NATIONAL TREASURY

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAXATION LAWS AMENDMENT BILL, 2010

[W.P. –- '10]

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Taxable income	Rate of tax
Not exceeding R132 000	18 per cent of the taxable income
Exceeding R132 000 but not exceeding R210 000	R23 760 plus 25 per cent of amount by which taxable income exceeds R132 000
Exceeding R210 000 but not exceeding R290 000	R43 260 plus 30 per cent of amount by which taxable income exceeds R210 000
Exceeding R290 000 but not exceeding R410 000	R67 260 plus 35 per cent of amount by which taxable income exceeds R290 000
Exceeding R410 000 but not exceeding R525 000	R109 260 plus 38 per cent of amount by which taxable income exceeds R410 000
Exceeds R525 000	R152 960 plus 40 per cent of amount by which taxable income exceeds R525 000

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Taxable income	Rate of tax
Not exceeding R140 000	18 per cent of the taxable income
Exceeding R140 000 but not exceeding R221 000	R25 200 plus 25 per cent of amount by which taxable income exceeds R140 000
Exceeding R221 000 but not exceeding R305 000	R45 450 plus 30 per cent of amount by which taxable income exceeds R221 000
Exceeding R305 000 but not exceeding R431 000	R70 650 plus 35 per cent of amount by which taxable income exceeds R305 000
Exceeding R431 000 but not exceeding R552 000	R114 750 plus 38 per cent of amount by which taxable income exceeds R431 000
Exceeds R552 000	R160 730 plus 40 per cent of amount by which taxable income exceeds R552 000

Table III: Current rate for trusts (no change proposed):

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All taxable income	40 per cent of the taxable income

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Taxable Income	Rate of Tax
All taxable income	28 per cent of the taxable income

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Taxable Income	Rate of Tax
Not exceeding R57 000	0 per cent of taxable income
Exceeding R57 000 but not exceeding R300 000	10 per cent of the amount by which the taxable income exceeds R57 000
Exceeding R300 000	R24 580 plus 28 per cent of the amount by which the

	taxable income exceeds R300 000

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Taxable turnover	Rate of tax
Not exceeding R100 000	0 per cent of taxable turnover
Exceeding R100 000 but not exceeding R300 000	R1 per cent of amount by which taxable turnover exceeds R100 000
Exceeding R300 000 but not exceeding R500 000	R2 000 plus 3 per cent of amount by which taxable turnover exceeds R300 000
Exceeding R500 000 but not exceeding R750 000	R8 000 plus 5 per cent of amount by which taxable turnover exceeds R500 000
Exceeds R750 000	R20 500 plus 7 per cent of amount by which taxable turnover exceeds R750 000

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On gold mining taxable income	See formula in paragraph 4*(b)* of Appendix I
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On recovery of capital expenditure	Greater of average rate or 28 per cent of the taxable income

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All taxable income	33 per cent of taxable income

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All taxable income	33 per cent of taxable income

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Taxable income of company policyholder fund	28 per cent of taxable income
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All taxable income from South African source	33 per cent of taxable income

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Taxable income from benefits	Rate of tax
Not exceeding R22 500	0 per cent of taxable income
Exceeding R22 500 but not exceeding R600 000	18 per cent of taxable income exceeding R22 500
Exceeding R600 000 but not exceeding R900 000	R103 950 plus 27 per cent of taxable income exceeding R600 000
Exceeding R900 000	R184 950 plus 36 per cent of taxable income exceeding R900 000

Table XIV: Current rates for retirement lump sum benefits (no change proposed):

Taxable income from benefits	Rate of tax
Not exceeding R300 000	0 per cent of taxable income
Exceeding R300 000 but not exceeding R600 000	R0 plus 18 per cent of taxable income exceeding R300 000
Exceeding R600 000 but not exceeding R900 000	R54 000 plus 27 per cent of taxable income exceeding R600 000
Exceeding R900 000	R135 000 plus 36 per cent of taxable income exceeding R900 000

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Primary rebate	R9 756
Secondary rebate	R5 400

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Secondary rebate	R5 675

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Broad-based employee share		

schemes		
Maximum exemption for shares received by an employee in terms of a broad-based employee share plan	Definition of "qualifying equity share" in section 8B(3)	R50 000
Maximum deduction for shares issued by an employer in terms of a broad-based employee share plan	The proviso to section 11(*l*A)	R10 000
Exemption for interest and certain dividends		
Exemption for foreign dividends and interest from a source outside the Republic which are not otherwise exempt	Section 10(1)*(i)*(xv)*(aa)*	R3 700
In respect of persons 65 years or older, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt	Section 10(1)*(i)*(xv)*(bb)*(A)	R32 000
In respect of persons younger than 65 years, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt	Section 10(1)*(i)*(xv)*(bb)*(B)	R22 300
Annual donations tax exemption		
Exemption for donations made by entities	Section 56(2)*(a)* and the proviso thereto	R10 000
Exemption for donations made by individuals	Section 56(2)*(b)*	R100 000
Capital gains exclusions		
Annual exclusion for individuals and special trusts	Paragraph 5(1) of Eighth Schedule	R17 500
Exclusion on death	Paragraph 5(2) of Eighth Schedule	R120 000
Exclusion in respect of disposal of primary residence (based on amount of capital gain or loss on disposal)	Paragraph 45(1)*(a)* of Eighth Schedule	R1,5 million
Exclusion in respect of disposal of primary residence (based on amount of proceeds on disposal)	Paragraph 45(1)*(b)* of Eighth Schedule	R2 million
Maximum market value of all assets allowed within definition of small business on disposal when person over 55	Definition of "small business" in paragraph 57(1) of Eighth Schedule	R5 million
Exclusion amount on disposal of	Paragraph 57(3) of Eighth	R750 000

