in securities or property) are connected to the policyholder with the policyholder fully bearing gain or loss upon disposal of the underlying asset. Nationality does not exist under this system so no reason exists to force a mark-to-market event (not even netting by an insurer is permitted).

It should also be noted that the deemed mark-to-market event will not give rise to any recoupment of prior allowances. Hence, real estate assets will not be subject to a recoupment of prior depreciation allowances. However, as a trade-off, no depreciation allowances will be allowed for these assets going forward.

B. Liquidity relief

The 29 February capital mark-to-market event of taxation for policyholder funds will undoubtedly create liquidity pressures on long-term insurers. In order to alleviate these liquidity pressures, all mark-to-market capital gains and losses will be spread equally over four years of assessment (at the pre-1 March 2012 capital gain rate). This spreading means that pre-1 March 2012 capital gain or loss stemming from the initial shift to the mark-to-market approach will be spread equally over a four year period beginning in the year of assessment ending in 2012 (and ending in 2015).

C. Weighted average method

To the extent that the above financial instrument assets are of a capital nature and taken into account under the 2012 mark-to-market event, these policyholder capital assets must henceforth be accounted for on the basis of weighted averages (as opposed to specific identification) if identical in nature. The weighted average method for identical assets is more in sync with financial accounting and more properly neutralises gain or loss associated with specific notional interests held by specific policyholders. Assets already under the weighted average system via the pre-existing election for weighted average will remain under weighted average (even if not subject to the 2012 mark-to-market event).

D. Impact of the proposed changes on collateral rules

- Capital clogged losses between connected persons: The capital clogged loss rules (of paragraph 39 of the Eighth Schedule) do not apply to the 2012 mark-to-market event because the disposal is deemed performed by and acquired by the same person. Paragraph 39 applies only to connected person disposals.

- Three-holding period for shares: Shares held for three years are generally eligible for capital gain treatment (see section 9C). The 2012 mark-to-market event does not adversely impact this three-year holding period because the assets still remain in the hands of the same policyholder fund (i.e. the same owner).

- Anti-capital loss rules for 45 sale/repurchases: Taxpayers are denied a capital loss in respect of identical financial instruments sold and repurchased within 45 days. These anti-loss rules prevent taxpayers from artificially realising a loss without any overall economic change in position. These anti-loss rules will be specifically excluded from the 2012 mark-to-market event because this event was wholly outside the control of the parties involved. In addition, the 45-day sale/repurchase rules will be removed from ambit of policyholder assets operating under the (elective or mandatory) weighted average method because the weighted average method is not conducive to the avoidance of concern.

IV. Effective dates

The new rates for capital gains affecting the capital mark-to-market taxation regime will apply in respect of disposals/reacquisitions occurring from 1 March 2012. The proposed mark-to-market event will be deemed to occur on 29 February 2012. The changes in respect of the weighted average method of determining identical assets will take effect from 29 February 2012.

3.3. REVISED DEDUCTION FORMULA FOR TAXABLE INSURER POLICYHOLDER FUNDS

[Key applicable provisions: 29A]

I. Background

Under general tax principles, taxpayers can only deduct expenses allocable against the production of income. Hence, expenses directly allocable against interest, rent and trading stock are fully deductible. However, expenses allocable against capital gains and dividends are generally not.

Tracing of expenses to income is more complicated in the case of individual and company policyholder funds. Expenses and allowances directly attributable against ordinary revenue are fully deductible (other than selling and administration expenses). On the other hand, selling, administration and indirect expenses are deductible in accordance with a separate formula for each of the individual and company policyholder funds. The policyholder formula seeks to pro rate these expenses based on overall net revenue versus total net proceeds with many of the numbers indirectly assuming a level of non-deductible expenses attributable to deferred and realised capital gains.

II. Reasons for change

The deduction formula for indirect expenses allocated to policyholder funds is complex. Much of the complexity stems from the fact that the formula had to account for unrealised gains (especially gains relating to the pre-2001 capital gain tax system effective date) by way numerical assumptions. Many of these numerical assumptions depart from reality. However, with the advent of the 2012 mark-to-market event, most of the reasons for this complexity disappear.

III. Proposal

A. Simplification of the deduction formula

With the advent of mark-to-market taxation for policyholder funds, a wholly revised deduction formula can be proposed for selling, administration and indirect expenses. More specifically, both the company and individual policyholder funds will be allowed deductions for selling, administration and indirect expenses on the basis of the following formula:

$$\frac{\text{taxable income}}{\text{net economic income}}$$

For purposes of the numerator, the concept of "taxable income" means taxable income determined before taking into account selling, administration and indirect expenses that require allocation in this formula. For purposes of the denominator, the concept of "net economic income" is intended to reflect total taxable income without a reduction of non-includible dividends, foreign dividends and capital gains. More specifically, the term has the same starting point as "taxable income" with the following additions: (i) domestic and foreign dividends received (e.g. dividends less any domestic and foreign withholding taxes), and (ii) the portion of capital gain determined without regard to the partial exclusions (of 33.3 per cent and 66.6 per cent).

B. Deemed transfers from policyholder funds to the corporate (shareholder) fund

Under current law, if the market value of assets in an individual or company policyholder fund exceeds total liabilities associated with that fund, the fund obtains a deduction for that excess. Under current law, this deduction for the excess equals the value of the excess multiplied by the deduction formula ratio multiplied by 50 per cent. As a practical matter, the total amount for most insurers generally falls around 15 per cent of the excess.

Because the revised formula is more generous than the current formula, the 50 per cent factor is being reduced to 30 per cent. This change is designed to ensure that the excess percentage remains at the current 15 per cent effective level.

IV. Effective date

The revised four fund deduction formula for each of the individual and company policyholder funds will apply in respect of years of assessment commencing from 1 January 2013. The reduction to the 30 per cent level for excess assets will also apply from the same effective date.

3.4. CREATION OF A UNIFIED SYSTEM FOR TAXING REAL ESTATE INVESTMENT VEHICLES

[Applicable provisions: sections “REIT” definition and 25BB]

I. Background

A. Role of property investment schemes

Property investors have a choice of directly investing in immovable properties for the rental stream or indirectly achieving rental streams through (immovable) property investment vehicles. At an investor level, property investment vehicles provide a balance between bonds and shares. A steady rental stream acts as a substitute for interest income and the growth in the underlying property operates as a relatively stable method of achieving appreciation that substitutes for share growth. Unlike direct property investment, ownership in property investment vehicles is highly liquid. Meanwhile, like direct property investment, the steady rental stream allows for gearing (i.e. borrowing) – a feature not available for typical share investments.

Internationally, property investment vehicles of this nature are commonly referred to as Real Estate Investment Trusts (REITs). REITs can be in the form of companies or trusts and tend to be more regulated than standard companies engaged in property management and development.

- One common feature of a REIT is the requirement to make annual distributions, typically ranging from 70 to 90 per cent of total profits. This required distribution feature again differs from the standard company, which distributes dividends only upon director/shareholder declaration. The minimum distribution requirement is an essential guarantee that allows for investors to obtain the unique gearing desired. The minimum distribution requirement also allows for the REIT to act as a form of retirement vehicle because the yield can act as a steady annuity stream without undermining the underlying capital.

- A second feature of the REIT is the long-term nature of the property investments because the REIT holds property for rental income and capital growth.

- As a general matter, the REIT is largely invested in commercial and industrial property but can invest in residential property. In South Africa, property investment schemes have exclusively invested in commercial and industrial property, but interest exists to expand into certain forms of residential.

In South Africa, two main types of property investment vehicles exist that operate in the same space as an international REIT – the Property Unit Trust (PUT) and Property Loan Stock (PLS). The PUT is regulated on an on-going basis by the Financial Services Board, having been the traditional stakeholder in the property investment scheme space. The PLS, the newer entrant, is regulated by the Companies Act. Both sets of property investment schemes are listed on the JSE so as to provide the required liquidity for investors. PUTs and PLSs are therefore also regulated by JSE rules. At present, there are over 20 listed entities operating as a PLS and under 10 listed entities operating as a PUT.

B. Regulation and taxation of PUTs

1. FSB regulation

A PUT is a portfolio of investment grade properties that is held in the form of a trust and is managed by an external company. The overall arrangement is a regulated arrangement, known as a property investment scheme approved by the FSB in terms of Collective Investment Schemes Control Act. Many of the rules associated with property investments of this nature are designed to be akin to collective investment schemes in securities.

The PUT is governed by a trust deed with the FSB providing a model as a pre-packaged format. Investors in a PUT hold units in the trust that operate as equity ownership. The trustee provides fiduciary responsibility and the external company manager makes the investment decisions. Operational oversight of the properties is either directly performed by the external company or through the hiring of separate property administrators. The investors in PUTs do not have any voting rights. External management of a PUT can only be altered with the assistance of the FSB.

The PUT typically derives the bulk of its income from the rental of immovable property. As a regulatory matter, the FSB limits PUT investments to the following categories:

- Specified immovable property assets (e.g. buildings, land and leaseholds);
- Shares in property companies; and
- Liquid debt-related investments.

2. Income taxation

The PUT falls within a unique tax regime that allows for the PUT to be effectively treated as a tax conduit. PUT distributions are treated as ordinary revenue in the hands of investors. Unlike companies, the net effect is to tax the rental income at only one level.

PUTs also have the advantage of being free from any capital gains tax. Investors only pay capital gains tax when investors dispose of their units. On the other hand, one disadvantage of this regime is that the PUT is unable to benefit from the reorganisation rollover rules because the PUT operates as a trust.

C. Property Loan Stock (PLS)

1. Contractual terms

As a practical matter, the PLS is a company that is not regulated by the FSB. The PLS is simply regulated by the Companies Act and the listing requirements of the JSE. Unlike the PUT, the PLS is internally managed. The unique feature of the PLS is the dual-linked nature of the units held by investors. In this dual-linked structure, the investor holds a share and a debenture with 99 per cent of the value attributable to the debenture.

The terms of the debenture are controlled by the debenture trust deed. The debenture trust deed typically requires regular interest payments from the company (quarterly, semi-annually or annually). These interest payments are available only to the extent of PLS company profits. It should also be noted that the debenture is not redeemable.

2. Income tax

As a PLS is a registered company, the PLS is liable to pay tax at the standard company income tax rate of 28 per cent and the capital gains tax rate of 18.6 per cent. If form fully governs, the debenture generates regular interest payments. This interest arguably gives rise to annual interest deductions for the company and annual interest income for the investors. Because most entities that qualify as a PLS company distribute most or all of their profits in the form of interest, these interest deductions typically leave the PLS with little or no taxable income. This distribution system roughly reflects the conduit system allowed for PUTs.

II. Reasons for change

A. Uneven regulation

Although both the PUT and the PLS are subject to the same listing requirements for purposes of the JSE, only the PUT is subject to FSB regulation. This additional regulation potentially reduces the flexibility of a PUT, whereas, the PLS faces none of these direct restrictions. On the other hand, the PLS lacks the certainty of regulatory formalisation.

At a policy-level, the emergence of the PLS as the dominant form of (immovable) property investment vehicle raises the question whether a modernised set of financial rules is required to govern this sector overall. More specifically, the rules need to be updated based on experience while ensuring that this property investment vehicle operates within its classical paradigm – a relatively steady bond-like yield along with capital growth.

B. Tax legitimacy of the PLS

While the dual-linked share/debenture structure of the PLS arguably gives rise to tax-deductible interest, the excessive level of the interest (along with the profit-like yield) makes this form of interest questionable in tax terms. Even if these debentures are viewed as interest at an interpretation level, ongoing acceptance of this dual-linked structure is problematic at a policy level. In particular, the dual-linked structure calls into question substance-over-form principles. The debenture element of the dual-linked structure effectively mimics an equity yield in all but name. To accept this practice is to essentially abdicate the question of debt versus equity (and perhaps the two-tier company tax system altogether). Hence, the yield in respect of these debentures must be viewed as dividends as a tax policy matter.

III. Proposal

In view of the above, a unified approach will be adopted for property investment schemes. The new entity will be called a Real Estate Investment Trusts (REIT) in line with the international norms (encompassing both the PUT and PLS regimes). The objective of the REIT is to provide investors with a steady rental stream while also providing capital growth stemming from the underlying property.

If a REIT falls within the new regime, the flow-through principle will apply. Income and capital gains will normally be taxed solely in the hands of the investor and not in the hands of the REIT.

A. Entry criteria for REIT

In order to qualify as a REIT for tax purposes, the entity must be a resident and its securities must be a listed on the JSE as securities in a REIT. The JSE is currently amending its listing requirements to create a category for the listing of REIT securities. These rules will apply equally to the PLS and to the PUT. The REIT tax regime will treat a PUT as a company (thereby placing the PUT on the same footing as the PLS).

B. REIT distributions

1. Entity-level deduction for REIT distributions

The main benefit of a REIT is that a REIT may claim a deduction in respect of distributions to investors. The deduction may only be claimed if the distribution is a “qualifying distribution (i.e. more than 75 per cent of the gross income of the REIT consists of rental income or income from certain property entities described below). The REIT may claim deductions in respect of amounts:

- declared by the REIT as dividends (other than in respect of share buy-backs) to its shareholders; and
- incurred by it as interest on the debenture portion of a linked unit issued to shareholders (if applicable),

during the year of assessment. In the case of a pre-existing company, the 75 per cent test is measured during the preceding year of assessment (i.e. the year before the declaration or incurral). In the case of a newly formed company, the 75 per cent test is measured with reference to the current year (i.e. the year of declaration or incurral) up until the date of the declaration/incurral.

The aggregate amount of the distribution deduction is limited to the REIT's taxable income for the year of assessment before: (i) the inclusion of taxable capital gain, and (ii) the distribution deduction are taken into account. Therefore, a REIT cannot create an assessed loss by virtue of a distribution deduction nor can deductible distributions be fully derived from capital gains.

Example 1
Facts: REIT X's gross income in its first year of assessment is R10 million. Of this amount, R7.6 million of the gross income consists of rental income. REIT X's taxable income before the distribution deduction and the inclusion of any taxable capital gain is R8 million. It declares a dividend of R8 million at the close of the year.

Result: In its first year of assessment, REIT X may claim a R8 million distribution deduction. The 75 per cent test is met before the distribution is declared.

Example 2
Facts: The facts are the same as Example 2. In its second year of assessment, REIT X's gross income is R12 million. Of this amount, R7 million constitutes rental income. The REIT X's taxable income before the distribution deduction and inclusion of taxable capital gain is R9 million. REIT X declares dividends of R12 million.

Result: In its second year of assessment, REIT X may again declare a dividend because the 75 per cent test was satisfied in the prior year. However, the deduction is limited to R9 million because pre-capital gain/distribution income is limited to R9 million.

Example 3
Facts: The facts are the same as Examples 1 and 2. In its third year of assessment, REIT X's gross income is R10 million. Of this amount, R8 million constitutes rental income. The REIT X's taxable income before the distribution deduction and inclusion of taxable capital gain is R9 million. REIT X declares dividends of R10 million.

Result: In its third year of assessment, the REIT will not be allowed to claim a distribution deduction. This distribution deduction is disallowed because the 75 per cent test was not met in the prior year (i.e. only R7 million out of R12 million consisted of rental income).

2. Shareholder-level impact of REIT distributions

   a. Resident shareholders

Dividends distributed by a REIT to its resident shareholders are subject to normal tax (and exempt from dividends tax) regardless of whether the REIT makes qualifying distributions during the year of assessment. Ordinary treatment applies to any resident shareholder regardless of whether the shareholder is a company, trust or natural person. Interest forming part of a dual-linked unit are treated in similar fashion.

b. Foreign shareholders

Going forward, dividends distributed to foreign shareholders of a REIT will be subject to dividends tax (i.e. are not treated as ordinary revenue). This treatment also applies to deemed dividends from dual-linked units (i.e interest on debentures forming part of a linked unit). However, this treatment will be deferred until 1 January 2014 to allow various parties (including intermediaries such as central securities depository participants) to adjust their systems. In the meantime, all payments of this nature paid to foreign persons will be exempt. (Note: Because most of the current yield of a PLS is in the form of interest, the amounts paid are already largely exempt in the hands of foreign shareholders so the proposed transition merely extends the current exemption for another year.)

C. Controlled property companies and associated property companies

The tax dispensation under the REIT regime will also apply to controlled property companies. A controlled property company is a company that is a subsidiary of a REIT. For this purpose, subsidiary status is an IFRS definition, not a tax definition. Hence, a subsidiary can include a controlled trust. Lastly, control is an IFRS concept – not a tax concept (IFRS generally requires practical control with the default favouring a more than 50 per cent voting interest).

Hence, a controlled property, like a REIT, can make deductible distributions of the 75 per cent rental test is satisfied. Moreover, if a REIT receives a qualifying distribution from a controlled property company, the distribution can be treated as rental income (note: a controlled property company can also treat a qualifying distribution from another controlled property company as rental income).

A second category of property company is an associated property company. An associated property company is a company that is at least 20-per cent owned by a REIT or a controlled property company. Although this entity is not entitled to deduct distributions, any distributions received by a REIT (or a controlled property company) from an associated property company can qualify as a rental income if the distribution is a qualifying distribution (i.e. from an associated property company satisfying the 75-per cent rental test).

D. Other provisions applicable to REIT-level taxation

1. CGT relief for property interests

Capital gains or losses determined in respect of the disposal by a REIT or a controlled property company of:

- immovable property;
- a share in a REIT; and
- a share in a controlled property company (but not other shares even shares of an associated property entity),

will not be taken into account when determining the aggregate capital gain or loss of that company. This exemption has the same impact as the capital gains rules for collective investment schemes. Capital gains is largely exempt at the entity-level with only the only of units being charged with capital gains tax when disposing of units.

2. Other financial instrument holdings

Any amount received or accrued during a year of assessment by a REIT in respect of a financial instrument (other than a share in a REIT, a controlled property company or an associated property company) is deemed to be not of a capital nature and must be included in the income of the REIT. In effect, this ordinary treatment applies to both the disposal and the yield. The purpose of this ordinary treatment is to deter REITs from holding other forms of investments (e.g. portfolio shares), thereby coming into conflict with the mandate of a collective investment in securities.

Example
Fact: REIT holds shares in a mining company. REIT receives dividends from a mining company and sells the shares in the mining company after 10 years.

Result: The dividends distributed to the REIT will be income in its hands, and not a dividend (which is exempt from normal tax in the hands of a typical company shareholder). The REIT will also be subject to normal tax (and not capital gains tax) on when disposing of the mining company shares.

3. Building allowances not allowed

REITs may not claim deductions depreciation allowances in respect of immovable property (i.e. are disallowed from claiming an allowance in terms of section 11(g), 13, 13bis, 13ter, 13quat, 13quin or 13sex). However, it should be noted that this disallowance prevents recoupments from arising in respect of the sale of immovable property (meaning that the sale of immovable property gives rise to exempt capital gains).

E. Transitional rules

It should be noted that no entry charge tax will be payable if an entity becomes a REIT. In addition to that, roll-over relief will apply if a property linked unit is converted to equity shares (see the Notes on SHARE-FOR-SHARE RECAPITALISATIONS).

F. Exemption from Securities Transfer Tax

The acquisition of shares in a REIT will be exempt from Securities Transfer Tax. The relief matches the relief for acquisitions in a collective investment in securities.

IV. Effective date

The proposed amendment comes into effect in respect of years of assessment commencing on or after 1 April 2013.

3.5. ENHANCED REGULATORY/TAX CO-ORDINATION IN RESPECT OF SHORT-TERM INSURANCE BUSINESS

[Applicable provision: Sections 1 "gross income", section 11(a) and 28(2) and (3)]

I. Background

A. Required regulatory reserves

The Financial Services Board (FSB) informally breaks short-term insurance into the following categories: property, transportation, motor, accident and health, guarantees, liability, engineering and miscellaneous. Short-term insurers provide these forms of insurance to the public by assuming risk in return for premiums. Premiums are generally paid monthly or annually (and are sometimes funded with upfront pre-payments).