small business when person over 55	Schedule	

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Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amount
Deductible retirement fund contributions		
Pension fund monetary ceiling for contributions	Proviso to section 11*(k)*(i)	R1 750
Pension fund monetary ceiling for arrear contributions	Paragraph *(aa)* of proviso to section 11*(k)*(ii)	R1 800
Retirement annuity fund monetary ceiling for contributions (if also a member of a pension fund)	Section 11*(n)(aa)*(B)	R3 500
Retirement annuity fund monetary ceiling for contributions (if not a member of a pension fund)	Section 11*(n)(aa)*(C)	R1 750
Retirement annuity fund monetary ceiling for arrear contributions	Section 11*(n)(bb)*	R1 800
Permissible lump sum withdrawals upon retirement		
Pension fund monetary amount for permissible lump sum withdrawals	Paragraph (ii)*(dd)* of proviso to paragraph *(c)* of definition of **"pension fund"** in section 1	R50 000
Retirement annuity fund monetary amount for permissible lump sum withdrawals	Paragraph *(b)*(ii) of proviso to definition of **"retirement annuity fund"** in section 1	R50 000

Table XIX: Deductible business expenses for individuals

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Car allowance		
Ceiling on vehicle cost	Section 8(1)*(b)*(iiiA)*(bb)*(A)	R400 000
Ceiling on debt relating to vehicle cost	Section 8(1)*(b)*(iiiA)*(bb)*(B)	R400 000

Table XX: Employment-related fringe benefits

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Exempt scholarships and bursaries		

Annual ceiling for employees	Paragraph (ii)*(aa)* of proviso to section 10(1)*(q)*	R100 000
Annual ceiling for employee relatives	Paragraph (ii)*(bb)* of proviso to section 10(1)*(q)*	R10 000
Exempt termination benefits	Section 10(1)*(x)*	R30 000
Medical scheme contributions		
Monthly ceiling for schemes with one beneficiary	Section 18(2)*(c)*(i)*(aa)* and paragraph 12A(1)*(a)* of Seventh Schedule	R670
Monthly ceiling for schemes with two beneficiaries	Section 18(2)*(c)*(i)*(bb)* and paragraph 12A(1)*(b)* of Seventh Schedule	R1 340
Additional monthly ceiling for each additional beneficiary	Section 18(2)*(c)*(i)*(cc)* and paragraph 12A(1)*(c)* of Seventh Schedule	R410
Awards for bravery and long service	Paragraphs *(a)* and *(b)* of further proviso to paragraph 5(2) of Seventh Schedule	R5 000
Employee accommodation	Paragraph 9(3)*(a)*(ii) of Seventh Schedule	R57 000
Accommodation for expatriate employees	Paragraph 9(7B)(ii) of Seventh Schedule	R25 000
Exemption for *de minimis* employee loans	Paragraph 11(4)*(a)* of Seventh Schedule	R3 000
Additional employer deductions for learnerships		
Monetary ceiling of additional deduction for the employer when utilising a learnership agreement with an employee	Section 12H(2)	R30 000
Monetary ceiling of additional deduction for the employer in the case of an employee completing a learnership agreement	Section 12H(3) and (4)	R30 000
Monetary ceiling of additional deduction for the employer involving a learnership agreement with an employee with a disability	Section 12H(5)	R20 000

Table XXI: Depreciation

Description (The contents of this column are solely for convenience and shall	Reference to Income Tax Act, 1962	Monetary amounts

be of no force or effect)		
Small-scale intellectual property	Paragraph *(aa)* of proviso to section 11*(g*C)	R5 000
Urban Development Zone incentive	Section 13*quat*(10A)	R5 million

Table XXII: Miscellaneous

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Low-cost housing		
Maximum cost of residential unit where that residential unit is an apartment in a building	Paragraph *(a)* of definition of "low-cost residential unit" in section 1	R250 000
Maximum cost of residential unit where that residential unit is a building	Paragraph *(b)* of definition of "low-cost residential unit" in section 1	R200 000
Industrial policy projects		
Maximum additional investment allowance in the case of greenfield projects with preferred status	Section 12I(3)*(a)*	R900 million
Maximum additional investment allowance in the case of other greenfield projects	Section 12I(3)*(a)*	R550 million
Maximum additional investment allowance in the case of brownfield projects with preferred status	Section 12I(3)*(b)*	R550 million
Maximum additional investment allowance in the case of other brownfield projects	Section 12I(3)*(b)*	R350 million
Maximum additional training allowance (per employee)	Section 12I(5)*(a)*	R36 000
Maximum additional training allowance in the case of industrial policy projects with preferred status	Section 12I(5)*(b)*(i)	R30 million
Maximum additional training allowance in the case of other industrial policy projects	Section 12I(5)*(b)*(ii)	R20 million
Minimum cost of manufacturing assets for greenfield projects	Section 12I(7)*(a)*(i)*(aa)*	R200 million
Amounts to be taken into account in determining whether an industrial project constitutes a brownfield project	Section 12I(7)*(a)*(i)*(bb)*(A) Section 12I(7)*(a)*(i)*(bb)*(B)	R30 million R200 million
Venture capital companies		
Annual deduction limit (natural	Section 12J(3)*(a)*	R750 000

persons)		
Lifetime deduction limit (natural persons)	Section 12J(3)*(a)*	R2,25 million
36 months minimum investment (in respect of the acquisition of qualifying shares in a junior mining company)	Section 12J(6A)*(a)*(i)	R150 million
36 months minimum investment (in respect of the acquisition of qualifying shares in companies other than junior mining companies)	Section 12J(6A)*(a)*(ii)	R30 million
After 36 months, at least 80 per cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a junior mining company, with assets of which the book value does not exceed the amount indicated immediately after the issue	Section 12J(6A)*(b)*(i)	R100 million
After 36 months, at least 80 per cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a company, other than a junior mining company, with assets of which the book value does not exceed the amount indicated	Section 12J(6A)*(b)*(ii)	R10 million
Presumptive turnover tax		
A person qualifies as a micro business for a year of assessment where the qualifying turnover of that person for that year does not exceed the amount indicated	Paragraph 2(1) of Sixth Schedule	R1 million
Maximum of total receipts from disposal of immovable property and assets of a capital nature by micro business	Paragraph 3*(e)* of Sixth Schedule	R1,5 million
Minimum value of individual assets and liabilities in respect of which a micro business is required to retain records	Paragraphs 14*(c)* and *(d)* of Sixth Schedule	R10 000
Public benefit organisations		
PBO trading income exemption	Section 10(1)*(cN)*(ii)*(dd)*(ii)	R150 000
Deduction of donations to transfrontier parks	Section 18A(1C)*(a)*(ii)	R1 million
Housing provided by a PBO:	Paragraph 3*(a)* of Part I of	R7 500

maximum monthly income of beneficiary household	Ninth Schedule and paragraph 5*(a)* of Part II of Ninth Schedule	
Recreational clubs		
Club trading income exemption	Section 10(1)*(cO)*(iv)*(bb)*	R100 000
Prepaid expenses		
Maximum amount of deferral	Paragraph *(bb)* of proviso to section 23H(1)	R80 000
Small business corporations		
Maximum gross income	Section 12E(4)*(a)*(i)	R14 million
Housing associations		
Investment income exemption	Section 10(1)*(e)*	R50 000

Table XXIII: Administration (Taxation Laws Second Amendment Bill)

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Investment income exempt from provisional tax		
In the case of natural persons below age 65	Paragraph 18(1)*(c)*(ii) of Fourth Schedule	R20 000
In the case of natural persons over age 65	Paragraph 18(1)*(d)*(i) of Fourth Schedule	R120 000
S.I.T.E. threshold	Items *(a)* and *(b)* of paragraph 11B(2) and items *(a)*, *(b)*(ii) and *(b)*(iii) of paragraph 11B(3) of Fourth Schedule	R60 000
Threshold in respect of automatic appeal to High Court	Section 83(4B)*(a)*	R50 million

Table XXIV: Value Added Tax: Monetary thresholds subject to periodic legislative change

Description (The contents of this column are solely for convenience and are of no force or effect)	Reference to Value-Added Tax Act, 1991	Monetary amount
Registration		
-Compulsory	Section 23(1)*(a)*	R1 million
-Voluntary	Section 23(3)*(b)*, *(c)* and *(d)*	R50 000
-Commercial accommodation	Paragraph *(a)* of definition of ‘commercial accommodation’ in section 1	R60 000
-Payments basis of VAT registration	Section 15(2)*(b)*(i)	R2,5 million

-Exception to payments basis : in respect of supplies of goods or services made by a vendor	Section 15(2A)	R100 000
Tax invoices		
-Abridged tax invoice	Section 20(5)	R3 000
-No tax invoice required	Section 20(6)	R50
Tax periods		
- Category C (monthly) submission of VAT 201 return	Section 27(3)*(a)*(i)	R30 million
-Category D (6-monthly) submission of VAT 201 return	Section 27(4)*(c)*(i)	R1,5 million
-Category F (4-monthly) submission of VAT 201 return	Section 27(4B)*(a)*(i)	R1,5 million

Table XXV: Transfer Duty: Imposition

Value	Rate of Tax
Does not exceed R500 000	0%
Exceeding R500 000 but not exceeding R1 million	5% on such value
Exceeds R 1 million	8% on such value

Table XXVI: Diamond Export Levy: Rate and Exemptions

Exemption from levy (Levy not applicable in following instances)	Applicable levy
	5% of gross sales
Large producers	
-40% of the producer’s gross sales must be to South African diamond beneficiators, and	
-total gross sales must exceed R3 billion	
Medium producers	
-15% of the producer’s gross sales must be to South African diamond beneficiators, and	
-total gross sales exceeds R20 million but does not exceed R3 billion	
Small producers	
-total gross sales does not exceed R20 million	

Table XXVII: Royalty Act: Rate and Exemption

Royalty formulae	Rate
-**Refined**: 0.5 +[EBIT / (gross sales x 12.5)] x100	Cannot exceed 5%

-**Unrefined**: 0.5 + [EBIT / (gross sales x 9)] x 100	Cannot exceed 7%
Exemption for small business	
-Gross sales of extractor does not exceed R20 million	

Table XXVIII: Estate Duty: Rates, thresholds and abatement

Description	Rate / Amount
Imposition of estate duty	20% of the dutiable amount of the estate
Reduction of duty payable	
Reduced as follows of the second dying dies within 10 years of the first dying:	
- 2 years	100%
- 2-4 years	80%
- 4-6 years	60%
- 6-8 years	40%
- 8-10 years	20%
Exemption	
Abatement	R3.5 million

2. INCOME TAX: EMPLOYMENT, INDIVIDUALS AND SAVINGS

2.1. EMPLOYER-PROVIDED MOTOR VEHICLES

[Clauses 10, 91; Applicable provisions: section 8(1)(a)(i)(aa); paragraph 7 of the Seventh Schedule]

I. Background

Employers often provide their employees with a travel allowance to defer business-related car travel expenses. Some employers alternatively provide their employees with the use of a company-owned motor vehicle for the same purpose.