Short-term insurers are highly regulated by the FSB so that the public has certainty that actual funds are in reserve to pay claims. More specifically, short-term insurers are required to maintain their business in a financially sound condition by having assets, providing for liabilities and generally conducting business so as to be in a position to meet their liabilities at all times (see section 28 of the Short-Term Insurance Act, 1998 (Act No. 53 of 1998) ("Short-Term Insurance Act"). Required provision for liabilities explicitly includes (see section 32 of the Short-Term Insurance Act):

1. <u>Outstanding claims (OCR) and incurred but not reported (IBNR) reserves</u>: These liabilities relate to all claims incurred (but not yet paid) before the insurer valuation date (regardless of whether the amount has been fully determined or whether the claim has been reported). These claims generally fall into two broad categories: (i) OCR - claims incurred and reported but not yet paid (event known but amount estimated), and (ii) IBNR – estimated claims incurred but not reported (event estimated and amount estimated). These two categories are set to be combined into a single "claims reserve" (CR) as part of the SAM process.

   These reserves are reduced by the amount by which the insurer estimates will be paid in respect of those claims under approved reinsurance policies. An approved reinsurer is a South African insurer or a foreign insurer that has South African funds available dedicated to cover insurance risk. Estimated payments from unapproved reinsurance are not taken into account to reduce the OCR and IBNR.
   .
2. <u>Unearned premium provision (UPP):</u> These reserves relate to the matching of premiums accrued that relate to claim protection beyond the financial year. More specifically, the amounts involve estimated future payments arising from future events under existing policies where the future extends beyond the financial year. For instance, if a short-term insurer receives premiums upfront for a one-year contract, the premiums less certain deductions allowed, both which relate to any portion of the year beyond the short-term insurer's financial year, must be placed in

the UPP. The UPP is calculated by reducing the gross premiums in respect of a policy for the full-term of the policy with refunds of premiums, amounts payable under approved reinsurance policies and deferred acquisition costs (the DAC) and by spreading these amounts over the period of the policy. The DAC represents commissions and other administration costs payable by a reinsurer. A reserve for cash-back bonuses is added to the UPP.

3. <u>Unexpired risk provision:</u> These reserves are meant to defray net underwriting losses that may arise in future from unexpired risks. This provision arises when it is expected that claims in respect of future financial years relating to a policy will exceed future premiums.

Funds set aside to satisfy regulatory reserve requirements are not freely usable. These funds must be maintained in the form of money-market deposits or other forms of near-cash investments. These limitations effectively limit the short-term insurer's profit potential for reserved assets.

B. Tax Implications

Although most taxpayers are not allowed to deduct reserves, specific rules exist that allow short-term insurers to do otherwise (i.e. section 28). Unlike most taxpayers, the reserves of short-term insurers are strictly regulated in terms of amount and use (and are dedicated to protect public clients). These deviations are the justification for allowing short-term insurers to deduct their reserves.

The tax rules associated with short-term insurers are partially aligned with the system of regulatory reserves. The tax rules specifically allow short-term insurers to deduct the OCR, IBNR and the UPP (being linked to section 32 of the Short-Term Insurance Act). However, SARS has the authority to make tax adjustments to these calculations.

Other aspects of the regulatory reserving system are largely determined based on general principles (e.g. the treatment of premiums as gross income, the payment of claims as deductions under the general deduction formula and the recovery of salvages and third party recoveries as gross income). The treatment of reinsurance appears to be covered under both the specific rules for reserves as well as general principles.

II. Reasons for change

The FSB is currently developing the Solvency Assessment and Management (SAM) framework for insurers. This framework is a risk-based supervisory regime for prudential regulation of both long-term and short-term insurers. These rules represent a partial shift away from a pure "prudential" approach that tended to emphasize reserves with a higher margin of safety. The solvency regime also requires the insurer to invest in a manner that is appropriate to the nature of its liabilities. The imposition of SAM has triggered a review of the entire reserve system for short-term insurers. This revised reserving system will have an impact on the tax calculation.

While co-ordination between the tax and regulatory regimes currently exists as noted above, concerns have long-existed that this co-ordination is incomplete. Financial regulation has historically tended to favour a level of over-reserving (i.e. reserves determined on a prudential basis) to provide a margin of safety; whereas, tax enforcement has expressed concerns about over-reserving because excessive reserves mean excessive deductions (at least in present value terms). With the SAM process, however, improved convergence is expected because SAM favours accuracy as opposed to over-reserving on a prudential basis.

A final issue of on-going concern is the discretionary authority held by SARS to disallow reserves. The wholly discretionary nature of this disallowance creates uncertainty for taxpayers. Differences in tax reserves versus regulatory reserves also undermine the regulatory process, especially when the grounds for deviation are not explicitly prescribed upfront. While it is understood that regulatory and tax perspectives have different considerations, deviations between the two regimes should be made explicit at the policy level. The current unfettered discretion creates difficulties both for taxpayers and SARS alike.

III. Proposal

A. Overview

In view of the above, a new tax regime is proposed for short-term insurers. In the main, the tax system will use the regulatory regime as a starting point for calculations so that the tax computation can largely be derived from the regulatory computation. The convergence of the two calculations will greatly simplify compliance and enforcement. The proposed tax rules will also better co-ordinate the specific reserving system and the general tax principles of gross income and deduction.

The current SARS discretion to make adjustments to reserves will be eliminated. Tax deviations will be made explicit via legislation; otherwise, the tax computation will match the regulatory computation. This revised approach for deviations will not only create more certainty but will also ensure that deviations between the regulatory and tax regimes will be made explicit at the policy level.

B. Basic tax computations of non-reserve items (subsection (2) refers)

Regulatory gross premiums will serve as the starting point because these premiums are the basis in which regulatory reserves are calculated. Short-term insurers will include premiums within gross income solely on the basis as those premiums are included as gross premiums for regulatory purposes.

1. Advanced premiums

For regulatory purposes advanced premiums are not included in gross premiums. Advanced premiums typically arise when premiums are received by an insurer before the date of commencement of the risk cover under the policy. In terms of general tax principles an amount must be included in gross income when it is received or when it accrues. Under the revised tax approach, advanced premium receipts will be ignored for tax purposes (as a form of book entry debt) and will only be included in the insurer’s gross income on the date of commencement of the risk cover under the policy.

2. Deductions for refunds of premiums

For regulatory purposes, a premium which has been refunded by an insurer during the financial year in which it was received or accrued to the insurer is treated by some insurers as a reversal of gross premium income. Others include the premium in gross premiums and claim the refund of the premium under the general deduction formula. Under the revised tax approach, amounts of expenditure actually incurred by an insurer in respect of a refund of a premium may only be deducted to the extent that the amount of the premium was included in short-term insurer's gross income.

3. Exclusion of sections 23(c) and 23H

Section 23(c), which *inter alia* disallows deductions recoverable under contracts of insurance, does not apply to short-term insurers in respect of policies issued or reinsurance policies entered into. Section 23H, which match the time of a deduction with the period of the benefit, will also not apply (because the new regime has its own timing rules).

4. Amounts of claims only deductible when paid

Under the reserve regime (see below), an insurer can deduct a provision in respect of outstanding claims, known as the OCR and IBNR. To prevent a double deduction for claims incurred, the insurer may only deduct expenses under the general deduction formula in respect of claims only when the expenses are actually paid (not merely when incurred).

5. Amounts recoverable in respect of claims

For practical reasons, amounts recoverable by an insurer via rights of subrogation will be included in the gross income of the insurer on the basis of actual receipts. Amounts recoverable by the insurer include salvages of damaged property, recoveries from unrelated third parties associated with the insured event and amounts reimbursed by a reinsurer.

C. Deviations from reserve regulation

The tax system will continue to allow deductions in respect of OCR, IBNR and UPP, but the tax system will contain deviations from the regulatory reserve regime. However, these deviations will be limited and explicitly stated (i.e. the overall system will no longer be subject to a SARS discretionary adjustment). At this stage, the following deviations have been identified: (i) unapproved reinsurance, (ii) unexpired risk reserve cash-back bonuses, and (iii) the unexpired risk reserve .

1. Unapproved reinsurers

Short-term insurers cannot rely upon unapproved reinsurers as part of their reserves for regulatory purposes. Therefore, the UPP, OCR and IBNR of a short-term insurer utilising an unapproved reinsurer is calculated as if the unapproved reinsurance did not exist. The current tax system, on the other hand, appears to be allowing a deduction for reinsurance premiums in respect of an unapproved reinsurance policy without reducing the amount allowed under the OCR with estimated claims payments under such a policy. The net result is an elevated level of deductions. It is accordingly proposed that short-term insurers for tax purposes take into account estimated reinsurance pay-outs under the UPP, OCR and IBNR regardless of whether the reinsurer were approved or not.

2. Cash-back bonuses

Cash-back bonuses have long been a source of contention between SARS and short-term insurers. The purpose of the cash-back system is to reward the insured for not making claims (e.g. obtaining a cash-back bonus for not having accidents). From a revenue perspective, two concerns have been raised. Firstly, concerns have existed whether the cash-back system could operate as a disguised form of investment. Secondly, concerns have existed that the level of reserving is too high because the FSB allows for a default formula method that favours prudence over accuracy (Government Gazette, 28 October 2011, No. 34715 (Board Notice 169 of 2011).

As stated in the notes on INVESTMENT CONTRACTS DISGUISED AS SHORT-TERM INSURANCE, the issue of insurance disguised as investment contracts can be addressed more directly than strictly prohibiting cash-backs reserves. In terms of accurate reserving, the SAM process will require a reserve based on the best estimates of the outstanding liability plus a risk margin because accuracy has become more important for regulatory purposes than excessive prudence.

In view of these changes, short-term insurers will be allowed to deduct reserves for cash-back bonuses, especially since the cash-back system is generally driven from a commercial perspective. However, in order to deduct reserves associated with cash-back bonuses, the insurer must have elected out of the formula for FSB purposes in favour of an approach relying on best estimates plus risk margin (currently allowed by the FSB as an alternative to the current formula default). The current default formula approach to reserving will not be taken into account for tax purposes nor can the taxpayer separately seek a “best estimate” reserve for tax and a formula approach for the FSB.

3. Unexpired risk reserve

As under current law, the unexpired risk reserve will not be deductible. The risk reserve essentially seeks to cover net losses anticipated in future financial years in respect of pre-existing insurance contracts. The tax rules have long disregarded premiums and claims in respect of future financial years under a matching principle. On the other hand, the unexpired risk reserve effectively brings forward future net losses as opposed to future net gains. It is understood that the nature of the risk reserve may be revisited as part of the SAM process with both net gains and net losses possibly being brought forward from future years. The policy decision in terms of tax will be revisited depending on the outcome of the SAM process.

D. Annual add-backs

All amounts allowed as deductions in respect of the OCR, IBNR and UPP in a year of assessment will be added back as inclusions for the following year. As with the regulatory system, add-backs are performed annually.

E. Reinsurers

Many insurers rely on reinsurers as a matter of sound business practice. The purpose of reinsurance is to mitigate the potential risks of an insurance business. Reinsurance may be used to cover large but unusual risks or to cover risks that are more efficiently handled by the reinsurer. In terms of the computation, reinsurers raise two sets of considerations - premiums incurred and insurance pay-outs received.

Premiums incurred in respect of the reinsurance may be claimed under the general deduction formula when actually incurred. The provisions of section 23H will not apply to reinsurance premiums which relate to benefits in subsequent year of assessment. Recoveries by insurers from reinsurers will be included in gross income on receipt of payment by the insurer.

IV. Effective date

The proposed amendment will be effective for years of assessment commencing on or after 1 January 2013.

3.6. INVESTMENT CONTRACTS DISGUISED AS SHORT-TERM INSURANCE

[Applicable provision: New section 23L]

I. Background

A. Payment of insurance premiums

Under the general deduction formula, taxpayers can deduct premiums paid or incurred for (risk) insurance if those premiums are incurred in the ordinary course of trade for the production of income. Many businesses can accordingly deduct various forms of insurance premiums.

The deduction for (risk) insurance premiums is to be contrasted with payments for investment products (e.g. endowment policies, bank deposits and debt instruments). The latter are not deductible because the latter generally represent a conversion of cash into investment assets.

B. Required regulatory reserves by short-term insurers

Short-term insurance comes in many forms, including motor, property, guarantees and construction risk cover. Short term insurers assume risk from the insured in return for premiums. Premiums received or accrued by the insurer are included in the insurer's gross income. In the course of business, short-term insurers are required by the regulator (specifically the Financial Services Board (FSB)) to reserve specified amounts of capital to meet potential claims.

II. Reasons for change

Given the fact that capital expenditures are not deductible, taxpayers have an incentive to disguise these expenditures as operating expenses. One means utilised to arguably achieve this objective is to disguise capital investment in the wrapper of short-term (risk) insurance. Admittedly, insurance will only be legally recognised as such if the contract involves a legally insurable interest. However, taxpayers have devised various means that arguably allow for this threshold to be readily breached.

If premium payments are respected as such, the "insured" can often readily claim a deduction for an instrument that essentially operates as an investment. At the insurer level, the insurer is generally allowed to avoid taxable income by setting aside a reserve (which is easy to justify given the required return of funds to the payor as a form of cash-back payment). The effect is a netting of income and reserves that neutralises any tax arising from the premium received (giving rise to growth based on pre-tax income versus post-tax income).

It should also be noted that quasi-insurance premiums create a book/tax disparity. Companies making these payments often treat these payments as made in respect of investment contracts despite the insurance label. The result is a net tax deduction (as outlined above) while book profits are not reduced because the payment merely represents a conversion into an asset (as an investment contract).

The use of short-term insurers as the providers of investment products is also highly questionable as a matter of regulatory policy. Investment products are better regulated through more traditional offerings (e.g. collective investment schemes and long-term insurers). No policy reason exists for the tax system to be used as an indirect means of channeling investment funds into this sector.

III. Proposal

A. IFRS limitation

To remedy the distortions outlined above, contracts labeled as insurance will not be treated as such for income tax purposes if the underlying contract is not viewed as an insurance contract under IFRS standards. For purposes of IFRS,

> *"an insurance contract is one in "which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain event (the insured event) adversely affects the policyholder"* (IFRS 4: Appendix A).

Hence, an insurance contract will be viewed as an investment contract if the short-term insurer fails to accept significant risk from the policyholder. It should be noted that this proposal will apply to wholly domestic transactions and to cross-border transactions (because the concerns in both sets of transactions are the same).

B. Short-term investment policies in the hands of the insurer.

Investment contracts will have no effect on the taxation of short-term insurers or on the insurance reserve system.

C. Impact on policyholders

Policyholders may not deduct premium payments in respect of short-term policy contracts viewed as investment contracts. Upon exit, the policyholder of an investment contract will be subject to tax on ordinary revenue (not capital gains) when receiving or accruing policy benefits less non-deductible premiums in respect of that investment. If receipts of cash-back payments occur in tranches, the policyholder must include in gross income benefits received or accrued by performing an aggregate calculation. Under this aggregate calculation, the policyholder aggregates all amounts received or accrued during the current and prior years, less (i) the aggregate amount of premiums incurred in respect of that policy that were not tax deductible, and (ii) less the aggregate amount of policy benefits that were included in the gross income of the policyholder during previous years of assessment.

Example
Facts: Policyholder pays the following premiums to a short-term insurer pursuant to a policy viewed as an investment policy under IFRS. In 2013, policyholder pays deductible premiums of R200 000. In 2015, Policyholder receives R160 000. In 2016, Policyholder receives R50 000.

Results: In 2015, Policyholder will must include the full R160 000 of benefits as gross income. In 2016, Policyholder must include R50 000 of policy benefits as gross income (R160 000 + R50 000 less R160 000).

IV. Effective date

The proposal will apply in respect of all premiums incurred and policy benefits received or accrued on or after 1 January 2013.

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4. INCOME TAX: BUSINESS (INCENTIVES)

4.1. DEPRECIATION OF SUPPORTING STRUCTURES FOR ENERGY PROJECTS

[Applicable provisions: sections 11(e)(iiA), 12B(1)(h)-(i) and further proviso to section 12C(1)]

I. Background

Machinery and plant relating to electricity generation from wind, sunlight, gravitational water and from biomass (that comprises of organic wastes, landfill or plants) is depreciable. These assets are depreciable over a three-year period at a 50:30:20 per cent rate. The purpose of this regime is to stimulate investment in these assets, thereby encouraging investment in electricity generation projects.

II. Reasons for change

Machinery and plant (such as windmills and solar energy projects) dedicated to electricity generation often require ancillary supporting structures that can be costly in relation to the associated plant and machinery. However, as a technical matter, only the plant and machinery is depreciable – not the supporting structures. No policy reason exists for this exclusion, especially since depreciation is allowed in respect of supporting structures associated with other forms of plant or machinery.

III. Proposal

Supporting structures associated with machinery and plant that are dedicated to electricity generation projects will be depreciable over a three-year period at a 50:30:20 per cent rate. More specifically, the supporting structure must be mounted or fixed to the machinery or plant and must be integrated with the machinery or plant. The useful life of that structure must also be limited to the useful life of that machinery or plant. These requirements match the requirements for supporting structures that are associated with other forms of depreciable machinery or plant.

IV. Effective date

The proposed amendment will be effective for supporting structures brought into use on or after 1 January 2013 in respect of years of assessment commencing on or after that date.

4.2. REVISION OF THE INDUSTRIAL POLICY PROJECT INCENTIVE

[Applicable provisions: sections 12I(3), (7)(b) and (11)]

I. Background

A. General overview

The tax incentive for industrial policy projects seeks to promote investment within the domestic manufacturing sector, thereby promoting South African competitiveness. The main benefit of the exemption is an additional immediate allowance for investment in manufacturing assets associated with industrial policy projects. A secondary benefit is an additional training allowance for associated employees.

The size of the investment allowance depends on whether the project has a preferred or basic status (as determined by the adjudication committee operating under the auspices of the Department of Trade and Industry). As a general matter, preferred projects receive an additional investment allowance of 55 per cent; whereas, non-preferred projects receive an additional investment allowance of only 35 per cent. The additional training allowance equals the total cost of training subject to a R36 000 ceiling per employee.

In order to contain the fiscal impact of the incentive from a Government revenue perspective, both sets of additional allowances are subject to ceilings, as follows:

- *Additional investment allowance:* Greenfield (i.e. wholly new) projects are subject to a R900 million ceiling if these projects have a preferred status; non-preferred greenfield projects are subject to a R550 million ceiling. Brownfield (i.e. upgrade and expansion) projects are subject to a R550 million ceiling if these projects have a preferred status; non-preferred greenfield projects are subject to a R350 million ceiling.

- *Additional training allowance:* All projects with preferred status have a R30 million ceiling. Non-preferred projects have a R20 million ceiling.

B. Approval and information reporting

As a control measure, a company will receive the above additional allowances only after obtaining approval of an industrial project from the adjudication committee. To this end, the adjudication committee uses a regulatory point scoring criteria.

Once the adjudication committee approves a project, a company that is eligible for the allowance must submit reports from the year that the project was approved. These reports must be submitted to the adjudication committee on annual basis in order to provide Government with information about the progress of a qualifying project.

II. Reasons for change

Experience with the incentive has revealed some anomalies, as follows:

- In terms of substance, questions have arisen as to the meaning of the aggregate ceilings associated with the additional investment allowance. More specifically, it is being argued that the technical wording associated with the additional investment allowance is an annual ceiling as opposed to an aggregate ceiling over the life of the project. This argument stems from differences in the ceilings associated with the additional investment allowance versus the training allowance, the latter of which contains explicit wording indicating an aggregate ceiling over a six-year period.

- In terms of the approval process, certain procedural requirements have given rise to unexpected challenges. Most notably, the requirement that companies submit a tax compliance certificate to qualify for the allowances has proved untenable. The main issue in this regard is the fact that all connected persons (including all group members) must submit a tax compliance certificate. In the case of large groups with a member seeking approval, this requirement imposes an inadvertently significant burden.

- In terms of information reporting, questions exist as to timing. In this regard, the reporting period appears to be open-ended (i.e. without a cut-off date).