Private use of an employer-provided company-owned vehicle is a taxable fringe benefit. The fringe benefit included in the employee's income is generally at a rate of 2.5 per cent per month in respect of the first vehicle provided and 4 per cent per month in respect of each additional vehicle. In the case of the first vehicle provided to an employee, some business use is presumed; in the case of the additional vehicles, all use is presumed private unless proven otherwise.

The above monthly percentages are only a starting point. An employee may reduce the taxable fringe benefit for license fees, insurance, fuel and maintenance expenses directly incurred by that employee. SARS also has further discretion to reduce the above percentages as long as private use of a vehicle is less than 10 000 kilometers during the year of assessment.

II. Reasons for change

Over the last several years, the rules for claiming car travel allowances have steadily become more restrictive. Most recently in 2009, the deemed business kilometer method was repealed. As a result, taxpayers seeking to claim a travel allowance must now maintain travel log books showing business use.

In view of these changes to the car allowance, corresponding changes are required for the employer vehicle fringe benefit rules. Both sets of rules must roughly reach the same outcome so as to prevent arbitrage.

III. Proposal

A. Starting percentage rate change

The starting percentage for all employer-provided vehicles will henceforth be based on the presumption that all employee use is deemed to be private unless facts are provided to the contrary. The percentage rate for all employer-provided vehicles (including the first) will now generally be 3.5 per cent per month of the vehicle's determined value. This starting presumption matches the revised car allowance rules, which limits the allowance to proof of business use via the travel log book (i.e. assumed private use unless actual proof of business use).

The rules for calculating determined value will generally be the same as current law with some deviations as follows:

Firstly, the current exclusion of value-added tax makes little sense since the purchase of a vehicle by an employee includes the value-added tax without any corresponding claim for input credits. The proposed inclusion of value-added tax in the determination also matches the current calculation for the car travel allowance.

Secondly, special rules are required for vehicles purchased with maintenance plans included within the purchase price. Inclusion of these plans in the purchase price effectively results in a double inclusion because the percentage rate implicitly assumes ongoing maintenance plan coverage directly by the employer (instead of the third party seller). However, a simple exclusion of maintenance plan coverage is impossible for certain employers because the purchase price of many vehicle sales often do not explicitly separate the price of the plan from the vehicle. Therefore, in order to resolve the issue equitably, employer-provided vehicles with maintenance plans included within the purchase price will trigger only a 3.25 per cent monthly inclusion instead of the standard 3.5 per cent inclusion. For purposes of this rule, a maintenance plan means a contractual obligation undertaken by the provider (i.e. seller) of the vehicle to underwrite all costs of maintenance (other than costs related to top-up fluids, tyres or abuse of the motor vehicle) as long as the coverage lasts for at least three years and 60 000 kilometres (whichever comes first).

On a related note, current law requires that employer cost of the vehicle is reduced for any consideration paid by the employee for the vehicle. While this principle is retained, the proposal clarifies that this employee offset does not include ongoing license fees, insurance, fuel and maintenance paid by the employee in respect of the vehicle because these costs are already applied to reduce the fringe benefit at year-end assessment on an annual basis (see below).

B. Revised allowable offsets

As stated above, the starting point for the fringe benefit calculation assumes no business use unless proven to the contrary. The starting point for the calculation also assumes that all operating expenses are incurred by the employer. Given these assumptions, on assessment employees are entitled to reduce the fringe benefit calculation for both actual business use and for private expenses incurred by employees.

1. Across-the-board business-use percentage reduction

Employees can obtain an across-the-board reduction to the extent that proof of actual business kilometer usage is provided. This across-the-board reduction is determined by simply using a ratio of business use over total use as applied against the 3.5 per cent (or 3.25 per cent) presumed monthly inclusion. For instance, if a comparison of kilometers driven shows that the vehicle was used 30 per cent for business use (out of total use), the 3.5/3.25 percentage is reduced by 30 per cent.

2. Employee assumption of private costs / expenses

Employees may additionally obtain offsets relating to private use to the extent payments are undertaken by the employee, for:

Insurance
Licensing fees
Fuel and
Actual maintenance costs.

Insurance and licensing costs: If an employee directly pays all insurance and licensing costs, the employee can obtain an additional reduction for the private element of the costs (the business element already being reduced by virtue of the across-the-board reduction). This reduction is determined by simply using a ratio of private use over total use as applied against the actual insurance and licensing costs incurred.

Maintenance: If an employee directly pays all maintenance, the employee can obtain an additional reduction for the private element of the actual costs (the business element already being reduced by virtue of the across-the-board reduction). This reduction is determined by simply using a ratio of private use over total use as applied against the actual maintenance costs incurred.

Fuel: If an employee directly pays all fuel, the employee can obtain an additional reduction for the private element of the costs (the business element already being reduced by virtue of the across-the-board reduction). These reductions are based on deemed costs relating to private kilometers driven. More specifically, the starting point for the fuel reduction is to determine the cost scale for these items based on Ministerial regulation (GN 177 Government Gazette 28850 of 24 February 2006; section 8(b)(1)(iii)). The fuel amount is then multiplied by total private kilometers driven.

3. Partial employer reimbursement

If the employer partially reimburses the employee for the amounts so paid, the employee may not deduct any private expenses. Moreover, the employer's deduction for business use is reduced by the employee to the extent of the employer reimbursement. The purpose of these rules is to prevent any direct or indirect double reduction of costs by employees.

Note: None of the reductions refer to above may reduce the net fringe benefit below zero.

Examples

Example 1 (Employer covering all costs):
Facts: An employer purchases a vehicle for sole use by an employee at a cost of R300 000 (including VAT). The employee maintains a logbook indicating a total of 40 000 kilometers travelled of which 10 000 are business kilometers. The employer pays all costs.

Result: The starting point for the monthly fringe benefit calculation is the 3,5 per cent inclusion rate. The withholding amount (PAYE) is 80 per cent of the 3,5 per cent, effectively 2,8 per cent per month. The actual reduction occurs on assessment. On assessment for all cases, a business use reduction is applied. This is done using the cost-scale method as provided for in the regulation. See GN 177 Government Gazette 28850 of 24 February 2006.

Using the facts above (10 000 kilometers for business use) the business use reduction calculation consist of :
Value of fringe benefit - R126 000 (R300 000 x 3.5% x 12)
Business reduction – R31 500 (R126 000 X10 000kms/40 000kms

The net fringe benefit, after considering the business use reduction, would be R94 500 (The gross fringe benefit of R126 000 less R31 500).

Example 2 (Employee covers "fuel"):
Facts: Employee has been granted the right to use a motor vehicle. The motor vehicle was acquired by the employer at a cost of R300 000 (including VAT). Employee maintains a logbook indicating a total of 40 000 kilometers travelled of which 10 000 are business kilometers. Under the terms of the employment contract, employee is solely responsible for all fuel costs for private use pf the vehicle.

Result: The monthly withholding for PAYE purposes will be 80 per cent of the 3,5 per cent with concomitant reductions effected on assessment.

In calculating the net fringe benefit the business use reduction would be the same in example 1, with further relief provided where employee pays for fuel.

In considering the fuel payment by the employee, the fringe benefit is further reduced as follows:
Fuel cost component (pvt kms) R0,857 x 30 000kms = R25 710

The net fringe benefit, after considering the business use reduction and the employee paid fuel, would be R68 790 (R126 000 – R31 500 – R25 710).

Example 3 (Employee covers all fuel with some employer reimbursement):
Facts: The facts are the same as *Example 2*, except that Employer paid employee a partially reimbursed Employee (R10 000 of R25 000) for fuel relating to business travel.

Result: Employee can obtain an additional reduction for the private element of the actual net cost of the fuel payment (employee payment for fuel less reimbursement - the business element already being reduced by virtue of the across-the-board reduction), by simply using a ratio of private use over total use as applied against the actual net fuel costs incurred. The private element is calculated as follows

Private kms = 75%
Total fuel payment = R25 000
Reimbursement = R10 000
Net fuel payment = R15 000
Private fuel claim = R11 250 (75% of R15 000)

Car travel allowance

Taxpayers cannot claim a double allowance/offset in respect of employer-provided cars. More specifically, employees cannot claim car allowance in respect of employer-provided cars. Only the offsets described above will be allowed.

Withholding

The monthly fringe benefit calculation is designed to roughly mirror the travelling allowance arrangement. Reductions based on the cost-scale method (kilometers travelled) are determined on the date of assessment. For the purposes of the monthly PAYE withholding, the full fixed 3.5/3,25 percentage will be reduced by 20 per cent. Final adjustments for actual business kilometers and private coverage of actual private kilometers (or the lack thereof) will occur on final assessment.

[include no reduction for vehicles mainly used for business]

> **Example 3**: (Employee bears all fuel costs for private use)
> **Facts***:* Employee is granted the right to use a motor vehicle. The motor vehicle is acquired by the employer at a cost of R300 000 (including VAT). Under the terms of the contract, the employee is solely responsible for all fuel for private travel with all other expenses covered by Employer. Employee travels a total of 40 000 kilometers, of which 10 000 kilometers represents business travel.
>
> **Result:** For purposes of withholding, Employee has a monthly withholding of 2,8 per cent (3,5 per cent less 20 per cent) of R300 000, amounting to R100 800 per annum. The business kilometers travelled are only relevant upon assessment.

IV. Effective date

The above proposal will apply to years of assessment commencing on or after 1 March 2011.

2.2. EMPLOYER-PROVIDED INDEMNITY INSURANCE

[Clause 92; Applicable provisions: paragraph 13(2) of the Seventh Schedule]

I. Background

Certain professional organisations require their members to obtain indemnity insurance for the conduct of various practices whilst other organisations merely advise their members to obtain insurance cover. Indemnity insurance seeks to protect the insured member against liability arising from professional negligence claims in the conduct of the professions.

Professionals often pay for the indemnity insurance directly from their own salaries. However, some employers cover these benefits on behalf of employees, especially when these fees are an absolute or practical pre-requisite for engaging in their respective professions.

II. Reasons for change

An employee is deemed to have an accrual of a taxable benefit when an employer tenders payment to a third party for a debt owed by that employee (as long as the employee does not, or is not required to, reimburse the amount so paid). It has been noted that many employers tender these payments for indemnity insurance on behalf of their employees and insurance of this nature is often a concomitant factor of that trade.

III. Proposal

It is proposed that legislation exempt (i.e. place no value on) employer-provision of premiums expended for indemnity insurance against profession-related negligent acts or omissions. This form of coverage is a working condition fringe. Employees are either legally required to obtain this coverage as a legal pre-requisite for working within the profession or as a practical necessity. This form of insurance is most typically utilised in the fields of medicine, law, accounting and construction.