III. Proposal

It is proposed that the above anomalies be rectified. More specifically:

- The law will be clarified to explicitly state that the aggregate ceilings associated with the additional investment allowance will apply over the life of the project (as opposed to an annual ceiling) from the date of approval of the project. The goal of these ceilings is to ensure that the tax expenditures associated with each project should not exceed a certain maximum. Without these ceilings, the R20 billion in tax expenditure associated with Government's commitment to the incentive could easily be disproportionately utilised in favour of a few larger projects.

- In view of the challenges experienced above, the tax certificate compliance criteria will be completely dropped. No reason exists for this criteria to exist in respect of this incentive when this criteria does not exist in respect of other tax incentives (e.g. see section 11D relating to research and development allowances).

- The period for annual reporting will be administratively clarified. In particular, the Minister will be given the authority to prescribe the time period. It is generally envisioned that annual reporting period will be limited to the years of assessment in which the additional depreciation and/or training allowances are claimed.

IV. Effective date

The effective date relating to the clarification associated with the aggregate ceiling for the additional investment allowance will commence from the date of the incentive's inception (insertion by section 26 of Act No. 60 of 2008). The effective date relating to deletion of the compliance certificate and the clarification of annual reporting periods will commence from 1 January 2012.

4.3. OIL AND GAS INCENTIVE AND STABILITY REVISIONS

[Applicable provisions: sections 26B(2), 64B and paragraphs 2, 3 and 6 of the Tenth Schedule].

I. Background

A. General overview

South Africa's current regime to encourage investment for oil and gas exploration and production was initially established in 1997 via prospecting lease OP26. This regime was updated and formalised via legislation in 2007. The purpose of the regime is two-fold: (i) to incentivise oil and gas exploration and production, and (ii) to offer stability against future tax changes in relation to oil and gas exploration and production. The 2007 formalised legislation is mainly contained in the 10th Schedule to the Income Tax Act.

Among other provisions, the 10th Schedule contains the following elements:

- *Income tax rates:* A ceiling on the corporate income tax rate applies for both domestic and South African branches of foreign companies conducting oil and gas activities. To this end, the corporate tax rate for domestic oil and gas companies will not exceed 28 percent while the company tax rate for South African branches of foreign companies are capped at a maximum rate of 31 per cent.

- *Rates on taxes relating to dividends:* As a general matter, the rate of Secondary Tax on companies levied on dividends derived from oil and gas profits by an oil and gas company may not exceed 5 percent. However, if the oil and gas company's oil and gas rights are (directly or indirectly) derived from existing OP26 rights, these dividends will be wholly free from tax (i.e. will be taxed at a rate that does not exceed zero per cent).

- *Thin capitalisation:* Historically, deductions relating to interest in respect of certain debt may be limited if subject to the thin capitalisation anti-avoidance rules designed to prevent excessive interest deductions. The Tenth Schedule effectively provides a safe harbour that prevents these anti-avoidance rules from applying to the extent the loan, advance or debt does not exceed three times the total fixed capital value of the oil and gas company.

II. Reasons for change

The oil and gas fiscal stability regime needs to be updated to account for recent changes occurring elsewhere within the Income Tax Act. More specifically:

- The distinction in tax rates that apply to South African companies (28 per cent) and South African branches of foreign companies (31 per cent) has been eliminated. All companies are now subject to a flat rate of 28 per cent regardless of whether the company is domestic or foreign.

- The secondary tax on companies has been eliminated and replaced with the new Dividends Tax. The Dividends Tax generally applies at a 15 per cent rate.

- The specific set of rules that prevent taxpayers from deducting interest in respect of excessive amounts of debt in relation to equity have been eliminated. Consistent with OECD principles, the rules prohibiting excessive interest are now implicitly contained within the rules associated with prohibitions against transfer pricing.

III. Proposal

In view of recent changes to other aspects of the Income Tax Act as outlined above, it is proposed that the oil and gas regime (i.e. the Tenth Schedule to the Income Tax Act) be updated accordingly. More specifically:

- The ceiling in respect of rates of tax on oil and gas profits for oil and gas companies will now be set at a flat 28 per cent rate for all domestic and foreign companies.

- The current rate ceilings in respect of the secondary tax on companies will now apply in respect of the new dividends tax.

- The current restrictions against application of the obsolete thin capitalisation rules will be removed. Restrictions will now apply in respect of the newly revised transfer pricing anti-avoidance rules.

IV. Effective date

The company rate limitations to the Tenth Schedule will apply with effect from years of assessment ending on 31 March 2013. The dividend rate limitations will apply in respect of dividends paid on or after 1 April 2012. The transfer pricing limitations will apply in respect to years of assessment commencing on or after 1 April 2014.

4.4. TAXABILITY OF GOVERNMENT TRANSFERS AND SUBSIDIES

[Applicable provisions: sections 10(1)(zA), 10(1)(zH), 10(1)(y), new section 12P, 23(n); paragraphs 20(3)(c) and 64A of the Eighth Schedule.]

I. Background

A. Flow of funds

National Treasury (under the authority of the Minister of Finance) allocates national funding. This funding is generally allocated to the various governmental entities (e.g. national departments, provinces, municipalities, agencies and government parastatals). In some cases, National Treasury allocates funding to specific programmes intended for the direct benefit of the private sector. These programmes come in the form of transfers or subsidies (hereinafter referred to as grants). These grants are usually transmitted to a department, which either administers payment directly or through an agency.

Most government grants to the private sector are intended to stimulate various aspects of the economy; some grants assist groups in distress while others induce an otherwise non-economic activity (i.e. the taxi recapitalisation programme). Allocation of funding to the private sector typically occurs in the following ways:

- Funding can be for anticipated purchases of goods and services by a private party (declining use);

- Funding can be made directly for goods and services purchased for the benefit of a private party;

- Funding can be reimbursive after the private party has purchased the goods and services; and

- Funding can be in the nature of a reward for achieving certain milestones (e.g. for creating so many jobs or providing a required level of value addition) (uncommon).

B. Tax impact of grants

The Income Tax Act contains various provisions which exempt certain government grants. These exemptions take two different forms. Firstly, an exemption exists for certain grants specifically listed by name in the tax legislation. Secondly, authority exists to exempt other grants by way of notice. This latter exemption will potentially apply if the grant is approved pursuant to the national budget and approved by the Minister via notice in the Gazette.

Other collateral issues associated with the exemption relate to various anti-double-dipping rules. More specifically, taxpayers cannot claim a deduction for expenses if the funds for the expense stem from a grant (because these expenses are not actually incurred by the taxpayer). The cost of allowance assets or capital assets must similarly exclude portions of the cost subsidised by government grants. It should be noted that these anti-double-dipping-rules may be waived via notice in the Gazette under the authority of the Minister of Finance.

II. Reasons for change

The income tax rules pertaining to government grants are scattered and seemingly lack any overall policy direction. As an initial matter, all grants are taxable. Exemptions exist but the policy rationale for exempting some grants and not others is difficult to discern. While policy criteria exists that act as grounds for the Minister to provide exemption by way of notice, most of the criteria are not strongly compelling upon close examination. More specifically, although the basis of the regulatory exemption is premised on (i) policy criteria, (ii) the financial implications for government, and (iii) the tax implications considered when the grant was made, how to weigh these factors is wholly uncertain.

Most notably, the overall tendency to tax grants is questionable. As a practical matter, most grant recipients do not expect the grants received to be taxed because taxation of the grant is viewed as a partial withdrawal of the grant promised. Moreover, government officials making the grant allocation often do not consider the tax implications of the grant when making the allocation, thereby leaving a potential short-fall in the intended objective once tax is taken into account.

Lastly, the current system of relief is limited solely to grants at the national level. Grants paid by a provincial authority pursuant to a provincial budget process are fully taxable and do not qualify for exemption, even if no tax was envisioned when the grant is made.

III. Proposal

A. General Overview

In view of the above, a unified system for exempting (or taxing) grants is proposed. Under this unified system, the presumption will be shifted in favour of exempting genuine grants as opposed to taxation. While a list approach will be retained, the list will be greatly expanded. The purpose of the list is solely to provide enforcement and compliance certainty. Without a list, a generic distinction between a grant and a normal taxable transfer (i.e. a transfer that directly or indirectly operates as a service or other benefit to government) could give rise to unintended interpretations.

B. Revised list approach for exemptions

Under the revised approach, a comprehensive legislative list of exempt grants will be published and updated annually (see the list under the Eleventh Schedule below). Furthermore, the Minister of Finance will retain the power to exempt grants by way of notice. The purpose of this Ministerial authority is to provide exemption for certain grants devised between the annual budget periods.

As stated above, the revised list will contain a greatly expanded number of exempt grants. The key determinations for offering this exemption at a legislative or notice level are: (i) whether the payment at issue is a genuine grant or disguised consideration for goods and services required by Government, and (ii) whether the financial and tax implications were borne in mind when deciding the payment amount (i.e. whether the official setting the grant grossed-up the grant for taxes to be paid).

Lastly, potential exemption for grants will be extended to allow for provincial grants (regardless of whether or how national funding is traced to those amounts). This exemption will again be allowed only by way of legislative list or by way of notice.

C. Anti-double-dipping

1. Reduction of tax attributes

In the case of exempt grants, a comprehensive set of anti-double-dipping rules will apply. Stated differently, the use of exempt grant funding should not be allowed as a means of achieving a further net tax reduction that can be used against non-grant earnings. Application of the anti-double-dipping rules will vary depending upon the allocation of the grant funding received. More specifically, these rules will apply as follows:

a. If an exempt grant is awarded to the taxpayer and the grant is used to fund the acquisition, creation or improvement of trading stock or to reimburse expenses so incurred, the cost price of thae trading stock must be reduced by the amount of the grant. If an exempt grant exceeds the cost price of the trading stock, the excess will reduce the taxpayer's allowable deductions (to the extent these deductions are otherwise available) (see d. below)

b. If an exempt grant is awarded to the taxpayer and the grant is used to fund the acquisition, creation or improvement of an allowance asset or to reimburse the cost so incurred, the base cost of the allowance asset must be reduced by the amount of the grant. If the grant exceeds the base cost and the asset is an allowance (i.e. depreciable) asset, the base cost of that asset will be deemed to be zero and the excess grant funding will reduce the taxpayer's allowable deductions (to the extent these are otherwise available) (see d. below).

c. If an exempt grant is awarded to the taxpayer and the grant is used to fund the acquisition, creation or improvement of a capital asset or to reimburse expenses so incurred, the base cost of the capital asset must be reduced by the amount of the grant. If the grant exceeds the base cost and the asset is a capital asset, the base cost of that asset will be deemed to be zero.

d. If an exempt grant is awarded to the taxpayer and the grant is "not" used to fund the acquisition of an asset that is trading stock; an allowance asset or a capital asset, the taxpayer must reduce section 11 deductions otherwise allowed. In addition, if the grant exceeds the total amount of otherwise allowable deductions, the excess will be carried over into the next year (so as to potentially reduce the following year's deductions).

Example 1
Facts: Company X spends R700 000 in 2013 on business expenditures. Company X spends a further R800 000 in 2014 on business expenditures. Company X receives an exempt government grant of R1 million in 2014 as a reimbursement for business expenditures incurred by Company X.

Result: Company X will initially obtain a full deduction for the expenditures of R700 000 in 2013. Company X will also initially obtain a full deduction for the expenditures of R800 000 in 2014. However, these deductions will be reduced to zero due to the exempt grant funding. The grant funding excess (of R200 000) will be carried over to the next year of assessment so as to potentially reduce the general deductions otherwise available in 2015 (or onward).

Example 2
Facts: Company Y acquires a manufacturing plant in 2013 for R6 million. Company Y depreciates the plant by R1.2 million in 2013, leaving R4.8 million of base cost (R6 million less the R1.2 million of depreciation). Company Y then receives an exempt government grant of R5.5 million in 2014.

Result: Company Y will obtain a depreciation deduction of R1.2 million in 2013. The R5.5 million of grant funding will be applied towards the remaining base cost so as to reduce the base cost of the plant from R4.8 million to 0. Company Y must also reduce its otherwise allowable deductions (to the extent these are available) under section 11(a) by the excess grant funding of R700 000.

2. Limitations on future (depreciation) allowances

A new set of rules will apply where taxpayers claim allowances for assets acquired, created or improved with exempt grant funds. If an exempt grant is awarded to the taxpayer and the grant is used to fund the acquisition, creation or improvement (or to reimburse the prior acquisition, creation or improvement of an allowance asset), the total allowances to be claimed by the taxpayer on the asset must not exceed:

- the aggregate expenditure, reduced by
- the amount of the exempt grant and all allowances previously claimed.

The net effect of the regime is to burn-up future allowances starting with the final potential allowances first.

Example 1
Facts: Company X receives an exempt government grant of R600 000 in 2013 and uses the exempt grant funds to acquire machinery and equipment for R3.5 million. Setting aside the grant, Company X may claim a depreciation deduction of R700 000 on the machinery and equipment over 5 years.

Result: Company X's grant funding of R600 000 will be applied towards the base cost so as to reduce the base cost of the machinery and equipment from R3.5 million to R2.9 million. Furthermore, Company X will only be allowed to claim a total future depreciation deduction of R2.9 million (i.e. R700 000 in years 2013 through to 2016 and R100 000 in 2017).

Example 2
Facts: Company Y acquires business assets in 2013 for R2 million. Company Y may claim a depreciation deduction of R400 000 on the business assets over 5 years. Company Y then receives an exempt government grant of R500 000 in 2013 as a reimbursement for the expenditures Company Y incurred to acquire the business assets.

Result: Company Y's grant funding of R500 000 will be applied towards the base cost so as to reduce the base cost of the storage warehouse from R2 million to R1.5 million. In addition, Company Y will only be allowed to claim a total future depreciation deduction of R1.5 million (i.e. R400 000 in 2013, 2014 and 2015 and R300 000 in 2016). Company Y will not obtain any allowance on its business assets in 2017.

Example 3
Facts: Company Z acquires a bottling plant in 2013 for R8 million. Company Z may claim a depreciation deduction of R3.2 million in 2013 when Company Z acquires the plant, and R1.6 million in each of the three succeeding years. Company Z depreciates the plant by R3.2 million in

2013, leaving R4.8 million of base cost (R8 million less the R3.2 million of depreciation). Company Z then receives an exempt government grant of R2 million in 2014 as a reimbursement for its expenses to acquire the bottling plant.

Result: Company Z's grant funding of R2 million will be applied towards the base cost so as to reduce the base cost of the bottling plant further from R4.8 million to R2.8 million. In addition, Company Z will only be allowed to claim a total future depreciation deduction of R2.8 million (i.e. R1.6 million in 2014 and R1.2 million in 2015). Company Z will not obtain any allowance on the plant in 2016.

D. In-kind benefits

Under common law principles, the receipt of a government grant as an in-kind award for the benefit of a taxpayer will have a zero base cost (for expenditures on allowance assets and capital assets) or will not be deductible (for trading stock expenditures) since these expenditures have not been incurred by the taxpayer. To this end, the proposed base cost reduction rules and the proposed rules to decrease expenditures under the general deduction formula under the proposed regime will not apply to government grants that are awarded as an in-kind benefit to the taxpayer.

Example
Facts: Taxpayer is awarded an exempt government grant to facilitate Taxpayer's small business start-up activities. Under the grant, government purchases R50 000 worth of business training classes for the benefit of taxpayer and R75 000 of computer equipment.

Result: Under common law principles, taxpayer cannot deduct the training classes because these expenses were not incurred by the taxpayer. The computer equipment similarly has a zero tax cost. No further reduction is required under section 12P.

IV. Effective date

The effective date for the proposed amendments will apply to all grants received or accrued on or after 1 January 2013.

Eleventh Schedule: Legislative List of Exempt Grants		
Name of grant	*Department paying grant*	*Administrator of grant*
Integrated National Electrification Programme: Off- Grid	Department of Energy	Same
Eskom - Integrated National Electrification Programme: Electricity Connection to Households	Department of Energy	Same

Food Fortification Grant	Department of Health	Same
Capital Restructuring Grant	Department of Housing	Same
Youth Technology Innovation Fund	Department of Science and Technology	Technology Innovation Agency
Idea Development Fund	Department of Science and Technology	Technology Innovation Agency
Technology Development Fund	Department of Science and Technology	Technology Innovation Agency
Equity Fund	Department of Science and Technology	Technology Innovation Agency
Industry Matching Fund	Department of Science and Technology	Technology Innovation Agency
South African Research Chairs Initiative	Department of Science and Technology	National Research Foundation
Automotive Production and Development Programme	Department of Trade and Industry	Same
Small, Medium Enterprise Development Programme	Department of Trade and Industry	Same
Small/Medium Manufacturing Development Programme	Department of Trade and Industry	Same
Automotive Incentive Scheme	Department of Trade and Industry	Same
Business Process Services	Department of Trade and Industry	Same
Black Business Supplier Development Programme	Department of Trade and Industry	Same
Capital Projects Feasibility Programme	Department of Trade and Industry	Same
Critical Infrastructure Programme	Department of Trade and Industry	Same
Co-operative Incentive Scheme	Department of Trade and Industry	Same
Enterprise Investment Programme	Department of Trade and Industry	Same
Export Marketing and Investment Assistance	Department of Trade and Industry	Same
Sector Specific Assistance Scheme	Department of Trade and Industry	Same
Film Production Incentive	Department of Trade and Industry	Same
Industrial Development Zone Programme	Department of Trade and Industry	Same
Clothing and Textiles Competitiveness Programme	Department of Trade and Industry	Industrial Development Corporation
Technology and Human Resources for Industry Programme	Department of Trade and Industry	Same
Support Programme for Industrial Innovation	Department of Trade and Industry	Same

Manufacturing Competitiveness Enhancement Programme	Department of Trade and Industry	Same
Transfer to Non-profit Institutions: South African National Taxi Council	Department of Transport	Same
Transfer to Universities and Technikons: University of Pretoria, KwaZulu-Natal and Stellenbosch	Department of Transport	Same
Taxi Recapitalisation Programme	Department of Transport	Taxi Scrapping Administrator
Jobs Fund	National Treasury	Development Bank of South Africa
Eastern Cape Jobs Stimulus Fund	Department of Economic Development Environmental Affairs and Tourism of the Eastern Cape	Eastern Cape Development Corporation

5. INCOME TAX: INTERNATIONAL

5.1. NARROWING OF THE PARTICIPATION EXEMPTION IN RESPECT OF FOREIGN EQUITY SHARE DISPOSALS

[Applicable Provision: Section 41(1)(definitions "domestic financial instrument holding company" and "foreign financial instrument holding company") and paragraph 64B(1), (2) and (3) of the Eighth Schedule to the Act]

I. Background

The current tax framework provides relief for South African multinationals seeking to restructure their offshore subsidiaries through a combined set of rules.

- Initially, restructuring relief was contained solely through the capital gains participation exemption, which exempts certain disposals of foreign equity shares from capital gains taxation.

- Rollover reorganisation relief was initially limited to wholly domestic reorganisations. This relief has gradually been extended for certain inbound and foreign-to-foreign restructurings. As discussed in the drafter notes for REVISED ROLLOVER REGIME FOR CROSS-BORDER REORGANISATIONS and ROLLOVER RELIEF FOR CONTROLLED FOREIGN COMPANY (CFC) INTRA-GROUP TRANSACTIONS, this relief is now being extended to cover the full gamut of reorganisations roughly available within the domestic arena.

- It should also be noted that restructuring of controlled foreign company assets can also qualify for tax relief in terms of the foreign business establishment exemption or in terms of the high-tax country exception.

In order to qualify for the capital gains participation exemption: (1) the seller must hold a meaningful share interest in the foreign company (i.e. at least 10 per cent of the equity shares and voting rights) immediately before the disposal, and (2) this holding must generally have been existence for a period of at least 18 months prior to the disposal. The exemption does not apply to disposals (1) of shares in a foreign financial instrument holding company, (2) of an interest in a South African immovable property holding company or (2) if the foreign shares disposed of consist of hybrid equity instruments. One potential price for utilising the participation exemption when making a disposal of controlled foreign company equity shares to a connected person is the existence of a deferred capital gains charge if a group divests itself of the entity for little or no consideration.

II. Reasons for change

The initial purpose of the capital gains participation exemption was two-fold. As a theoretical matter, this relief was designed to match the impact of the participation exemption for foreign dividends. Cash received upon the disposal of foreign equity shares was said to be the same as cash dividends (the gain being representative of future dividends). In addition, the participation exemption for capital gains was intended to facilitate internal restructurings of offshore foreign subsidiaries at a time when no offshore reorganisation rollover rules existed.

In respect of the second objective, the participation exemption for offshore reorganisations will largely be supplanted by the full extension of the rollover regime for offshore intra-group reorganisations. Indeed, it has always been understood that the capital gains participation exemption as a tool for offshore intra-group reorganisations was intended solely as a temporary measure in the absence of these offshore reorganisation rollover rules. Rollover treatment (as opposed to exemption) has always been the more appropriate relief as a matter of tax theory, especially since rollover relief is the only option available domestically.

Concerns also exist that the participation exemption can be used in ways that were never intended. Outside of the intra-group restructuring arena, it was expected that the yield for the disposal of foreign shares would be for cash or cash-equivalent consideration. This consideration was expected to be ultimately reinvested in South African owned foreign business operations or repatriated on-shore as cash (or cash-equivalent) dividends for domestic business operations or for ultimate shareholders. Nonetheless, some taxpayers have sought to use the exemption as a means of achieving an indirect company migration or divestiture of core business operations outside the cash or cash-equivalent paradigm. The net result (if allowed) would be to ultimately strip the overall South African company tax base as opposed to ultimate enhancement. While anti-avoidance rules exist to prevent these practices, these rules are far from bullet-proof.

III. Proposal

A. Overview

In view of the above, the capital gains tax participation exemption will generally be limited to disposals of foreign equity shares as long as those disposals are to independent foreign persons. The participation exemption for controlled foreign company (CFC) restructurings will accordingly be deleted (but see REVISED ROLLOVER REGIME FOR CROSS-BORDER REORGANISATIONS and ROLLOVER RELIEF FOR CONTROLLED FOREIGN COMPANY (CFC) INTRA-GROUP TRANSACTIONS). The remaining aspects of the capital gains participation exemption will be re-aligned so as to eliminate the potential use of the exemption as a company migration or divestiture technique.

The revised capital gains tax participation exemption will be divided into two categories. The first (and main category) will apply to the disposal of foreign equity shares by general domestic companies and their CFCs. The second category will apply to the disposal of foreign equity shares by headquarter companies.

B. General participation exemption

Under the general participation exemption as revised, exemption for capital gains and losses upon the disposal of foreign equity shares applies if the following qualifying requirements are met:

The transferor (taking into account group members) must hold a participation interest of at least 10 per cent of the equity shares and voting rights of the transferred foreign company.

- The transferor must hold the required foreign equity share percentage of 10 per cent for at least 18 months prior to disposal (with interim holdings by group members taken into account for this purpose).

- The transferred foreign equity shares must be disposed of to a foreign person other than a CFC (e.g. the shares cannot be disposed of to a resident or to a foreign subsidiary controlled by a resident).

- The disposal must occur for full value consideration. More specifically, the transferor must receive full consideration for the foreign equity shares transferred. Full consideration means consideration that has a market value that equals or exceeds the market value of the foreign equity shares transferred.

The 10-per cent requirements are the same as pre-existing law. The general exclusion of residents and CFCs as transferees is roughly the same as prior law. However, the acceptance of CFCs as a qualifying transferee in a group scenario has been dropped as superfluous in light of the new offshore reorganisation rules. Another implicit change is the complete removal of the foreign financial instrument holding company restrictions. These latter restrictions have been dropped as an ineffective tool to prevent avoidance and because these restrictions have inadvertently hindered otherwise legitimate commercially-driven transactions.

The full value (cash or cash-equivalent) consideration requirement is new. This requirement ensures that the participation exemption will not be used as a migration or divestiture technique. Hence, unbundlings will no longer fall within the participation exemption (but can fall under the offshore reorganisation rollover rules). Lastly, the current anti-avoidance deferral charge will no longer be necessary for future disposals in light of the full value (cash or cash-equivalent) consideration requirement.

Example 1

Facts: South African Holding Company owns all the shares of CFC 1, which in turn owns all the shares of CFC 2. CFC 1 has a value of R50 million. CFC 1 sells all of the shares to Foreign Company, a foreign company with no direct or indirect South African shareholders. Foreign Company provides R20 million in cash and issues a R30 million note in exchange,

Result: The sale of CFC 2 by CFC 1 qualifies for the participation exemption. The sale is to a foreign company that is not a CFC and the consideration received equals the value transferred.

Example 2

Facts: South African Holding Company owns all the shares of CFC 1, which in turn owns all the shares of CFC 2, and CFC 2 owns all of the shares of CFC 3. CFC 2 unbundles all of the shares of CFC 3 to CFC 1.

Result: The unbundling does not qualify for the participation exemption because the unbundling is to a CFC. However, this unbundling qualifies for rollover relief under the offshore reorganisation rules.

C. Exit charge

As a final note, the participation exemption will continue to override the residual exit charge for the loss of CFC status. In particular, the transfer of a CFC (and one or more subsidiary CFCs of the transferred foreign company) may trigger an exit charge due to the loss of CFC status stemming from the disposal. The participation exemption will override this exit charge for deemed disposals of foreign equity shares (see notes on EXIT CHARGE UPON CEASING TO BE A RESIDENT IN SOUTH AFRICA).

D. Headquarter company exemption

The current blanket capital gains tax participation exemption for headquarter companies will largely be retained in simplified form. In particular, the exemption will apply to any disposal by a headquarter company as long as the headquarter company (taking into account group members) holds a participation interest of at least 10 per cent of the equity shares and voting rights of the transferred foreign company. The 18-month minimum holding period will be dropped.

It should be noted that the blanket exemption for headquarter companies stems from the fact that the headquarter company has a number of other deviations from the general rules. Firstly, this entity may not participate in the reorganisation rollover rules. Secondly, all transfers and conversions to a headquarter company will trigger immediate tax. The net effect of the change is to allow for the headquarter company to operate somewhat freely from the South African net (because the funds are derived offshore and redeployed offshore and because entry into the system requires an exit charge).

IV. Effective date

The proposed amendments will apply in respect of disposals of foreign equity shares on or after 1 January 2013.

5.2. REVISED ROLLOVER REGIME FOR CROSS-BORDER REORGANISATIONS

[Applicable Provision: Sections 41(4); 42(1) ("asset-for-share transaction" definition) and (6); 44(1) ("amalgamation transaction" definition), (2) and (13); 46(1) ("unbundling transaction" definition), (7)(b)(i); and 47(1)("liquidation distribution" definition), (2), and (6)(c)]

I. Background

In 2001, a new set of company reorganisation rules were enacted as part of the package associated with the implementation of capital gains taxation. These rules were largely limited to wholly domestic transfers (i.e. from a domestic person to a domestic person) with some limited rules allowing for the inbound transfer of built-in gain assets.

The objective of these rules was mainly to allow for the rollover of gains/losses (with the deferred gain/loss being potentially triggered at a later date). Each of these restructuring transactions can take the form of an asset-for-share (section 42) transaction, an amalgamation (section 44) transaction, an unbundling (section 46) transaction and a liquidation (section 47) transaction. In addition, these restructurings can take the form of an intra-group (section 45) transaction (see ROLLOVER RELIEF FOR CONTROLLED FOREIGN COMPANY (CFC) INTRA-GROUP TRANSACTIONS). This initial domestic reorganisation regime was kept fairly limited with the idea being that expansion of the regime could occur at a later stage based on further experience.

In 2011, the company reorganisation rules were expanded to cover a full array of cross-border reorganisations. More specifically, the expansion was designed to cover inbound transfers (i.e. the transfer from foreign persons to a South African company) and foreign-to-foreign transfers (of foreign entities directly and indirectly owned by South African residents).

II. Reasons for change

The 2011 expansion of the reorganisation regime to cover inbound and foreign-to-foreign transactions has much to be desired. In the main, the rules lack an internally coherent set of underlying principles, making the detail of each offshore rollover relief somewhat random. The rules also do not cleanly demarcate the differences between domestic-to-domestic, inbound and foreign-to-foreign transactions, thereby potentially causing unintended blockages and loopholes.

III. Proposal

A. Overview

In view of the above, the framework for offshore reorganisations will be wholly revised so that the rules are more clearly demarcated and logically consistent. The main aim of the offshore rules is to facilitate:

1. Inbound reorganisations: The movement of foreign incorporated assets directly into South African taxing jurisdiction; and

2. Foreign-to-foreign reorganisations: The movement of foreign incorporated assets to a controlled foreign company within the same (section 1) group of companies.

In the case of inbound reorganisations, the rules are roughly similar to wholly domestic reorganisations, except that the shares of the companies at issue must be held as capital assets (e.g. for investment as strategic assets). More notably, the relief extends only to built-in gain assets. This limitation exists because no policy reason exists to encourage the entry of built-in losses that will ultimately reduce South African taxation.

The rules relating to reorganisations involving movements to South African controlled CFC are more complex. The above capital asset and built-in gain limitations again apply. In addition:

- Offshore restructurings will be permitted only within a South African controlled group of companies (as defined in section 1 of the Act). Immediately before the transaction at issue, the transferor and transferee must form part of the same group of companies as defined in section 1. In addition, the transferee must be a controlled foreign company in relation to a resident that forms part of that group of companies.

- The transferred foreign company (or assets moving to a foreign company) must be squarely within indirect South African taxing jurisdiction. More specifically, at least 50 per cent of the equity shares of the transferred foreign company (or the foreign acquiring company that acquires the transferred assets) must be directly or indirectly held by a resident (alone or together with any other resident that forms part of the same section 41 group) after the transaction. As a slight deviation, the transfer of smaller stakes in a foreign company will be permitted in a foreign share-for-share transaction if these shares are transferred to a foreign transferee that is at least 70 per cent owned by a resident (or a group company).

B. Foreign share-for-share transactions

Taking into account the 2011 changes, the current asset-for-share transaction rules provide rollover relief in respect of three possible transfers: (i) the transfer of assets by a resident to another resident in exchange for equity shares; (ii) the transfer of assets by a non-resident to a resident in exchange for equity shares; and (iii) the transfer of foreign equity shares by a non-resident to another non-resident in exchange for issued equity shares. The third form of transfer (i.e. foreign share-for-share transfers) is the subject of revision.

In the main, a foreign share-for-share rollover involves the transfer of foreign equity shares by a foreign company transferor in exchange for the issue of new equity shares by a foreign company transferee. An asset-for-share transaction is a transaction in terms of which a company disposes of an equity share held in a foreign company as a capital asset. The market value of that capital asset must exceed or be equal to the base cost of the transferred shares in order to qualify for rollover relief.

The qualification criterion for foreign share-for-share rollover relief is divided into pre-transaction and post-transaction requirements. Compliance with pre-transaction requirements is measured immediately before the share-for-share transaction whilst post-transaction requirements are measured after the share-for-share transaction (i.e. at the close of the day).

Pre-transaction requirements:

- The transferee and transferor must be members of the same (section 1) group of companies.

- In addition, the transferee must be a CFC in relation to the same group of companies.

Post-transaction requirements:

- After the transaction, more than 50 per cent of the equity shares in the target company (i.e. in the equity shares of the company transferred) must be directly or indirectly held by a resident. This more than 50 per cent threshold is determined taking into account any resident company that forms part of the same (section 41) group of companies. This more than 50 per cent threshold must additionally be maintained for an 18-month period (like the 10 per cent qualifying interest test for domestic and inbound section 42 transfers).

- Alternatively, at least 70 percent of the equity shares of the transferee company must be directly or indirectly held by a resident. This post-transaction holding requirement is determined by taking into account any resident company that forms part of the same (section 41) group of companies. This post-transaction holding requirement for the transferee company must additionally be maintained for an 18-month period (like the 10 per cent qualifying interest test for wholly domestic and inbound section 42 transfers) (like the 10 per cent qualifying interest test for wholly domestic and inbound section 42 transfers). This alternative effectively allows for the movement of smaller share interests within an overall offshore group.

Example 1
Facts:

- South Africa Company owns 60 per cent of the shares of Foreign Company 1 (FC1) and 80 per cent of the shares of Foreign Company 2 (FC2). The other 40 per cent in FC1 and 20 per cent in FC2 are owned by unrelated foreign parties. The shares in each foreign company are of equal value, and the percentage shareholding also represents the actual number of shares issued and outstanding. All shares involved are equity shares and are held as capital assets. The FC2 shares have a value that exceeds base cost (i.e. are built-in gain shares).

- In the transaction, South African Company transfers its 60 per cent shareholding in FC1 to FC2 in exchange for the issue of additional FC2 shares by FC2. Upon completion of the transaction, South African Company's proportionate share interest in FC2 increases to 90 per cent (based on the additional contribution).

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. Both South African Company and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign). FC2 is also a CFC in relation to a member of the same group (i.e. South African Company). After the transfer, FC1 is indirectly more than 50 per cent held by South African Company (90 per cent multiplied by 60 per cent equals a 54 per cent indirect holding by South African Company). In the example, FC2 will also satisfy the alternative post-transaction requirement because at least 70 per cent of FC2 is owned by a resident group company (i.e. South African Company owns 90 per cent of FC2).

Example 2

Facts:

- South Africa Company owns 25 per cent of the shares of Foreign Company 1 (FC1) and 100 per cent of the shares of Foreign Company 2 (FC2). The other 75 per cent in FC1 is owned by unrelated foreign parties. The shares in each foreign company are of equal value, and the percentage shareholding also represents the actual number of shares issued and outstanding. All shares involved are equity shares and held as capital assets. The FC2 shares have a value that exceeds base cost (i.e. are built-in gain shares).

- In the transaction, South African Company transfers its 25 per cent shareholding in FC1 to FC2 in exchange for the issue of additional FC2 shares by FC2. Upon completion of the transaction, South African Company's proportionate share interest in FC2 remains at 100 per cent.

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. Both South African Company and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 50 per cent shareholding without regard to whether the companies are domestic or foreign). FC2 is also a CFC in relation to a member of the same group (i.e. South African Company). After the transfer, FC1 is not "more than 50 per cent" indirectly held by South African Company (with only a 25 per cent indirect holding by South African Company). However, this lack of a "more than 50 per cent" interest can be disregarded because the transferee company is more than 70 percent owned by a South African resident.

Example 3

Facts:

- South Africa Company owns 80 per cent of Foreign Company 1 (FC1) and 100 per cent of Foreign Company 2 (FC2). FC1 owns 80 per cent of the shares of Foreign Company 3 (FC3). The other 20 per cent in FC1 and 20 per cent in FC3 are owned by unrelated foreign parties.

The shares in each foreign company are of equal value and the percentage shareholding also represents the actual number of shares issued and outstanding. All shares involved are equity shares and all shares held are held as capital assets. The FC3 shares have a value that exceeds base cost (i.e. are built-in gain shares).

- In the transaction, FC1 transfers its 80 per cent shareholding in FC3 to FC2 in exchange for the issue of additional FC2 shares by FC2. Upon completion of the transaction, South African Company's proportionate share interest in FC2 is reduced to 90 per cent and FC1 obtains a 10 per cent proportionate interest in FC2.

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. Both FC1 and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign). FC2 is also a CFC in relation to a member of the same group (i.e. South African Company). After the transfer, FC3 is indirectly more than 50 per cent held by South African Company (90 per cent multiplied by 80 per cent) equals a 72 per cent indirect holding by South African Company plus a 6.4 per cent indirect shareholding through FC1 and FC 2 (i.e. 80 percent of 10 per cent multiplied by 80 percent equals a 6.4 per cent indirect holding by South African Company). The total shareholding in FC3 is therefore 78.4 percent. In the example, FC2 will also satisfy the alternative post-transaction requirement because at least 70 per cent of FC2 is owned by a resident group company (South African Company owns 90 per cent of FC2).

C. Cross-border amalgamation transactions

The proposed revised amalgamation transaction rules apply to both inbound and foreign-to-foreign amalgamations. An inbound amalgamation involves the transfer of amalgamating company assets to a resident resultant company. A foreign-to-foreign amalgamation involves the transfer of amalgamating company assets to a CFC. In the case of both inbound and foreign-to-foreign amalgamations, the amalgamating company must terminate (i.e. must liquidate, wind up, deregister or otherwise cease to exist). In addition, both forms of amalgamation require that the surrendered shares in the foreign transferor company (amalgamating company) must be held as a capital asset immediately before the amalgamation.

In addition to the above requirements, foreign-to-foreign amalgamation transactions contain the following additional requirements:

- The amalgamating and resultant companies must be members of the same (section 1) group of companies. In addition, the resultant company must be a CFC in relation to the same group. These requirements will be measured immediately before the transaction.

- Immediately after the transaction, more than 50 per cent of the equity shares in the resultant company must be directly or indirectly held by a resident. This more than 50 per cent threshold is determined taking into account any resident company that forms part of the same (section 41) group of companies.

The relief for inbound amalgamations applies only to built-in gains assets at the amalgamating company level. More specifically, the market value of the amalgamating company assets (both capital assets and trading stock) must equal or exceed the tax cost of those assets for rollover relief to apply to those assets. The general premise is that both loss and gain assets can be moved, but the loss element cannot be imported into direct South African taxing jurisdiction. The anti-loss rule does not extend to foreign-to-foreign amalgamations.

Example 1:

Facts:

- South Africa Company owns 80 per cent of the shares of Foreign Company 1 (FC1) and 40 per cent of the shares of Foreign Company 2 (FC2). The other 20 per cent in FC1 and 60 per cent in FC2 are owned by various unrelated South African residents. The shares in each foreign company are of equal value and the percentage shareholding also represents the actual number of shares issued and outstanding. All shares involved are equity shares and all shares held are held as capital assets. FC1 has two assets: trading stock with a value of R5 million and a cost price of R3.5 million as well as a capital asset with a value of R3 million and a base cost of R3.3 million.

- In the transaction, FC1 merges into FC2. As part of the merger, South African Company surrenders all of its FC2 shares in exchange for an additional 15 per cent share interest in FC1, leaving South African Company with a 55 per cent share interest in FC2.

Result: The transaction fails to qualify for rollover relief under the foreign amalgamation rules. FC2 is not part of the same group of company as South African Company.

Example 2:

Facts: The facts are the same as EXAMPLE 1; except that FC2 is effectively managed within South Africa (i.e. qualifies as a South African resident).

Result: The amalgamation transaction qualifies for rollover relief because the amalgamation is an inbound transaction (i.e. the percentage ownership and CFC requirements are irrelevant). In respect of FC2 assets, rollover relief applies to the trading stock (with value exceeding cost price) but not to the capital assets (with the value falling below base cost).

D. Unbundling transactions

The revised unbundling rollover rules will be extended to apply to the unbundling of foreign companies (including controlled foreign companies). This form of unbundling can be undertaken either by a domestic or controlled foreign company unbundling company. In each instance, the unbundling (domestic or controlled foreign) company must be part of the same (section 1) group as the unbundled (foreign) company. As in the case with domestic unbundlings, the unbundled shares must be distributed pro rata (i.e. in accordance with the effective interests held by the shareholders in the unbundling company). Like of cross-border reorganisations, there are both pre-transaction and post-transaction requirements.