It should be noted, however, that the indemnity coverage must be directed solely to negligence-related professional claims as opposed to coverage against more serious charges (e.g. coverage against criminal fines). The latter limitation exists because the tax system should not be perceived as providing relief for criminal activity (see section 23(o) denying deductions per se for certain costs and fines relating to criminal activity).

IV. Effective date

The effective date is for taxable benefits derived by an employee during the employee's year of assessment commencing on or after 1 March 2011.

2.3. EXECUTIVE SHARE SCHEMES

[Clause 12; Applicable provisions: Section 8C]

I. Background

Share and other equity-based incentive schemes (typically involving key employees) feature prominently in tax jurisprudence. Many of these schemes are initiated to convert the ordinary revenue nature of salary into capital gain. The essential nature of these schemes is to provide employees with a stake in the growth of their employer company (e.g. by having a stake in a specified number of shares or through phantom share schemes). Section 8C (enacted several years ago) is the latest attempt by Government to prevent this artificial conversion of ordinary revenue into capital.

Unlike many anti-avoidance provisions, section 8C seeks to defer (rather than accelerate) taxation. More specifically, section 8C generally seeks to trigger taxation only when an employee effectively cashes out the employee's stake in the employer or effectively has the freedom to cash-out when desired. Taxation under section 8C seeks to preserve ordinary treatment for growth-related salary as opposed to artificial characterisation as capital. Vertical notions of equity require executives to pay tax on their earnings at top marginal rates as opposed to a maximum 10 per cent capital gain rate.

II. Reasons for change

While section 8C appears to be having the impact desired in the main, certain anomalies continue to exist that may detract from the core principles that section 8C seeks to achieve. These anomalies appear to exist in three areas: (a) company distributions in respect of certain restricted equity shares, (b) restricted share swaps, and (c) acquisition of restricted equity instruments by employees. Some circumstances wrongly accelerate ordinary revenue treatment while others wrongly defer the same.

III. Proposal

A. Distributions

1. Current law

Holders of shares qualifying as restricted equity instruments may receive distributions in respect of their shares during the period of restriction. These distributions may come in the form of dividends or as capital distributions.

Capital distributions in respect of shares generally give rise to capital gains. However, if a taxpayer receives a capital distribution arising from a restricted equity instrument, the distribution is treated as ordinary revenue. Dividends in respect of shares (restricted or otherwise) are exempt in the hands of the holder and generally subject to the Secondary Tax on Companies.

2. Proposal

The treatment of capital distributions and dividends in respect of restricted shares will be aligned to one another.

Both events will generally trigger ordinary revenue in recognition of this partial cash-out. However, if the capital distribution or dividend consists of another restricted equity instrument, the capital distribution or dividend will be treated as a non-event. The restricted equity instrument will then be taxed like any other restricted equity instrument falling under section 8C.

B. Rollover treatment for swaps

1. Current law

Taxpayers holding restricted equity instruments subject to section 8C may swap their instruments or other restricted equity instruments if the terms of the instruments so permit. Under current law, section 8C largely seeks to treat this form of swap as a non-event to the extent a restricted equity instrument is received in exchange (the receipt of other forms of consideration will trigger ordinary revenue). The restricted equity instruments received will be subject to section 8C just like the section 8C instruments surrendered. However, for this rollover treatment to apply, the restricted equity instrument received in exchange must be from the employer, an associated institution or by arrangement with the employer.

2. Proposal:

The trigger for section 8C rollover treatment in respect of restricted equity swaps needs to be adjusted more in align with the principles of section 8C. Generally, the issue is whether the employee-holder of the restricted equity instrument has a continuing direct or indirect stake in the employer (i.e. is motivated by the employer's profitability). Therefore, section 8C rollover treatment should apply as long as the new equity instrument received is of the same employer or associated institution. The employer's (or associated institution's) actual involvement is irrelevant. Hence, if two employees swap restricted equity instruments without employer involvement, section 8C rollover treatment will apply. On the other hand, a swap of restricted equity instruments originally issued by wholly independent employers will trigger ordinary revenue.

C. Acquisition by co-employees or directors

1. Current law

An employee must include in the employee's income for a year of assessment any gain or loss in respect of the vesting of a restricted equity instrument, if the instrument was acquired under one of the following circumstances:

By virtue of the employee's employment or office of director of any company or from any person by arrangement with the employer; or by virtue of any other restricted equity instrument held by that employee.

2. Proposal

There is a strong possibility of collusion as it is extremely difficult to determine when an employee acquired a restricted equity instrument from a co-employee or director or from an employer directly. In light hereof, there is a presumption that there is an automatic inclusion in section 8C without regard to a factual test. Therefore, the roll-over treatment will apply if the new equity instrument is received from another employee or director of the same employer. It is presumed that the new equity instrument is acquired by virtue of employment.

IV. Effective date

Distributions: This rule will be deemed to come into operation on 1 January 2011 and applicable in respect of a capital distribution or dividends received by or accrued on or after that date

Share swaps: The revised direct and indirect swap rules will come into operation for acquisitions occurring on or after 1 January 2011.

Section 8C(5) anomaly: The technical correction will come into operation for restricted equity instruments acquired on or after 1 January 2011.