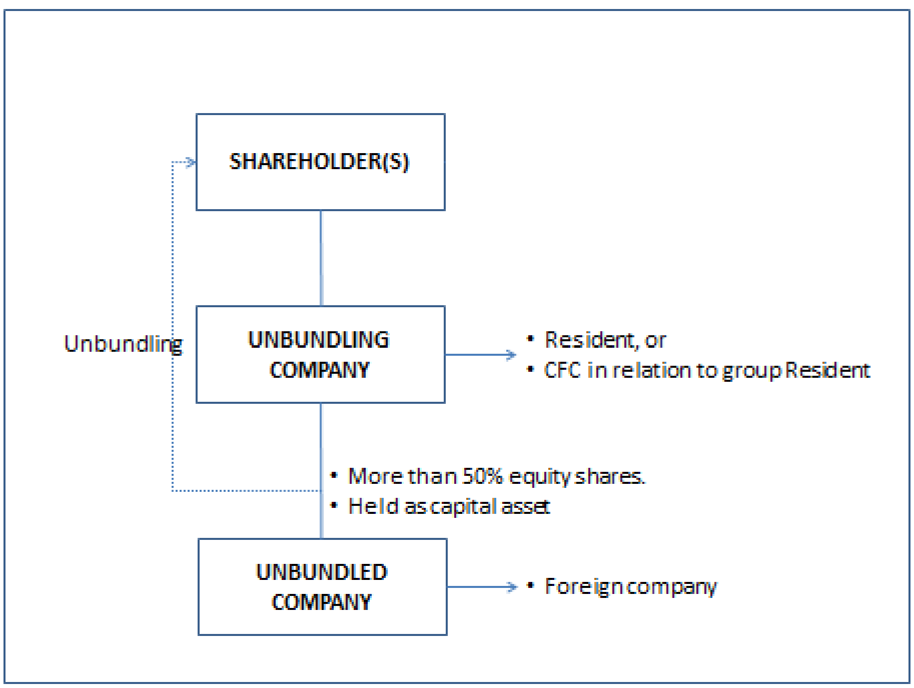
Pre-transaction requirements:

- The unbundled foreign company must be more than 50 per cent owned by the unbundling company;
- The distributed shares in the unbundled company must be held as a capital asset by the unbundling company immediately before the unbundling; and
- Where the unbundling company is a foreign company, the unbundling company must be a CFC in relation to any resident that forms part of the same group of companies.

Post-transaction requirements:

- More than 50 per cent of the equity shares of the unbundled foreign company must be directly or indirectly held by a resident that is part of the same (section 1) group as as the unbundled foreign company.

Application of the inbound and foreign-to-foreign unbundling can be schematically illustrated as follows:



In addition to the above, an additional set of rules applies in relation to the shareholders of the unbundling company. More specifically, as with other forms of unbundlings, significant holdings in the unbundled company (i.e. 20 per cent of more) cannot be held by a "disqualified" person immediately after the unbundling. Disqualified persons are largely foreign shareholders or exempt persons (such as a pension fund). These rules prevent unbundling rollovers from being used as a means of moving shares from a taxable position to a tax-free position. The revised rules relax the disqualified person rules slightly by allowing distributions to a CFC shareholder if more than 50 per cent of the shareholder CFC is held by a resident (taking into account resident companies within the same section 41 group).

Example 1
Facts: South African Holding Company holds 100 per cent shares in a South African Subsidiary, which in turn owns 70 per cent of Foreign Subsidiary. The other 30 per cent of Foreign Subsidiary is held by an unconnected resident. The South African Subsidiary unbundles its 70 per cent share interest in Foreign Subsidiary to the South African Holding Company.

Result: The unbundling qualifies for rollover relief. South African Subsidiary (an unbundling company) owns more than 50 per cent of the shares of Foreign Subsidiary (an unbundled company) before the unbundling, and the South African Holding Company is a (section 1) group member in relation to South African Subsidiary. Immediately after the transaction, Foreign Subsidiary is more than 50 per cent owned by South African Holding Company.

Example 2
Facts: South African Holding Company holds 100 per cent of the shares in a Foreign Subsidiary 1 (FS1). FS1 owns 100 per cent of Foreign Subsidiary 2 (FS2). FS2 owns 70 per cent of Foreign Subsidiary 3 (FS3). The other 30 per cent of Foreign Subsidiary is held by FS1. FS2 unbundles its 70 per cent share interest in FS3 to FS1.

Result: The unbundling qualifies for rollover relief. FS2 (an unbundling company) is a CFC in relation to a resident, is part of the same group of companies, and owns more than 50 per cent of the shares of FS3 (an unbundled company) before the unbundling. FS1 (the shareholder) is a (section 1) group in relation to FS2. Immediately after the transaction, FS3 is more than 50 per cent owned by FS1, a controlled foreign company that is more than 50 per cent owned by South African Holding Company (a resident company).

Example 3
Facts: Foreign Holding Company holds 100 per cent shares in a South African subsidiary (SA1). SA1 holds 100 per cent of Foreign Subsidiary 1 (FS1). SA1 unbundles its 100 per cent share interest in FS1 to Foreign Holding Company. Foreign Holding Company is listed abroad and mainly held by multiple foreign shareholders.

Result: The unbundling does not qualify for roll over relief. The transaction meets all the pre-transaction requirements. FS1 is a CFC in relation to a resident, who is part of the same group of companies, and SA1 is a resident and owns more than 50 per cent shares in FS1. However, after the transaction, FS1 will not be more than 50 per cent owned, directly or indirectly, by a resident (or a controlled foreign company held by a resident). In addition, FS1 is leaving the South African taxing jurisdiction, thereby triggering an exit charge (with FS1 moving out of controlled foreign company status).

E. Liquidation distributions

The proposed liquidating distribution transaction rules apply to both inbound and foreign-to-foreign liquidations. An inbound liquidation involves the transfer by a liquidating CFC of all assets to a resident holding company, and a foreign-to-foreign liquidation involves the transfer by a liquidating CFC of all assets to another CFC. A group company nexus between the liquidating and holding companies is required. In both forms of liquidations, the liquidating company must terminate (i.e. must liquidate, wind up, deregister or otherwise cease to exist). and the surrendered shares in the foreign liquidating company must be held as a capital asset by the holding company immediately before the liquidation. In addition to the above requirements:

- In the case of foreign-to-foreign liquidation transactions, more than 50 per cent of the equity shares in the holding company must be directly or indirectly held by a resident immediately after the transaction. This more than 50 per cent threshold is determined taking into account any resident company that forms part of the same (section 41) group of companies.

- In the case of inbound liquidations, only built-in gains assets at the liquidating company level are eligible for relief. More specifically, the market value of the liquidating company assets (both capital assets and trading stock) must equal or exceed the tax cost of those assets for rollover relief to apply to those assets. The general premise is that both loss and gain assets can be moved, but the loss element cannot be imported into direct South African taxing jurisdiction.

Example
Facts: South African Holding Company holds 100 per cent shares in Foreign Subsidiary 1 (FS1). FS1 in turn owns 70 per cent of Foreign Subsidiary 2 (FS2). The other 30 per cent of FS2 is held by an unconnected foreign person. FS2 liquidates, transferring 70 per cent of its assets to FS1 and 30 per cent to unconnected foreign person.

Result: The liquidation qualifies for rollover relief in respect of the transfer to FS1 (but not to unconnected foreign person). Immediately before the liquidation, FS1 is a CFC and the shares in FS1 are held as a capital asset, and both companies are part of the same group. In addition, immediately after the liquidation, more than 50 percent of the shares in FS1 are owned by South African Holding Company.

F. Note on terminating amalgamating and liquidating companies

As discussed above, amalgamating and liquidating rollovers require termination of the amalgamating and liquidating companies (i.e. the companies that will be transferring assets). Termination is equally required for in-bound and foreign-to-foreign transactions. As a technical matter, these terminations could potentially trigger an exit charge because the terminating company technically ceases to be a CFC upon termination. However, this result is contrary to policy because the exiting assets will either become owned by a South African company or another CFC. The exit charge will accordingly be switched off in the case of a qualifying amalgamation transaction or liquidation distribution.

IV. Effective date

All of the above adjustments to the cross-border reorganisation rules will apply in respect of transactions entered into on or after 1 January 2013.

5.3. ROLLOVER RELIEF FOR CONTROLLED FOREIGN COMPANY (CFC) INTRA-GROUP TRANSACTIONS

[Applicable Provision: Section 45(1), (4) and (4B)]

I. Background

Tax rollover relief has existed in respect of wholly domestic (resident-to-resident company) transactions for over ten years. This relief takes various forms (i.e. asset-for-share transactions, amalgamations, intra-group transactions, liquidation distributions and unbundling transactions). In 2011, a comprehensive set of rollover rules were enacted for offshore reorganisations, but these rollover rules did not include rollover intra-group transactions due to the domestic issues relating to that regime at the time.

In order to qualify for domestic intra-group relief, the transferor and transferee must form part of the same section 41 group of companies after the transaction. This group relationship must be preserved for six years after the intra-group transaction so as to avoid any subsequent de-grouping charge (a de-grouping charge may also be triggered by certain post-intra group distributions). Rollover relief involves the rollover of ordinary and capital gains and losses. The group company transferee may provide consideration to the transferor of the rollover asset in any form other than the issue of equity shares. Consideration provided by a group company transferee typically involves cash, the issue of debt and the issue of non-equity (i.e. preference) shares.

I. Reasons for change

As indicated above, the current tax system fully extends the domestic rollover regime to cross-border transactions but for intra-group transactions. As indicated above, this omission existed due to anti-avoidance concerns associated with domestic intra-group transactions in existence at the time. No reason exists to continue with that omission given the fact that the avoidance issues of concern are now being contained.

II. Proposal

A. Qualifying entry criteria

The domestic intra-group rollover rules will be extended to include inbound and foreign-to-foreign restructurings. An inbound intra-group transaction involves the transfer of foreign equity shares by a CFC transferor to a resident company transferee in exchange for the issue debt or issue of non-equity shares by the resident company transferee. A foreign intra-group transaction involves the transfer of foreign equity shares by a resident company or CFC transferor to a CFC transferee in exchange for the issue of debt or the issue of non-equity shares by the CFC transferee. The residency and CFC status of the transferor and transferee is measured immediately before and after (i.e. at the end of the day of) the intra-group transaction.

In both inbound and foreign-to-foreign intra-group transactions, rollover relief is provided if the transferor and the transferee form part of the same (section 1) group of companies before and after the transaction. The equity shares transferred must be held as capital asset and acquired in the same character by the transferee.

The relief for inbound intra-group transactions (i.e. a transfer by a CFC to a resident) is limited to built-in gain equity shares at the transferor company level. More specifically, the market value of the foreign equity shares transferred must equal or exceed the base cost. This requirement is measured immediately before the transaction. The general premise is that both loss and gain assets can be moved, but the loss element cannot be imported into direct South African taxing jurisdiction.

Example:
Facts:

- South Africa Company owns 80 per cent of the shares of Foreign Company 1 (FC1) and 90 per cent of the shares of Foreign Company 2 (FC2). The other 20 per cent in FC1 and 10 per cent in FC2 are owned by unconnected foreign parties. The shares in each foreign company are of equal value, and the percentage shareholding also represents the actual number of shares issued and outstanding. All shares involved are equity shares and are held as capital assets.
- In the transaction, South African Company transfers all of its equity shares in FC1 to FC2 in exchange for a debenture issued by FC2. Upon completion of the transaction, South African Company's proportionate share interests in both foreign companies will remain the same.

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. In the transaction, the transferor is a resident (South African Company) and the transferee is a CFC in relation to South African company. Both South African Company and FC2 are part of the same (section 1) group of company of companies before and after the transfer (i.e. are connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign).

B. Potential de-grouping charges

As with domestic intra-group rules, foreign intra-group relief will be subject to a six years potential de-grouping charge. Stated differently, the transferee company will be subject to tax for built-in gains (i.e. the capital gain that would otherwise be rolled over by virtue of the intra group transfer) if the transferee ceases to satisfy the (section 1) group and CFC requirements at any point within a six-year period. Any gain resulting from the de-grouping charge is capped at the lesser of the gain at the time of the intra group transfer or the gain existing at the time of the de-grouping. The de-grouping charge for large post-intra-group distributions will also potentially apply (i.e. for large distributions within two years after the intra-group transfer).

III. Effective date

The proposed amendments will apply in respect of transactions entered into on or after 1 January 2013.

5.4. EXIT CHARGE UPON CEASING TO BE A RESIDENT IN SOUTH AFRICA

[Applicable provisions: Section 9H of the Income Tax Act and paragraphs 12(2) and 13(1)(g) of the Eighth Schedule to the Income tax Act]

I. Background

When a taxpayer changes residence to another tax jurisdiction, the taxpayer will cease to be a South African resident (even if the taxpayer continues to have some or all its operations in South Africa). The cessation of South African residence is deemed to be a disposal for capital gains tax purposes. The taxpayer is treated as having disposed of its assets for an amount received or accrued equal to the market value of the assets on the day before ceasing to be a South African resident and to have immediately reacquired the same assets at a cost equal to the same market value.

The cessation of residence generally occurs in the following forms:

- For a person other than a natural person, cessation of residence takes place when that person moves its place of effective management to another tax jurisdiction; and

- For a natural person, cessation of tax residence takes place when that individual leaves South Africa.

The above rules also apply when a company becomes a headquarter company.

II. Reasons for change

On 8 May 2012, the Supreme Court of Appeal (“SCA”) delivered its decision in the matter between CSARS and Tradehold Limited (“Tradehold). Tradehold (the taxpayer in the case) was an investment holding company incorporated in South Africa and listed on the Johannesburg Stock Exchange. Tradehold’s main asset comprised of shares in Tradegro Holdings Limited (Tradegro), a company incorporated in Guernsey.

At a meeting held in Luxembourg on 2 July 2002, Tradehold's board of directors resolved to hold all further board meetings in Luxembourg. This resolution had the effect that Tradehold became effectively managed in Luxembourg as from 2 July 2002, thereby ceasing to be resident in South Africa. Under domestic South African tax law, this cessation triggered a deemed disposal. At issue was whether the Article 13(4) (the capital gains exemption) contained within the South African-Luxembourg tax treaty overrode the charge arising from the domestic deemed disposal.

In its conclusion, the SCA took the view that Article 13(4) of the double tax agreement applied in respect of the deemed disposal and that Tradehold was accordingly exempt from the capital gains exit tax upon changing its South African tax residence. However, the SCA did not express any view whether the double tax agreement could apply in respect of a disposal that was deemed to have occurred before the taxpayer ceased to be a resident.

On the other hand, it is clear from international precedent in this regard that treaty relief does not apply to a deemed disposal before cessation of residence. Treaty relief should apply only once a cross-border relationship exists (i.e. foreign residence status vis-à-vis a domestic event such as a domestic disposal). Unlike the South African exit charge, however, most exit charges also trigger a deemed cessation of tax year with a new tax year beginning once ex-residence status begins.

III. Proposal

The proposed legislation aligns the exit charge with international norms and clarifies that a double tax agreement does not exempt a person from capital gains tax the day before that person ceases to be a resident. In a nutshell, the revised rules apply to a person that ceases to be a resident, a resident company that ceases to be a resident or becomes a headquarter company and a controlled foreign company that ceases to be a controlled foreign company (otherwise than by becoming a resident).

A. Individuals

As was previously the position, a natural person will be deemed to have disposed of each of that person’s assets at market value on the day immediately before ceasing to be a resident and to have reacquired each of those assets at market value on the day on which that person ceases to be a resident. In addition, that person’s year of assessment will be deemed to have ended the day immediately before that person becomes a resident of another country.

B. Companies

Similar to natural persons, cessation of residence for a company triggers a deemed disposal and reacquisition as well as a cessation of the company’s year of assessment. In addition, a resident company that ceases to be a resident or becomes a headquarter company will be deemed to have distributed its assets as a dividend in specie in accordance with each shareholder’s effective interest. The company will therefore potentially be liable for an additional dividends tax (depending on the availability of any dividends exemptions). The amount of the deemed dividend is deemed to be the market value of the shares in the emigrating company (i.e. the emigrating company’s gross value net of liabilities) less the sum of contributed tax capital.

Example 1
Facts: South Africa Parent owns all the shares in South African Subsidiary. South African Subsidiary moves its effective management to a foreign jurisdiction, ceasing to be a South African resident. South African Subsidiary has assets of R100 with a base cost of R25, and liabilities of R40.

Result: South African Subsidiary will be deemed to have sold all its assets on the day before ceasing to be resident, resulting in a taxable gain of R75 (R100 assets less base cost of R25). The year of assessment for South African Subsidiary will close on that day and a new year of assessment will begin. While a deemed dividend in specie is deemed to have been distributed to South Africa Parent, the dividend is exempt because the deemed dividend is deemed paid to an exempt party (i.e. a domestic company shareholder).

Example 2
Facts: Foreign Parent owns all the shares in South African Subsidiary. South African Subsidiary moves its effective management to a foreign jurisdiction, ceasing to be a South African resident. South African Subsidiary has assets of R100 with a base cost of R25, and liabilities of R40.

Result: South African Subsidiary will be deemed to have sold all its assets on the day before ceasing to be a resident, resulting in a taxable gain of R75 (R100 assets less base cost of R25). The year of assessment for South African Subsidiary will close on that day and a new year of assessment will begin. A deemed dividend in specie equal to R60 (assets of R100 less liabilities of R40) is deemed to have been distributed to Foreign Parent. Dividends tax will be payable on the deemed dividend (possibly reduced by a tax treaty).

C. Exempted Assets

The exit charge does not apply to certain assets, including:

- Immovable property situated in South Africa
- Any interest or right in movable property situated in South Africa (including interests or rights to an immovable property company; and
- Any asset which will be attributable to a permanent establishment in South Africa if the exit charge is triggered by virtue of a cessation or residence or a cessation of controlled foreign company status (but not the conversion to headquarter company status).

D. Loss of controlled foreign company status derived from disposals that are exempt by virtue of the participation exemption

If a person disposes of an equity share in a foreign company that is a controlled foreign company, the capital gain or loss on the disposal may be disregarded by virtue of the participation exemption (i.e. in terms of paragraph 64B of the Eighth Schedule). In addition, the exit charge normally associated with the loss of controlled foreign company status will be waived if the loss of residence status stems directly or indirectly from a disposal eligible for the participation exemption.

Example
Facts: South African Parent owns all the shares in CFC 1, which in turn owns all the shares in CFC 2, and CFC 2 owns all of the shares in CFC 3. This ownership structure has been in place for more than five years. CFC 1 has a net value of R 50 million (taking into account its direct and indirect ownership in CFC 2 and CFC 3. South African Parent sells CFC 1 to an independent foreign company. Foreign Company provides R20 million cash and issues a R30 million note in exchange.

Result: The disposal will qualify for the participation exemption. South African Parent held more than 10 per cent of the equity shares of CFC 1, and held these shares for more than 18 months. The sale of CFC 1 was to an independent foreign person, and the consideration received equals the value transferred. Although the sale will trigger a loss of CFC status for CFC1, CFC2 and CFC3, the exit charges for these controlled foreign companies will be waived because the loss of controlled foreign company status was a or indirect direct result of a disposal eligible for the participation exemption.

In addition, the exit charge will not apply in respect of a company that ceases to be a resident as a result of an amalgamation transaction or a liquidation distribution. These events may be a technical cessation, but the assets are merely moving to a different company falling within the same tax paradigm. (The exit charge will also not apply if an entity loses its residence status when effective management relief comes into effect for high-taxed controlled foreign companies, see notes on RELIEF FROM THE EFFECTIVE MAMAGEMENT TEST IN THE CASE OF HIGH-TAXED CONTROLLED FOREIGN COMPANIES.)

IV. Effective date

The proposed amendment will apply in respect of any year of assessment commencing on or after 8 May 2012 (this being the same date the Minister issued a Media statement on the Tradehold case).

5.5. RATIONALISATION OF WITHOLDING TAXES ON PAYMENTS TO FOREIGN PERSONS

[Applicable provisions: Sections 35 and 37J through 37N; 49A through 49G, 64E]

I. Background

A. Overview

South African persons making payments to offshore investors are potentially subject to various withholding taxes. Common cross-border payments subject to withholding taxes involve dividends, interest, and royalties. These withholding taxes are often reduced or eliminated by tax treaty.