2.4. EMPLOYER-PROVIDED LONG-TERM INSURANCE

[Clause 6 (m) and (n), 19(i), 41, 42 and 43; Applicable provisions: paragraph (m) of the section 1 “gross income” definition; insertion of paragraph (n) in the section 1 “gross income” definition; section 11(w); addition of section 23 (p) and (q); addition of section 23B(4); section 23H(1)]

I. Background

Employers often use insurance policies to protect themselves against the loss of profits arising from the loss of key employees. These plans typically involve a life or disability insurance contract in respect of a key employee (or director). Insured events typically include disability, severe illness or dread disease and death. In some cases, key employee/director owners guarantee debts of their business and the insurance covers the debt upon loss of the key employee/director.

Under a genuine key person plan, an employer generally obtains an immediate deduction for policy premiums when incurred. Benefits payable under these policies are included in the employer’s gross income when the insured event subsequently arises.

II. Reasons for change

Salary is generally deductible by employers and simultaneously includible as ordinary revenue by employees. The rules for non-cash fringe benefits are largely intended to work the same way. For instance, employer-provided life insurance for the benefit of employees creates deductible premiums for employers with a simultaneous inclusion of the same amount for employees.

Although many key employee plans have legitimate uses as discussed above, some key employee plans are arranged to create a tax mismatch. In schemes of this nature, the key employee plan is allegedly designed for the employer, but the expected insurance proceeds are actually intended for the benefit of employees. If form governs, the employer obtains a deduction as the premiums are paid. The insurance payout will trigger an ordinary inclusion for the employer, but the employer will then deduct the pre-planned payment of these proceeds to the employee (leaving the employer in a tax neutral position). The employee will typically treat the sum as a retrenchment benefit eligible for certain tax benefits. The net result is an upfront deduction for the employer and a delayed (possibly reduced) inclusion for the employee.

Existing anti-avoidance legislation has largely curbed the mismatch schemes outlines. However, some mismatch schemes remain viable. The anti-avoidance restrictions also sometimes undermine legitimate commercial practices, such as the use of insurance as collateral for debts owed. It is these concerns that require remedial legislation.

III. Proposal

A. Revised Entry Requirements

In view of the above concerns, it is proposed that the entry requirements for deductible key person insurance schemes be wholly revised. The objective is to continue the deduction for employers in the case of legitimate schemes (even allowing for commercial practices previously disallowed) while completely eliminating any remaining mismatch schemes outlined above.

Under the revised entry requirements:

- Entry requirement #1: The insured event for employers is restricted to key employee (or director) job terminations stemming solely from employee (or director) death, disability or severe illness.

- Entry requirement #2: Deductible premiums will be limited to term policies that solely cover the insured against insured risks. Policies with investment elements (e.g. whole life) will not be permitted.

- Entry requirement #3: The employer must be the sole owner and sole beneficiary of the policy throughout the year of assessment in which the premium is paid.

  However, the deductibility of premiums will not be adversely impacted if: (i) a creditor of the employer is the owner of the policy or beneficiary of the insurance proceeds, and (ii) the insurance acts as security for a debt (or the debt was made on the strength of the policy) when the insurance policy was initially concluded for the purposes of the taxpayer's trade "to the extent" that the value of the policy does not exceed the amount of the debt in respect of which the policy is ceded or pledged.

- Entry requirement #4: No deduction is allowed if the key person insurance plan is part of a transaction, operation or scheme to make the benefits payable to an employee/director or their relatives. Benefits payable implicitly include benefits payable by virtue of a cession of the policy or by virtue of an intended change of beneficiaries.

As a side matter, it should be noted that employer deductions for key person insurance plans are only deductible by virtue of this provision. These premiums would either be viewed as non-deductible capital expenditure or the general deduction formula of section 11(a) would not be available because of the existence of this provision (see section 23B(3)).

B. Insurance payouts

As a general matter, key person insurance policies will give rise to ordinary revenue when paid up. However, if premiums incurred are partly or completely non-deductible, the payout is exempt to the extent of the non-deductible premiums. This calculation is determined according to a formula (exempt premiums over total premiums multiplied by the insurance pay out).

Special anti-avoidance rules apply if the proceeds of qualifying insurance policies (i.e. policies eligible to receive deductible premiums) are actually applied for the benefit of employees/directors and/or their relatives. These anti-avoidance rules apply even if the initial conclusion of the insurance policy was not intended for the benefit of an employee (or director). In these circumstances, two additional rules apply.

- Firstly, the employer loses any deductions under section 11 otherwise available if the insurance policy proceeds are (directly or indirectly) applied for the benefit of employees/directors and/or their relatives. This denial applies in addition to the general inclusion for the receipt and accrual of key person insurance policy proceeds.

- Secondly, any receipt or accrual of the insurance proceeds by an employer (or director) is treated as fully taxable ordinary revenue, i.e. not as a "severance benefit." In other words, the special relief table otherwise applicable to retrenchment-type benefits is no longer available.

IV. Effective dates

<u>Section 11(w):</u> In respect of deductions, this proposal will apply to all premiums incurred during any year of assessment commencing on or after 1 January 2011.

<u>Section 1 – gross income (m) and (mA)</u>: In respect of key person insurance proceed payouts, "gross income (mA)" will apply to all receipts and accruals arising during any year of assessment commencing on or after 1 January 2011. In the case of "gross income (m)," this provision will continue to apply in respect of insurance contracts concluded on or before1 January 2011.

<u>Section 23(p):</u> This proposal will apply in respect of employer expenditure incurred on or after 1 January 2011.

<u>Section 1 - Definition of "severance benefit":</u> This proposal comes into operation on 1 March 2011 and applies in respect of amounts received or accrued on or after that date.