B. Dividends tax

As of 1 April 2012, Dividends Tax in respect of cross-border dividends are generally subject to tax at a 15 per cent rate (subject to treaty limits of 10 or 5 per cent). A company that declares and pays a dividend to a foreign person must generally withhold Dividends Tax unless regulated intermediaries are involved (who are instead required to withhold Dividends Tax). However, to the extent that sums are owing, ultimate liability rests with the beneficial owner. Payment of the Dividends Tax must be made at the close of the month following the month in which the dividend is paid.

Beneficial owners of a dividend seeking tax treaty (or other forms of) relief must submit a declaration by a date determined by the withholding agent (i.e. a date set by the company payor or by the regulated intermediary) or by the date of the dividend payment. Beneficial owners seeking treaty (or other forms of) relief after these dates must seek a refund. If the withholding agent is the company payor, the beneficial owner may initially seek a refund from the company (with the company offsetting the refund against future Dividends Tax or by requesting a refund directly from SARS), followed by requests for refunds directly from SARS. If the withholding agent is a regulated intermediary, the beneficial owner may seek a refund from the regulated intermediary for a period of up to three years (with the regulated intermediary offsetting the refund against future Dividends Tax).

C. Interest withholding tax

With effect from 1 July 2013, cross-border interest will be subject to withholding tax at the proposed rate of 10 per cent (subject to treaty limits). The person making payment for the benefit of a foreign recipient is liable to withhold this tax. However, to the extent that sums are owed, the ultimate liability rests with the person to whom the amount of interest is paid or accrues. Payment of withholding tax on interest must be made at the close of the month following the month in which the interest is paid.

Foreign recipients seeking tax treaty (or certain other forms of) relief must submit a declaration by date of payment. If a declaration is submitted within a three-year period, the foreign recipient may seek a refund from SARS.

D. Withholding tax on royalties

Cross-border royalties are subject to a withholding tax at a rate of 12 per cent. The person making payment of the royalty to (or the recipient of the royalty on behalf of) the non-resident is liable to pay withholding tax. Payment must be made over to SARS within 14 days or within a period that SARS may approve. The royalty withholding rules do not have a refund mechanism.

II. Reasons for change

As illustrated above, withholding taxes relating to dividend, interest and royalties differ as to rates, timing, refunds and other procedures. While some of these differences can be justified, many of these differences have arisen simply due to the dates in which these provisions were enacted. The result is a lack of coordination among these withholding taxes, thereby complicating administration and compliance. Greater uniformity is needed to greatly reduce these burdens.

III. Proposal

In order to remedy the lack of coordination among withholding tax regimes, it is now proposed that these withholding regimes be unified to the extent possible. In the main, these changes will require adjustments to the interest and royalty withholding regimes because the rules around the recently enacted Dividends Tax have been well-debated and settled. These changes will include a uniform withholding rate of 15 per cent.

A. Interest

1. Withholding tax rate and amount

The withholding tax rate will increase from 10 per cent to 15 per cent.

2. Liability

As currently proposed, the liability to withhold tax on interest will remain with the person making payment (payor) of interest for the benefit of a foreign person. In addition, ultimate liability will remain with the beneficial owner. However, a mere accrual will no longer be the basis for withholding. In line with the new Dividends Tax, the trigger date for withholding will now be the date that a sum is paid or becomes due and payable.

3. Timing of tax payment to SARS

Payment to SARS of withholding tax on interest must be made at the close of the month following the month in which the interest is paid. Because this timing rule matches the payment date of the Dividends Tax, this rule will remain unchanged.

4. Refund mechanism and declaration

Under current law, overpayments of interest amounts (due to delayed declarations or otherwise) may be refunded from SARS only if the foreign payee lodges a refund claim with the payor within three years after the payment of interest. This refund process will be slightly simplified. The refund claim will instead solely involve SARS (i.e. the claim must be made solely to SARS within the three-year period without regard to the payee).

5. Currency translation rules

The current interest withholding rules lack any currency translation rules if the interest amount is paid or payable in the form of foreign currency. In line with the rules for withholding in relation to foreign sportspersons and entertainers, the interest must be translated to the currency of the Republic at the spot rate on the date that the payor withholds or deducts the withholding tax. (A similar rule will also be added for the Dividends Tax paid or payable in a foreign currency.)

6. Clarification of interest exemptions

The withholding tax on interest does not apply in respect of any interest paid in respect of any Government debt instrument. Questions exist as to whether interest arising from a Government refund (e.g. a refund of tax) falls within this exemption because the interest does not appear to be in respect of any “debt instrument.” The debt instrument language will accordingly be dropped to clarify that the exemption should apply to this form of interest and any other for.

The reference to a “debt instrument” was also considered too narrow in respect of the South African banks. The wording similarly appeared to limit the exemption to interest from debt instruments, thereby not including other forms of interest-producing instruments, such as repos. Under the revised proposal, the exemption from the withholding tax on bank interest should apply to all forms of interest paid by a bank, regardless of whether a debt instrument is involved.

Lastly, 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.

7. Clarification of normal tax and interest withholding tax

Interest earned by foreign persons may fall within the normal tax rules or the interest withholding tax rules. As a general matter, foreign persons are exempt from income tax *unless* that person:

- is a natural person who is physically present within South Africa during the relevant year of assessment for more than 183 days, or

- has a permanent establishment within South Africa at any time during the relevant year of assessment.

In other words, foreign persons will be subject to normal tax on interest if those persons have a strong connection to South Africa. Otherwise, normal tax does not apply. On the other hand of the spectrum, withholding tax potentially applies when this strong connection does not exist (i.e. when the foreign person only has a passive connection to South Africa.

B. Royalties

1. Withholding tax rate

The withholding tax rate will increase from 12 per cent to 15 per cent.

2. Liability

The initial liability to withhold tax on royalties will remain with the person making payment (payor) of interest for the benefit of a foreign person. In addition, ultimate liability will lie with the beneficial owner of the dividend. However, a mere accrual will no longer be the basis for withholding. In line with the new Dividends Tax, the trigger date for withholding will now be the date that a sum is paid or becomes due and payable.

3. Timing of tax payments to SARS

Payment to SARS of withholding tax on royalties will be changed. The payment date must henceforth be made at the close of the month following the month in which the royalty is paid. This timing rule matches the rules for withholding in respect of dividends and interest.

4. Currency translation rules

The royalty regime will now contain currency translation rules. The amount of royalties must be translated to the currency of the Republic at the spot rate on the earlier of the date on which the amount of royalties is paid or becomes payable.

5. Refund mechanism and declaration

Overpayments of the amounts of royalties may be refunded only if the payor lodges a claim for refund with SARS within a period of three years after the payment of royalties.

6. Clarification of normal tax and royalty withholding

Royalties earned by foreign persons may fall within the normal tax rules or the royalty withholding tax rules. As a general matter, foreign persons are exempt from income tax _*unless*_ that person:

- is a natural person who is physically present within South Africa during the relevant year
  of assessment for more than 183 days, or

- has a permanent establishment within South Africa at any time during the relevant year of assessment.

In other words, foreign persons will be subject to normal tax on the royalties if those persons have a strong connection to South Africa. Otherwise, normal tax does not apply. On the other hand of the spectrum, withholding tax potentially applies when this strong connection does not exist (i.e. when the foreign person only has a passive connection to South Africa.

IV. Effective Date

The proposed amendment will be effective for royalties that are paid or payable on or after 1 July 2013.

5.6. REMOVAL OF THE CONTROLLED FOREIGN COMPANY (CFC) EXEMPTION FROM INTEREST AND ROYALTY WITHOLDING

[Applicable provision: Sections 9D(9), 10(1)(h) and 10(1)(l); Parts IA and IVA of Chapter II]

I. Background

A. Interest and royalty withholding exemptions for CFCs

Payments of cross-border interest to a CFC are exempt from withholding tax on interest. Further, royalties received or accrued by a CFC are excluded from the withholding tax on royalties.

B. Interest and royalties as CFC inclusions

Interest and royalties received by CFCs potentially give rise to CFC (i.e. section 9D) inclusions for certain South African holders of participation rights (e.g. of shares) in a CFC. The CFC net income calculation is based on hypothetical taxable income as if the CFC were a South African resident for a variety of purposes, including the receipt or accrual of interest. Therefore, interest received or accrued by a CFC would not be exempt from a CFC inclusion under the cross-border interest exemption described above (because the CFC is not viewed as a foreign person for the purposes of section 9D). Royalties will be potentially subject to a CFC inclusion unless subject to withholding.

II. Reasons for change

The current system appears to waive withholding in favour of potential CFC inclusions. This waiver has the effect of pushing interest and royalties received or accrued by CFCs outside direct South African taxing jurisdiction in favour of secondary taxing jurisdiction arising from CFC income. The latter form of income is notably harder to enforce and contains many more exemptions. The purpose of the CFC rules is largely to extend the South African tax base. Therefore, no reason exists to have CFC rules that effectively reduce direct South African taxing jurisdiction.

III. Proposal

In view of the above, it is proposed that the CFC exemptions from interest and royalties in respect of cross-border withholding be fully removed. Cross-border interest and royalties will be fully subject to tax unless a treaty applies to reduce or eliminate the tax. In effect, CFCs will be treated like any other foreign company for withholding purposes.

Both forms of cross-border amounts will be treated like any other amounts received or accrued by a CFC for purposes of determining potential CFC (i.e. section 9D) inclusions. However, an exemption from section 9D will exist if the amount is subject to any level of South African cross-border withholding (i.e. after taking tax treaties into account). This latter rule prevents double taxation (i.e. direct and indirect South African taxation).

IV. Effective Date

The proposed amendment will be effective for amounts that are paid or payable during years of assessment beginning on or after 1 January 2013.

5.7. RELIEF FROM THE EFFECTIVE MANAGEMENT TEST IN THE CASE OF HIGH-TAXED CONTROLLED FOREIGN COMPANIES (CFCs)

[Applicable provision: Section 1 (proviso to the “resident” definition]

I. Background

Over the past few years, Government has introduced a number of initiatives aimed at reducing potential double taxation for South African companies investing into Africa. These initiatives are aimed at facilitating the expansion, global competitiveness and smooth operation of South African multinational companies in other countries. These initiatives are also intended to eliminate perceived barriers that may negate the benefits of the newly established headquarter company regime (which is intended to facilitate South Africa’s role as a regional financial centre).

II. Reasons for change

Despite the various initiatives introduced over the past few years, active South African management in respect of foreign subsidiaries still has the potential to trigger dual residence status, thereby triggering potential double taxation (setting aside the potential application of tax rebates). This result may arise even though the day-to-day operational management activities of these foreign subsidiaries are conducted outside South Africa. This lack of local management typically occurs because of practical difficulties existing in the foreign country of concern (e.g. lack of infrastructure).

The SARS discussion paper in respect of Interpretation Note 6 also acknowledges this difficulty in respect of the headquarter company regime. In the problem statement, SARS states that “from a practical perspective, a determination that a foreign operating subsidiary of a headquarter company has its place of effective management in South Africa would negate many of the benefits offered by the new regime. In particular, this form of foreign operating subsidiary would have to recompute its income each year as if the company were a South African resident …”

It should also be noted that the effective management issue often arises in circumstances where the foreign country imposes tax at a level comparable to, or higher than, the South African tax. Dual taxation in these circumstances often provides little additional revenue for the South African fiscus because the potential additional South African tax is often offset by foreign tax rebates. The end result is a series of complex calculations that overly burden both taxpayer compliance and SARS enforcement.

III. Proposal

In order to eliminate the potential for double taxation described above, it is proposed that the "place of effective management test" for residency be eliminated in the case of South African owned foreign subsidiaries if: (i) the subsidiary is highly taxed, and (ii) the subsidiary has a foreign business establishment. Little is at stake for the fiscus in these circumstances (because the South African tax liability should be largely eliminated by tax rebates). Moreover, no policy rationale exists for taxing controlled foreign subsidiary income under the effective management test if the income from that foreign subsidiary is otherwise specifically excluded from the controlled foreign company (CFC) regime.

More specifically the effective management test for residency will be waived if the following three conditions are satisfied, namely:

- The foreign incorporated company qualifies as a controlled foreign company (determined without regard to the effective management test);

- The foreign company has a foreign business establishment during the year of assessment; and

- The foreign company is subject to a high level of tax (an aggregate effective rate of 75 per cent of the South African rate that would otherwise be imposed) during the relevant year of assessment. For purposes of this 75 per cent threshold, foreign taxes on income imposed by all foreign spheres of government (national, provincial and local) must be taken into account. The calculation of the aggregate effective rate also takes into account all income tax treaties, rebates, credits or other rights of recovery. Lastly, the rate is calculated after disregarding carryover losses as well as group losses.

- The proposed effective management test exemption will be determined and will apply on an entity basis. Stated differently, this relief applies to all of the company's income (i.e. not merely the high-taxed portions nor merely the business establishment portions).

- As a result of the effective management test exemption, the foreign company could potentially trigger an exit charge if the foreign company technically ceases to be a resident. This exit charge would apply the day before the cessation. This result should not arise as a policy matter, however, because the new regime is designed to assist taxpayers. The exit charge will accordingly be switched off in this instance if the entity shifts tax residence status as of 1 January 2013 by virtue of the proposed amendment.

IV. Effective date

The amendment will come into effect on 1 January 2013 and will apply in respect of any year of assessment commencing on or after that date.

5.8. RELIEF FROM TRANSFER PRICING IN THE CASE OF HIGH-TAXED CONTROLLED FOREIGN COMPANIES (CFCs)

[Applicable provision: Section 31(6)]

I. Background

Over the past few years, Government has introduced a number of initiatives aimed at reducing potential double taxation for South African companies investing into Africa. These initiatives are aimed at facilitating the expansion, global competitiveness and smooth operation of South African multinational companies in other countries.

II. Reasons for change

South African companies often make interest-free loans to controlled foreign subsidiaries for non-tax reasons. These soft-loans often operate as an implicit form of share capital (i.e. lacking interest and fixed dates of repayment). The purpose of these loans is mainly to allow for the seamless withdrawal of funds for foreign company law and to alleviate certain adverse impacts of foreign exchange controls. As such, these soft loans are an important method of indirectly funding offshore start-up operations. South African companies may also provide yield-free licenses (and other forms of yield-free intellectual property) to controlled foreign subsidiaries for similar non-tax reasons.

The lack of yield for these instruments unfortunately has undesirable side-effects for tax purposes. The South African holder may be subject to transfer pricing concerns, thereby being subject to tax based on a higher notional yield. On the other hand, the foreign company obligor will often be allowed a foreign deduction only for actual cross-border payments to the South African company (as opposed to a foreign deduction for the higher notional payments). The net result is a potential de facto double taxation; a result that reduces the international competitiveness of South African multinationals.

III. Proposal

In order to eliminate the potential for double taxation described above, it is proposed that transfer pricing not apply to certain cross-border financial assistance transactions (e.g. loans) and certain cross-border uses of intellectual property. More specifically, transfer pricing will not apply to holders (i.e. creditors) of a loan or holders of intellectual property if:

- The holder is a South African company;
- The obligor is a CFC in relation to the South African holder and 10 per cent of the equity shares and voting rights in the obligor is directly owned by that holder

(whether alone or together with any other company forming part of the same group of companies as the holder);

- The CFC has a foreign business establishment; and

- The CFC is highly taxed (an aggregate effective rate of 75 per cent of the South African rate that would otherwise be imposed). For purposes of this 75 per cent threshold, foreign taxes on income imposed by all foreign spheres of government (national, provincial and local) must be taken into account. The calculation of the aggregate effective rate also takes into account all income tax treaties, rebates, credits or other rights of recovery. Lastly, the rate is calculated after disregarding carryover losses as well as group losses.

Little possibility for avoidance exists in these circumstances because the high-taxed nature of the foreign obligor provides little overall net global tax savings if interest is under-stated. This relief also roughly corresponds with the effective management relief for high-taxed CFCs.

IV. Effective date

The amendment will come into effect on 1 January 2013 and will apply in respect of any year of assessment commencing on or after that date.

5.9. FOREIGN REBATES (I.E. CREDITS) FOR SERVICE FEES IMPROPERLY SUBJECT TO FOREIGN WITHOLDING TAXES

[Applicable provision: Section 6quin(a) and (b) of the Income Tax Act]

I. Background

Historically, foreign tax rebates (i.e. credits) have been limited to foreign source income. This limitation is based on the notion that foreign tax credits should be limited to situations in which the taxation of a foreign country overlaps with South African taxing jurisdiction.

In 2011, a limited foreign tax credit for service (e.g. management) fees was introduced. This limited foreign credit applies to foreign withholding taxes imposed in respect of service fees rendered in South Africa by a South African resident to a resident of a foreign country. Unlike the standard foreign tax credit, the limited foreign tax credit is determined income-stream-by-income-stream and excess credits cannot be carried over to subsequent years.

This limited credit is outside the standard theoretical paradigm. This limited credit effectively operates as a concession to facilitate international competitiveness. South African multinationals (and headquarter companies) require some form of relief or effectively face international double taxation due to potential dual taxation of cross-border service fees. Alternatively, entities in this circumstance will move their management services offshore into low-tax (or no-tax) jurisdictions so as to effectively eliminate this form of double taxation through pragmatic means. It makes little sense to force entities offshore solely to maintain purist tax norms.

It should be noted that foreign taxes in respect of South African sourced income typically arise in two circumstances. Sometimes, these charges come in the form of withholding taxes arising in violation of double tax treaties. Other times, these taxes arise when South Africa has no tax treaty with the country at issue. It should further be noted that these charges could be eliminated through bilateral negotiation and discussion between South Africa and the country at issue. In this vein, a reporting requirement has been added that will require specialised reporting to SARS so that aggregate data can be compiled to support South Africa in the bilateral process. This reporting requirement will be added once SARS administration support systems are implemented.

II. Reasons for change

In addition to the circumstances above, certain older treaties recharacterise South African source income as foreign source income. This recharacterisation prevents the section 6quin credit from applying even though the foreign tax treaty partner is wrongfully imposing tax. At the same time, South African foreign tax credits are again not an option for relief in these circumstances (because section 6quin credits must be derived from South African source income). In order for section 6quat foreign tax credits to be available, the taxes at issue must be "proved to be payable", and taxes imposed in violation of treaty cannot by definition be "payable" because the existence of the tax treaty means that no foreign tax should be required.

III. Proposal

In view of the above, it is proposed that the scope of the limited foreign tax credit (enacted in 2011) be extended. In addition to the current coverage relating to South African source income, the limited credit will be extended to taxes actually paid in respect of services rendered in a South African source, even if the activities are viewed as having a foreign source solely by virtue of a tax treaty. In essence, the foreign source treaty characterisation will not be applied to undermine the section 6quin credit.

IV. Effective Date

The proposed amendment will be effective for years of assessment beginning on or after 1 January 2012 in respect of amounts of foreign tax withheld on or after that date.

5.10. FURTHER REFINEMENTS TO THE HEADQUARTER (HQ) COMPANY REGIME

[Applicable provisions: Sections 9I, 20C, 31(5) and 35 of the Income Tax Act]

I. Background

A. Overview and qualifications

The Headquarter (HQ) company regime provides various tax rules that promote South Africa as a regional financial centre (i.e. as a holding company jurisdiction). The premise of the HQ company regime is that investments originated and redeployed offshore should not attract

South African tax merely because these investments are routed through South Africa. Additional tax charges in these circumstances create a serious price barrier for multinationals because little South African value addition occurs, thereby deterring multinationals from utilising South Africa as a holding company viable location.

The basic requirements for an HQ company are mainly that:

- Each shareholder of the HQ company must hold at least 10 per cent of the HQ's shares;
- The HQ company's asset base must comprise at least 80 per cent participation interests in foreign subsidiaries (i.e. equity, loans and intellectual property); and
- If the income of an HQ company exceeds R5 million per annum, at least 50 per cent of the HQ company's gross income must be derived from the aforementioned asset base.

The 10 per cent shareholder test and the 80 per cent asset test must be satisfied not only for the relevant year of assessment but also for all prior years of assessment in which that company exists. The 50 per cent income test needs to be satisfied only in respect of the relevant year of assessment. In addition, the company must file an annual election to become (and remain) an HQ company.

B. Back-to-back flows

The HQ company regime provides a number of tax benefits that are important for regional holding companies. One key area is the elimination of tax in respect of back-to-back cross-border flows. For instance, foreign dividends received by an HQ company are eligible for the general foreign dividend participation exemption (i.e. if the foreign dividend stems from a foreign subsidiary that is at least 10 per cent owned). Dividends paid by an HQ company are also fully exempt from the dividends tax (and effectively exempt from the normal tax).

Relief by way of exemption also exists for HQ companies involved in back-to-back loans to 10-per cent shareholders. This situation typically arises when the HQ company borrows funds from a significant foreign shareholder (e.g. the parent company in relation to the HQ company) and on-lends that amount to a foreign subsidiary. In addition, these back-to-back loans often contain rates of interest that deviate from standard transfer pricing principles. In order to alleviate these concerns, back-to-back loans sourced from offshore and redeployed via the HQ company into foreign subsidiaries are not subject to transfer pricing rules. However, excess losses from these loans are ring-fenced (so net losses cannot be used to reduce locally value-added income).

II. Reasons for change

A. Always qualification rule

As stated above, the 10 per cent shareholder test and the 80 per cent asset test must be satisfied not only for the relevant year of assessment but also for all prior years of assessment in which that company exists. This "always qualification" rule creates practical difficulties in the case of certain start-up operations. In particular, in order to accelerate the legal establishment of the entity, many businesses prefer to acquire "off-the-shelf" companies previously in existence. These "off-the-shelf" companies are dormant with nominal amounts of cash.

Nonetheless, despite their widespread commercial usage, these "off-the-shelf" companies are problematic from a HQ company perspective. These companies will often fail the "always qualification" due to the uncertainty surrounding the nominal history of the company during the dormancy period. No policy reason exists to curtail the use of "off-the-shelf" companies to accelerate the start-up of an HQ company.

B. Back-to-back royalties

Even though the HQ company regime eliminates tax as a barrier in the case of back-to-back dividends and loan interest, no comparable relief exists in the case of royalties. Like loans, back-to-back intellectual properties (e.g. licenses) are often routed through HQ companies. These additional levels of tax can create unnecessary barriers if a South African HQ company is to act as a central clearinghouse for intra-group intangibles.

III. Proposal

A. 10 per cent shareholding

It is also important to note that the 10 per cent shareholding test will become an annual test so as not to take into account ownership of prior years (i.e. the always qualification requirement will be dropped in this regard). This requirement is no longer necessary because conversion to a South African headquarter company triggers an exit charge.

B. Dormant company relief

In addition to the above, it is proposed that the 10 per cent shareholder test and the 80 per cent asset tests be waived to the extent that the company at issue is dormant. More specifically, the 10 per cent shareholder requirement will be waived during portions of the year in which no trade is conducted. The 80 per cent cost test is waived if the company never holds more than R50 000 worth of assets at any time during the year.

C. Back-to-back intellectual property

In line with the intended policy premise of the HQ company regime, it is proposed that the current transfer pricing rules be relaxed in respect of back to back licensing of intellectual property via an HQ company. The proposed rules in this regard will mimic the existing rules in respect of back-to-back loan interest. More specifically, transfer pricing will not apply, but net losses in this regard must be ring-fenced. As an ancillary matter, the HQ company will also be exempt from withholding tax on royalties in respect of back-to-back royalties if the royalties are paid to a 10-per cent or greater foreign shareholder.

IV. Effective date

The amendment will come into effect on 1 January 2013 and will apply in respect of any year of assessment commencing on or after that date.

5.11. SOUTH AFRICAN FUND MANAGERS OF FOREIGN INVESTMENT FUNDS

[Applicable provision: Section 1 (definition of "foreign investment entity" and further proviso to the "resident" definition]

I. Background

Foreign investors (especially pension funds and other institutional investors) utilise a variety of international funds as a vehicle for specified international investment mandates. Many of these investments are routed through low tax jurisdictions in order to ensure that these investments are tax efficient so as to avoid multiple levels of cross-border taxation. A growing object of these investment funds is the African region (including Southern Africa). These funds involve traditional investment funds as well as hedge funds.

Given the African focus of certain funds, the use of local South African expertise represents a desirable option. More specifically, certain foreign investment funds seek to use active local managers for direction when investing in South African assets or in other African assets. The South African manager is usually given an investment fund mandate (or a sub-mandate for a certain portion of the fund). The fund typically pays the South African investment manager a management fee. This fee is commonly based on a percentage of the assets of the fund, plus a performance fee if the fund's net asset value increases during the year. The fund also typically requires administration and other incidental financial services (e.g. accounting and legal compliance services).

II. Reasons for change

South Africa's economy, its reputation for financial services and regional expertise make South Africa an ideal destination for international capital dedicated to African regional investment. However, investing in African assets using the fund structure described above has the unintended side-effect of creating significant tax risks if a South African investment manager is involved.

Mainly at issue is the income tax test relating to "effective management". Like most global income tax systems, a fundamental feature of the South African income tax is the test for effective management as a trigger for South African taxation on a worldwide basis (i.e. resident-based taxation). If use of a local South African manager triggers this test, the whole of the fund could potentially be subject to South African worldwide tax. This possibility makes South African local managers potentially unattractive for foreign funds, especially since all of the funds are derived from an offshore location that has other global options. One practical way to limit this tax concern is to limit the local South African manager's freedom to make decisions, but this limitation undermines the very purpose of utilising the local manager.

It should also be noted that the "effective management" test is an important but older doctrine that was never really designed to address investment fund situations of this nature. The "effective management" test was mainly designed with traditional direct corporate investment in mind (e.g. for manufacturing and mining). For instance, many foreign companies will have a choice of undertaking active business operations within a South African subsidiary or branch. The effective management test would deem a foreign company with a South African branch to be a South African company if the core management overseeing those management operations is located in South Africa. In the case of a foreign-owned investment fund, management merely consists of balancing or choosing passive portfolio investments with little value addition to the underlying investments.

III. Proposal

A. Overview

In view of the above, it is proposed that a carve-out be created from the effective management test for foreign investment funds. The purpose of this carve-out is to remove the potential for South African worldwide taxation due to the full and free use of a local investment manager. The management fees and performance fees earned by the local investment manager will remain subject to tax in South Africa (i.e. local South African tax will be limited to local South African value-addition).

In order to receive the proposed carve-out from the "effective management" test, the fund at issue must satisfy the following tests:

a. The fund must be incorporated, formed or otherwise established in a foreign country;
b. The fund must consist of a portfolio;
c. The sole assets of the fund must consist of:
    i. Cash or cash equivalents;
    ii. Government bonds;
    iii. Listed financial instruments;
    iv. Unlisted instruments that are regularly traded by members of the general public through an established market platform (i.e. liquid over-the-counter financial instruments); and
    v. Rights to listed and over-the-counter instruments just described (e.g. derivatives).
d. The fund must have no employees and no full-time directors or trustees; and
e. South African residents may not directly or indirectly own more than 10 per cent of the value of the shares, units or participatory interests in the fund.

If the above requirements are satisfied, the "effective management" test in relation to the foreign investment fund will not take into account services provided by a company that qualifies as a licensed "financial services provider" under the Financial Advisory and Intermediary Services, Act 2002 (Act No. 37 of 2002). Disregarded activities involve financial product advice, intermediary service and incidental activities thereto. The net effect of this exclusion from the "effective management" test should allow local investment managers the freedom to compete for international investment fund business.

IV. Effective Date

The proposed amendment will be effective for years of assessment beginning on or after 1 January 2013.

5.12. REVISED CURRENCY RULES FOR INTRA-GROUP EXCHANGE ITEMS

[Applicable Provision: Section 24I(7A), (10), 10A]

I. Background

The system for taxing currency gains and losses arising among related companies is divided into two sets of rules that depend upon different effective dates. On set of rules deals with loans or advances obtained or granted during any year of assessment ending on or before 8 November 2005. The more recent set of rules deal with all exchange items between related companies to the extent the exchange items have been entered into after 8 November 2005.

From 8 November 2005, all exchange differences (not just debt–related items) in respect of related-company loans are simply deferred until realised (without any spreading over a 10-year period as existed under the pre-8 November 2005 regime). More specifically, this deferral applies to exchange items between (1) a resident and a connected person in relation to that resident, (2) a resident and a controlled foreign company in relation to that resident or a group company in relation to the resident, or (3) a controlled foreign company and another controlled foreign company in relation to the same resident or the same group of companies.

II. Reasons for change

As a general principle, the taxation of annual mark-to-market currency exchange gains and losses should closely follow the accounting principles of International Financial Reporting Statement (IFRS) unless there are good reasons for deviation. One of the main reasons for deviation is liquidity. In the case of intra-group loans there is a problem with liquidity, and therefore a deviation from IFRS is necessary. For instance, short-term loans are more efficient to keep on mark-to-market taxation even if these short-term loans are between a group or connected persons.

III. Proposal

A. Revised taxation of related-company monetary items

In the main, loans between group companies and connected persons will fall outside the mark-to-market regime. Loans of this nature will be subject to currency taxation only until the sooner of realisation or when the group/connected person nexus is lost. Once one of these events occurs, currency gain and loss is triggered as ordinary revenue.

However, the group/connected person relief does not apply to:

- Short-terms loans that constitute current assets and current liabilities;
- Hedged loans; and
- Loans funded by third-party loans.

Current assets and liabilities fall outside the relief because the nature of these short-term items means that taxation does not give rise to liquidity concerns. Hedged loans and loans funded by third-party loans are not a problem because the hedge/third party loan will move in an opposite direction to the underlying loan, thereby acting as an offset to gain or loss. This offset effectively neutralises the currency gain/loss of the underlying loan.

Example 1:
Facts: South African Parent owns all the shares of Foreign Subsidiary. South African Parent provides a 25-year interest-free loan out of South African Parent's capital reserves that will probably be refinanced by Parent at the end the 25-year period. The loan is not hedged.

Result: The South African Parent and the Foreign Subsidiary are members of the same tax group. In addition, Foreign Subsidiary will not recognise the loan as a current liability because of the long term nature of the loan. Therefore, these currency gains and losses will be deferred until realization (or until the group/connected person nexus between South African Parent and Foreign Subsidiary is lost).

Example 2:
Facts: South African Parent owns all the shares of Foreign Subsidiary. South African Parent borrows £5 million of funds from an independent U.K. bank for a five-year term at an interest rate of JIBOR plus 4 per cent. South African Parent on-lends the funds (in the form of pounds) to Foreign Subsidiary to be repaid when Foreign Parent is required to repay the initial loan to the U.K. bank.

Result: Both loans are taxed on an annual mark-to-market basis. The loan by independent U.K. bank to South African Parent is not part of the group. While part of a single group, the loan from South African Parent to Foreign Subsidiary is indirectly funded by a non-group member or non-connected party (U.K. Bank).

B. Ancillary post-8 November 2005 exchange differences

As an ancillary matter, the intra-group deferral rules under the current post-8 November 2005 regime will be completely abandoned. Exchange items falling within this regime will be deemed to be realised at the end of the year of assessment ending before the commencement of a new year of assessment on or after 1 January 2014. In terms of the 2014 cessation, any gain or loss arising may be deferred if the exchange item exists within a group/connected person relationship falling under the new rules. This gain or loss will be deferred until the sooner of realisation or the date when the group/connected person relationship is lost.

IV. Effective date

The proposed amendments will apply in respect of any year of assessment commencing on or after 1 January 2013.

5.13. REMOVAL OF MISPLACED NON-MONETARY AND MONETARY FOREIGN CURRENCY CALCULATIONS

[Applicable Provisions: Section 24I(11); paragraphs 43(1) and (4) of the Eighth Schedule]

I. Background

A. Non-monetary capital assets purchased and sold in a single foreign currency

As a general matter, the capital gains system ignores currency gains and losses when an asset is acquired and disposed of within the same foreign currency. In these circumstances, capital gain or loss is simply calculated utilising the foreign currency as the starting point with this gain or loss converted to Rands at the end (at an average exchange rate). However, currency gains and losses in respect of assets acquired and disposed of within a same foreign currency will trigger capital gains tax if the asset at issue consists of foreign equity or South African sourced assets. The CGT rules do not apply to monetary items falling under the mark-to-market system.

B. Loans (and associated hedges) matched against non-monetary items

Section 24I generally recognises foreign exchange gains and losses on an annual basis irrespective of whether the gains or losses are realised. One exception to this rule is currency gains and losses in respect of loans used to acquire assets other than monetary (and similar) assets. Under this exception, currency gain and loss in respect of these loans is generally ignored. A comparable rule exists for derivative hedges in respect of these loans.

II. Reasons for change

A. Inappropriate currency capital gain/loss calculations

The current capital gains tax rules that disregard currency gains and losses in respect of non-monetary assets is hard to justify. While a rule of simplicity is defensible for many natural persons and other non-business entities, calculation of currency gain or loss for the disposal of non-monetary assets is an accepted fact for multinationals and larger businesses operating in a cross-border paradigm. This currency gain or loss calculation is actually required for accounting systems. Hence, deviations from this calculation actually add to compliance costs because tax compliance systems need to deviate from the default system methods of financial accounting.

B. Inappropriate currency matching of monetary to non-monetary items

In terms of mark-to-market taxation of currency gains and losses, financial accounting does not generally match monetary items with non-monetary items. The current tax deviation creates unnecessary systems issues for larger companies and creates unnecessary book/tax disparities. Linking monetary items to non-monetary items also makes little policy sense since the change in value associated with the non-monetary item has no direct or immediate bearing on currency gain or loss.

III. Proposal

A. Mixed approach for capital gains tax in respect of assets acquired and disposed of within a single foreign currency

Currency gain or loss for non-monetary capital assets will be adjusted for different taxpayers. The current simplified method for calculating capital gain or loss in respect of assets acquired and disposed of within a single foreign currency will be retained for natural persons and non-trading trusts. Other persons (i.e. companies and trading trusts) will be subject to currency capital gain or loss in line with underlying economics. Hence, if these other persons acquire an asset in a foreign currency and dispose of that asset in the same foreign currency, the simplified method will no longer apply. Instead, the acquisition price will be translated into local currency (typically Rands) using the exchange rate upon acquisition, and the disposal price will be translated into local currency (typically Rands) using the exchange rate upon disposal. The currency exchange rate differences stemming from the different dates will give rise to currency capital gain or loss.

B. Removal of non-monetary matching for loans (and associated hedges)

While the linking of monetary to non-monetary items could possibly be justified as a means for countering the distortion resulting from capital gain or loss currency taxation described above, this justification is now removed with the deletion of this distorted method for companies and trading trusts. It is accordingly proposed that the current matching of monetary items (i.e. loans and associated hedges) to non-monetary items be completely removed from the mark-to-market system of currency taxation applicable to companies and trading trusts.

Monetary items will continue to be excluded from the new CGT framework for companies and trading trusts. The excluded exchange items are specified as units of currency, debt and related derivative instruments such as forward exchange contracts and foreign currency option contracts. This exclusion will apply regardless of whether these monetary items are subject to mark-to-market taxation.

IV. Effective date

The amendments to the capital gains tax in respect of currency will apply to the disposal of assets on or after 1 January 2013. The amendments to mark-to-market taxation of currency will apply in respect of exchange differences arising on or after 1 January 2013.

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6. VALUE-ADDED TAX

6.1. INSTALMENT CREDIT AGREEMENT

[Applicable Value-Added Tax Act provision: Section 1 (paragraph (b) of the ‘installment credit agreement’ definition)]

I. Background

A. Conventional instalment credit agreements

1. Definitional requirements

For VAT purposes, an instalment credit agreement is an agreement whereby goods are supplied:

(i) under an outright sale, whereby instalment payments are made over an agreement period), or

(ii) by way of a financial lease with an option to buy the good at the end of the lease-term upon payment of a residual.

In order for a financial lease to qualify as an instalment credit agreement, the agreement must satisfy several requirements. For instance, the rental for the lease payment must include an element of finance charges that is stipulated within the lease. In addition, the lessee must accept full risk of destruction or loss of the good (i.e. the risk must lie with the lessee as opposed to the lessor).

2. VAT implications

Instalment credit agreements trigger an upfront VAT charge. In the case of a financial lease offered by a bank, the bank typically purchases the good for the benefit of the lessee and then resells the good/asset to the client. The upfront purchases results in a VAT charge and an input claim by the bank. The bank then leases the good to the client, triggering another VAT charge (with the client obtaining an upfront VAT input if the client is a VAT vendor). This upfront charge is for the upfront value of the good (without regard to subsequent implicit interest).

B. Shariah compliant (Ijarah) sales

1. Ijarah qualifications

Islamic (Shariah) law forbids the charging of interest. However, Shariah law allows for more indirect means of financing. These indirect forms of financing include the Ijarah, which is a form of finance lease. An Ijarah typically assumes the following structure:

- The bank/financier purchases the asset and is the owner;
- The bank leases the asset to the client;
- The client pays a monthly payment (based on the Bank purchase price with a mark-up calculated with reference to time value of money principles);
- The client has an option to purchase the asset at the end of the lease period; and

- The bank is responsible for the costs of insuring the goods but recovers this charge by way of a separate invoice to the client

2. Current VAT impact

Strictly speaking, Ijarah leases do not conform to the requirements of an instalment credit agreement as defined in the VAT Act. In particular, the Ijarah lacks a formal "finance charge" and places the risk of loss on the lessor (despite the invoice charge to the client). Consequently, Ijarah leases are treated as normal rental agreements.

Rental agreements are a more expensive way of financing for clients because the VAT is calculated differently than for an instalment credit agreement. For instalment credit agreements, VAT is levied upfront on the cash cost of the asset (without regard to the implicit subsequent interest). On the other hand, in the case of rental agreements, VAT is levied on the full rental amount, including the implicit interest component. In terms of compliance, banks must account for Ijara financing differently from conventional instalment credit agreements.

II. Reasons for change

As stated above, Shariah (Ijarah) compliant financing agreements typically do not follow the same formal structure as that of conventional banking products, even though the economic impact is roughly the same. The net result is an additional VAT charge falling upon implicit interest that leaves this form of financing at a disadvantage. Over the last several years, various tax changes have been made to eliminate the tax disadvantages of various forms of Shariah compliant products vis-à-vis conventional Western products.

III. Proposal

It is proposed that the definition of "instalment credit agreement" be expanded to cater for certain aspects of Ijarah finance leases. In particular, the finance charge requirement will be expanded to include mark-ups based on time-value of money principles. In addition, risk of loss will be deemed to fall on the lessee if the lessee fully reimburses the lessor for the insurance undertaken by the lessor to protect against risk of loss.

IV. Effective date

The proposed amendment will apply in respect of instalment credit agreements entered into on or after 1 October 2012.

6.2. CREDIT AND DEBIT NOTES

[Applicable Value-Added Tax Act provision: section 21(1)]

I. Background

Vendors that make taxable supplies must issue a tax invoice to recipients within 21 days of the date of the supply. The VAT Act generally does not allow for the issue of more than one tax invoice per supply. However, vendors may issue credit and debit notes for supplies under specified scenarios so as to adjust the initial tax invoice. These scenarios cover cancelled supplies, fundamental changes to a supply, adjustments to agreed consideration and the return of supplies.

II. Reasons for change

If a vendor issues a tax invoice for an incorrect amount, the vendor is prohibited from issuing a corrected tax invoice via a debit or credit note (for the reasons explained above). For instance, if a vendor wrongfully issues a tax invoice for the amount of R1114 instead of R114, the vendor is prohibited from issuing a credit note to the recipient of the supply so as to correct the mistake because this scenario falls outside the list of permissible scenarios.

III. Proposal

It is proposed that the specified conditions for the issue of credit or debit notes be extended to allow for the correction of mispriced tax invoices. These corrections will cover credit notes (for incorrect overcharges) and debit notes (for incorrect undercharges).

IV. Effective date

According to general principles, the proposed amendment will apply to all supplies made by a vendor on or after the date of promulgation of this Bill.

6.3. POTENTIAL VAT DOUBLE CHARGE FOR GOODS REMOVED FROM CUSTOMS CONTROLLED AREAS

[Applicable Value-Added Tax Act provisions: sections 8(24) & 18(10)]

I. Background

A. Goods imported into a customs controlled area (CCA)

As a general rule, VAT applies when goods are imported into South Africa. However, an exemption exists for movable goods imported into a customs controlled area (CCA) of an industrial development zone (IDZ). In this latter instance, no VAT applies as long as the goods remain within the CCA. When the goods leave the CCA (i.e. entered for home consumption), a deemed importation occurs so as to trigger VAT once more.

B. Goods locally supplied to a vendor in a CCA

Goods locally supplied by a vendor to a vendor in a CCA are subject to a VAT rate of zero. This concession for supplies to a vender within the CCA generally remains as long as the goods remain within the CCA. VAT relief also exists for goods that are temporarily removed from a CCA for a period of 30 days. On the other hand, if:

(i) goods are temporarily removed from the CCA; and

(ii) those goods are not returned within 30 days from date of removal,

a VAT supply is deemed to be made by the CCA enterprise vendor (as if the supply stemmed from a disposal). IDZ operators fall within the same paradigm.

C. *Personal consumption of goods in a CCA*

If (i) goods are imported into a CCA (or (ii) goods are supplied to a vendor in a CCA at the VAT rate of zero, special rules apply to prevent loss of VAT due to personal consumption. More specifically, goods entering a CCA under either circumstance are subject to a VAT charge if not wholly consumed in the course of making taxable supplies (i.e. if personally consumed).

II. Reasons for change

The above three sets of rules pertaining to CCA goods are not properly coordinated: The removal of goods imported into a CCA conflicts with the removal of goods locally supplied to a CCA enterprise vendor. In addition, the removal of goods locally supplied to a CCA enterprise vendor conflicts with the personal consumption of goods within a CCA. This lack of coordination potentially leads to more than a single VAT charge for essentially the same event (i.e. for essentially for the same level of value-added).

III. Proposal

The proposal seeks to remove the above overlaps between the three sets of rules relating to the CCA. Firstly, it is proposed that the import rules be separated from local supplies to a CCA. More specifically, goods imported into a CCA will remain outside the VAT until entered for home consumption without regard to the 30-day legislative rule for temporary imports. Temporary imports from a CCA will be allowed only by customs officials who set the triggering event for home consumption (without the 30-day period set by legislation). Secondly, goods within the CCA that have been initially converted to private use and then removed from the CCA will not be subject to VAT a second time under the 30-day rule.

IV. Effective date

The proposed amendment will apply to all supplies or imports occurring on or after 1 January 2013.

6.4. IMPORTED GOODS SOLD BY FOREIGN PERSONS PRIOR TO ENTRY FOR HOME CONSUMPTION

[Applicable Value-Added Tax Act provision: section 12(k)]

I. Background

A. *Physical location of customs border posts vis-à-vis South African territory*

A foreign person that supplies goods that enter South African territorial land and waters may be required to register for VAT if this activity is continuous or regular. This registration will be required even if that foreign person has no permanent establishment/place within South Africa.

At a physical level, South African territorial land and sea is larger than the exact outer locations of customs clearing locations where goods are entered from home consumption. In terms of shipping, foreign persons first transport goods via ship into South African territorial waters but enter goods for South Africa home consumption only upon reaching South African ports. In terms of land, foreign persons first transport goods by road or rail into South African territorial land but enter goods for South African home consumption only upon reaching South African customs border posts. The imposition of VAT upon importation is only triggered at the customs locations where goods are entered for home consumption.

B. Customs control clearing areas

Like many countries, South Africa has special designated areas that are viewed as outside South African areas of home consumption, even though these areas are clearly within South African territory. In this vein, the VAT Act currently contains an exemption for goods imported into South Africa by a foreign person if entered into a storage warehouse but not entered for home consumption. However, the foreign person can waive the exemption upon SARS approval.

II. Reasons for change

A. Pre-entry coastal sales

The supply chain of South African companies often involves trading among foreign suppliers. Pre-entry sales among foreign persons often arise in South African territorial waters before coastal entry for home consumption. Pre-entry sales may arise because foreign suppliers/multinationals usually operate international trading desks, which conduct business purchasing and selling commodities while on ship, regardless of where the ship is located at the time of sale. Also, pre-entry sales may arise because foreign investor risk appetite does not extend into South African territorial waters (i.e., a foreign company is willing to carry the risk or loss of supplies until the supplies reach South African territorial waters, after which the risk transfers to the South African company/or other buyer). The circumstances described above usually manifest itself in respect of coal, ore, other mining products, oil (where the underlying product is not zero rated), etc sold by foreign multinational companies.

Foreign companies engaged in this practice may find themselves liable for VAT registration if these sales are regular or continuous within South African territorial waters. If liable for VAT registration, the foreign company becomes liable for VAT in respect of these pre-entry sales, followed by a second VAT charge when the goods are entered for home consumption (which is payable by the SA buyer).

At a practical level however, foreign companies that lack a permanent establishment/place within South Africa generally want to avoid the compliance burden of registering and accounting for VAT. VAT registration of these wholly foreign entities is to be avoided at a policy level because foreign companies may become reluctant to trade with South African if forced to undertake VAT registration without meaningful South African physical operations.

Another issue is the potential for dual VAT charges. The first charge occurs when the foreign company charges the South African buyer with VAT for the purchase. The second charge occurs when the South African buyer enters the goods for home consumption at the port. Although both charges are refundable, this dual charge may place unnecessary cash-flow pressures on the parties involved.

B. Pre-entry land sales

The issue of pre-entry sales within South African territorial land could also arise (though far less often). Foreign taxpayers may sell goods among themselves within South African territory (via road or rail) before formal entry for home consumption. These pre-entry sales often occur between members of the same group of companies.

If these pre-entry sales occur, the same VAT issues arise as the issues that arise at sea. There pre-entry land sales could trigger the foreign compliance burden of VAT registration despite the lack of any permanent establishment within South Africa. These sales also trigger unwieldy dual VAT charges (one for the pre-entry sale and one for the formal importation).

III. Proposal

It is proposed that pre-entry sales by foreign persons be treated as exempt if these pre-entry sales occur within South African territory before home consumption (e.g. typically South African territorial waters). This exemption would mirror the concession (i.e. the exemption) for the supplies of goods made by foreign persons where those goods are imported and stored within a customs and excise storage warehouse before entry for home consumption. Exemption in these circumstances would effectively prevent the need for foreign VAT registration (while also eliminating any VAT charge on the pre-entry sale because the initial sale is no longer undertaken by a VAT vendor).

Like the exemption for pre-entry sale for goods sold within a customs and excise storage warehouse, taxpayers may elect to waive the exemption. This waiver will similarly require SARS approval. It is expected that the main users of this exemption will be parties with significant local activities (i.e. parties that are already in the VAT net for other reasons).

IV. Effective date

According to general principles, the proposed amendment will apply to supplies made on or after the date of promulgation of this Bill.

6.5. RELIEF FOR BARGAINING COUNCILS

[Applicable Value-Added Tax Act provision: new section]

I. Background

Bargaining councils may be formed by trade unions and employer organisations. These organisations deal with a variety of issues involving employer-employee relationships, including collective agreements and resolution of labour disputes. All bargaining councils must be registered in terms of the Labour Relations Act, 1995 (Act No. 66 of 1995). Bargaining councils levy an administration fee that is payable by employees that are members of that specific bargaining council.

II. Reasons for change

Employee organisations currently enjoy an exemption from VAT. More specifically, this exemption applies in respect of membership contributions. A bargaining council is formed when a trade union and employer organisation coalesces to regulate employee-employer relationships, as contrasted with an 'employee organisation', which (although covering a similar scope) is a stand-alone entity.

The activities of a bargaining council (although similar to that of employee organisations), seemingly falls outside the exemption; this creates uncertainty as to the VAT treatment of bargaining councils.

III. Proposal

The activities of a bargaining council are not materially different from that of an employee organisation. It is accordingly proposed that goods or services supplied by bargaining councils to any of their members should be exempt from VAT to the extent that membership contributions are received as consideration.

Further, bargaining councils that are registered for VAT and solely supply services to their members in return for membership contributions must deregister as a vendor. The value of the supply made by a bargaining council on deregistration will be deemed to be nil. If, SARS have issued an assessment, before 1 January 2013, to charge VAT at 14 per cent on services supplied by a bargaining council to their members, and to the extent that the payment of the assessment was still outstanding, SARS must reduce that assessment to nil upon written application by the bargaining council. Bargaining councils that have charged VAT at 14 per cent in respect of the aforesaid supplies and paid it over to SARS will not be refunded this tax amount (as well as penalties and interest that was levied on the late payment of such tax).

IV. Effective date

According to general principles, the proposed amendment will apply to supplies made by a bargaining council on or after 1 January 2013 .

6.6. RELIEF FOR POLITICAL PARTIES

[Applicable Value-Added Tax Act provision: new section]

I. Background

In its simplest form, political parties seek to exert influence over Government policy by expressing their vision, ideas and goals. Political parties garner support for their vision, ideas and goals through their membership base. One way for members to express their support for political parties is through membership contributions (monetary or otherwise). Generally speaking, political parties do not provide legal reciprocity for these contributions.

II. Reasons for change

Unlike the Income Tax Act (which fully exempts political parties), the VAT Act does not contain any specific provision that deals with contributions received by political parties from their membership. This absence leads to uncertainty as to whether membership contributions by political parties could be subject to VAT. At issue is whether the contributions can be construed as “consideration” for taxable services “supplied.”

III. Proposal

It is proposed that the supply of goods or services by a political party be specifically exempted from VAT to the extent of any membership contributions or donations received in exchange.

Further, political parties that are registered for VAT and solely supply services to their members in return for membership contributions must deregister as a vendor. The value of the supply made by a political party on deregistration will be deemed to be nil. If, SARS have issued an assessment, before 1 January 2013, to charge VAT at 14 per cent on services supplied by a political party to their members, and to the extent that the payment of such assessment was still outstanding, SARS must reduce that assessment to nil, upon written application by the political party. Political parties that have charged VAT at 14 per cent in respect of the aforesaid supplies and paid it over to SARS will not be refunded this tax amount (as well as any penalties and interest that was levied on the late payment of such tax).

IV. Effective date

According to general principles, the proposed amendment will apply to supplies made by a political party on or after 1 January 2013.

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7. SECURITIES TRANSFER TAX: CLARIFICATION OF THE MEMBER EXEMPTION

7.1. SECURITIES TRANSFER TAX: CLARIFICATION OF THE MEMBER EXEMPTION

[Applicable provisions: sections 1, 2, 8 (1) (q), and section 8 (1) (s) of the Securities Tax Act]

I. Background

A. Basic trading through the JSE

1. JSE principal/agent distinction

All shares on the JSE must be traded through members (i.e. technically referred to as an "authorised user"). Only brokers can be members of the JSE. Banks and other financial institutions cannot be members of the JSE because their capital is not solely dedicated to the JSE exchange.

Brokers can either trade shares as an "agent" or as a "principal." Although the agency and principal distinction is not strictly defined under the JSE rules, a principal trade is largely viewed as a share acquired and owned by the broker in terms of common law principles.

Similarly, trading of shares as an agent will occur if the broker acts as an agent of a client in terms of common law principles. Brokers hold shares through one or more "stock accounts" when acquiring shares as principal. Brokers hold shares through one or more "client accounts" when acquiring shares as agents.

The agency/principal distinction is important for JSE stability. Members that trade shares as agents must maintain capital of about one-to-two per cent of the value of the shares. Members that trade shares as principal must maintain capital of about ten-to-fifteen per cent of the value of the shares after taking into account hedged positions. Amounts retained as capital must be held in liquid form (i.e. as cash or near cash equivalents). This liquidity requirement reduces the potential yield of the capital allocated.

2. Securities Transfer Tax: Broker Exemption

The Securities Transfer Tax applies at a rate of 0.25 per cent. This tax generally applies when a person acquires beneficial ownership of share. The role of the broker in the acquisition is a critical feature in the tax determination. If the broker acquires the shares as an agent, Securities Transfer Tax is generally payable. On the other hand, an exemption exists if the broker acquires the shares as principal (under prior law, technically referred to as an acquisition for the broker's "account and benefit").

The purpose of the exemption (as established in 1995) was to facilitate the broker's role as a market-maker in shares, thereby promoting liquidity. In the typical market-making transaction, the broker stands ready to purchase (i.e. "buy") a share at a set price publicly announced (as a form of unilateral offer) or to sell (i.e. "bid") at a set price that is publicly announced (as a form of unilateral offer). This unilateral setting of prices by brokers creates or enhances share liquidity by making prices commonly available. Greater liquidity means enhanced Securities Transfer Tax payments because non-brokers will be involved in a greater number of share acquisitions.

B. Shares held to facilitate the issue of derivatives

1. Broker-dealers and banks as market-makers in derivatives

Brokers have become central role-players in the equity derivative market due to their relationship with underlying shares. More specifically, brokers typically hold a “long” or “short” position in shares that operate to offset the risk associated with derivatives. In some cases, these brokers issue the derivatives directly to the open market backed by shares. In other cases (i.e. indirect market-making), these brokers offer derivatives to other intermediaries backed by shares with these intermediaries offering another set of derivatives offered to the open market.

Local and foreign banks represent the largest set of intermediaries offering derivatives to the open market. Users of these derivatives tend to be hedge funds, pension funds, life insurers and asset managers (e.g. collective investment schemes). Local and foreign banks acting as intermediaries typically rely on a broker that is a member of the same group as the bank (and often a wholly-owned subsidiary). These banks often guarantee the group broker’s risks associated with the transaction and may even fund the group broker via soft-loans.

2. Broker-dealer versus banking regulation and capital requirements

In order to fully control associated market and credit risks, the JSE does not allow banks, insurers and entities under other primary forms of regulation to be members of the JSE. In the case of bank intermediary and broker relationships, a dual form of regulation results. The JSE regulates the broker, including the capital requirements. The Reserve Bank regulates the bank with a different set of capital requirements via global Basel standards. The level of capital depends on the level of exposure with full proprietary positions requiring a higher level of capital (e.g. starting from 8 to 9.75 per cent) with the level of capital increasing as global Basel standards are tightening. Bank guarantees also require capital.

II. Reasons for change

The exemption for brokers under the Securities Transfer Tax was not designed with the derivative market in mind. The exemption merely envisioned the simple paradigm where brokers held shares at their own risk (i.e. for their own account and benefit or as principal) versus an agency relationship. The exemption did not explicitly address the use of shares that act as a risk offset for the issue of derivatives. This omission is significant. The growth in the equity derivative market has become substantial due to a variety of reasons (e.g. increased ability to obtain market exposure at lower cost) and the use of shares to back the derivative market is central to that market’s success.

The relationships between a financial institution (e.g. banks and long term insurers) and a broker (especially where the broker is the subsidiary of a financial institution) have become particularly challenging. These relationships undermine meaningful distinctions between principal and agency relationships. In the cases of concern, most of the broker’s risk in directly-held shares is passed on to the financial institution via the derivative with the financial institutions either holding a proprietary position in the derivative or offering another offsetting derivative to the open market.

Because financial institution funding is less expensive than funding for brokers, risk is further shifted to the financial institutions in respect of capital requirements. The financial institution will typically guarantee the broker’s capital at less than an arm’s length charge or provide financing in the form of soft loans.

Hence, as can be seen, while the broker in a financial institution /broker relationship may hold shares as principal (i.e. for the broker's own account) as a technical matter, it is questionable whether the broker is actually anything more than an agent as an economic matter. The "agency" nature of this relationship becomes even more obvious when the financial institution indirectly controls the broker's ability to dispose of shares without the financial institutions approval (via explicit agreements or internal-group management criteria).

In recent years, the financial institution/broker relationship has come under scrutiny precisely because of this blurred relationship. This scrutiny has given rise to concerns that the broker exemption for proprietary holdings may not apply, giving rise to a 0.25 per cent charge for each share acquired to back derivative trading. It is now contended that this charge would significantly disrupt the derivatives market because many of these derivative trades operate on narrow margins (e.g. between 0.1 and 0.2 per cent).

III. Proposal

A. New basis for exemption

The principal/agency distinction will be modernised in favour of the current electronic "stock account" categorisation pursuant to the rules and directives of the JSE. More specifically, under the revised approach, shares purchased by a broker and placed in qualifying stock accounts may be exempt from the Securities Transfer Tax as long as the shares remain in a qualifying stock account as described below. Principal/agency distinctions will be removed.

B. Stock account types

1. Overall categories

Under the proposed system, the "stock account" classification will be broken down into three types, namely:

- bank restricted stock accounts (STT exempt);
- unrestricted and security restricted stock accounts (STT exempt); and
- general restricted stock accounts (not STT exempt);

It is envisioned that these stock account classifications will be formally added to the rules and directives of the JSE so that these classifications can serve as the basis for enforcing the Securities Transfer Tax via brokers.

2. Bank restricted stock accounts (Exempt)

Under the JSE rules as envisaged, shares will be placed in a "bank restricted stock account" if the broker lacks the freedom to dispose of the shares solely due to the fact that the disposal requires approval from a domestic group bank. For this purpose, the group relationship is determined via IFRS standards (see IAS 27). This relief also applies to foreign bank restrictions if the foreign bank is subject to the same regulatory standards (and is also part of the same IFRS group).

The proposed relief for bank restricted stock accounts stems from the unique role that banks have as market-makers in the case of derivatives. Banks not only have the necessary balance sheets to support this market but are also highly regulated so as to protect local financial markets from systemic risk. Taxing these activities would effectively undermine the liquidity of the JSE.

3. Unrestricted and securities restricted stock accounts (Exempt)

In order for shares to be placed in an "unrestricted and security restricted stock account" under the proposed JSE rules and directives, the shares must fall under one of four categories as roughly envisioned below:

i. The broker must own the shares and have the full ability to acquire and dispose of the shares without being subject to the direct or indirect approval of another person (i.e. being viewed as unrestricted);

ii. The broker lacks the freedom to dispose of the shares solely due to the fact that approval is required from:

    - a lender of cash to the broker, or
    - another creditor of the broker

    to whom the shares are pledged or ceded for the money lent (or another debt). However, for this category to apply, the yield in respect of the loan or other debt must be charged at a rate which is unrelated to any changes in the value of the shares offered as security;

iii. The broker lacks the freedom to dispose of the shares solely due to the fact that approval is required from a lender of securities in terms of a "lending arrangement" as defined in the Securities Transfer Tax Act. This situation typically arises when a broker borrows shares in terms of a lending arrangement from the lender and pledges or cedes shares owned by the broker to the lender to secure the broker's obligations under the lending arrangement. However, for this category to apply, the fee charged by the share lender must not be determined with reference to the value of the collateralised shares; or

iv. The broker lacks the freedom to dispose of the shares solely due to the fact that the approval of a person to whom the shares were pledged or ceded as security for the fulfillment of the broker's obligation in respect of the purchase or sale of securities (i.e. shares and other financial instruments). In order for this category to apply, the benefits of the rights associated with the shares pledged or secured must remain with the broker.

4. General restricted stock accounts (not exempt)

If a broker does not acquire and hold shares in the stock accounts described above, the shares must be held in a general restricted stock account. The Securities Transfer Tax will be payable in respect of these shares.

IV. Re-allocation of shares between stock accounts

The exemptions proposed above will last only as long as the shares remain in qualifying exempt stock accounts. Movement of shares by a broker outside these exempt accounts to the general restrict stock account will trigger Securities Transfer Tax (even if the shares remain fully owned by the broker-member).

V. Effective date

The proposed amendment will apply in respect of transfers (and re-allocation) of shares occurring on or after 1 January 2013. In order to prevent unnecessary disputes prior to the effective date, interim relief for shares used as hedges for derivatives will apply from 1 July 2008. The wording of this interim relief has been expanded to capture all of the share-derivative circumstances at issue as originally intended. This interim relief will last until the close of business on 31 December 2012.