2.5. SEVERANCE EMPLOYMENT PAYMENTS

[Clauses 6(*z*F) 7, 9;18*(w)*, 80 *(a)*, *(b)*, *(c)*, *(e)* and *(g),* 84*(a)* ; Applicable provisions: insertion of the definition of "severance benefit" in section 1; section 5; section 7A; section 10(1)*(x)*; paragraph 2 of the Second Schedule; paragraph 6 of the Second Schedule]

I. Background

When taxpayers are retrenched, employers often pay a severance award that is usually linked to the taxpayer's period of service. In terms of the Basic Conditions of Employment Act, a typical severance package would provide a minimum of one week salary per each completed year of service. Under current law, these payments qualify for a R30 000 exemptions with the balance being taxed pursuant to an averaging formula.

Given the ongoing concerns about retrenched workers during the current global economic downturn, additional tax relief was afforded in 2009. If a taxpayer withdraws a lump sum benefit from a retirement fund as a result of retrenchment, the 2009 changes provide that the withdrawal benefit will be taxed as if the taxpayer had retired in respect of these retirement funds. This lump sum treatment means that the sum receives the benefit of the special retirement tables, including the R300 000 life-time exemption.

II. Reasons for change

The dual relief system for retrenched workers (one for employer-provided severance pay and the other for pre-retirement fund retrenchment withdrawals) makes little sense. Both sums achieve the same interim economic support for workers suffering a temporary shortfall. The averaging mechanism for retrenched severance pay offered by employers is also too complicated.

III. Proposal

Retrenched workers receiving a lump sum upon retrenchment (or pending retrenchment) will be subject to the same tax treatment regardless of whether that lump sum is obtained from an employer or by withdrawing funds from pre-existing retirement funds. Both sums will be subject to the special rates table for lump sum retirement withdrawals (including the R300 000 exemption) with the same principles of life-time aggregation. Effectively phasing-out the "additional" R30 000. Employer-provided severance packages for reasons of age, sickness, accident, injury, or mental incapacity will also receive the same tax benefit.

IV. Effective date

This proposal will apply to all lump sum termination of employment payments received or accrued on or after 1 March 2011.

2.6. POST-RETIREMENT COMMUTATION (CONVERSION) OF ANNUITIES INTO LUMP SUMS

[Clauses 79, 80*(f)*, 81, 82; Applicable provisions: definition of "lump sum benefit" in paragraph 1 of the Second Schedule; paragraph 2(1)*(a)* of the Second Schedule, paragraph 3 of the Second Schedule, insertion of paragraph 3A in the Second Schedule]

I. Background

At retirement, a member of a pension fund or a retirement annuity fund may generally commute (i.e. convert) up to a maximum of one third of fund benefits for a lump sum. The remaining two thirds must be used to purchase a pension or annuity. Annuities can be in the form of guaranteed annuities (payable in a fairly even stream until death) or in the form of living annuities, the latter of which allow for corpus withdrawals between 2 ½ per cent and 17, 5 per cent per annum. Of the two types of annuities, living annuities are far more common.

Living annuities are generally payable over the period of retirement until death. Due to relatively high service costs stemming from the greater flexibility of living annuities, the rules for living annuities were changed so that living annuities could be commuted into lump sums once the size of these annuities falls below a certain threshold. This threshold is currently set at R50 000 at time of commutation and applies per insurer (as opposed to per contract). Note also that the 2/3rd annuity requirement for pension funds and retirement annuity funds is waived (for all forms of annuities) if annuity values would not otherwise exceed R50 000 at the time of retirement.

Annuity beneficiaries may change over time due to death. If a member dies, the annuity can be converted to a lump sum or may continue in the hands of a successor (typically a spouse). If the successor dies, the annuity can again be converted to a lump sum or may continue in the hands of a subsequent successor (typically a child or grandchild).

II. Reasons for change

The tax rules do not explicitly cover the commutation of living annuities into lump sums after retirement (except upon the member's death). The rules also do not fully cater for subsequent commutation of annuities by a successor who previously inherited an annuity from a deceased member. At the present time, the practice has been to treat all of the above amounts as gross income without the special relief table.

III. Proposal

All commutations of retirement annuities should be treated similarly (whether these commutations occur during the member's life or afterwards) as long as the annuity directly or indirectly stems from membership or past membership of a fund. All lumps sums resulting from these commutations should accordingly be treated as gross income eligible for the special retirement table relief.

The only difference in taxing these commutations lies in the application of the aggregation principle required by the special retirement tables. If the commutation occurs during the member's life or upon the member's death, aggregation will occur in respect of the member. If the commutation occurs during a successor's life or upon the successor's death, aggregation will occur in respect of the successor.

IV. Effective date

This proposal will apply to all lump sum commutations or death recoveries arising on or after 1 March 2011.

2.7. PARTIAL WIND-UP OF UMBRELLA FUNDS

[Clause 6 *(s), (t),* (z),(zA) and (zB) ; Applicable provisions: paragraph *(a)*(i)*(bb)* to the further proviso of the section 1 "pension preservation fund" definition; paragraph *(a)*(ii)*(aa)* to the further proviso of the section 1 "pension preservation fund" definition; the section 1 "pension preservation fund definition"; proviso to the section 1 definition of "provident fund" definition; paragraph *(a)*(i)*(bb)* to the further proviso of the section 1 "provident preservation fund" definition; paragraph *(a)*(ii)*(aa)* to the further proviso of the section 1 "provident preservation fund" definition]

I. Background

Unlike a closed pension fund offered by a single employer, an umbrella retirement fund allows employees of different employers to place their retirement savings in a single fund.

Umbrella funds ostensibly offer a cheaper and easier alternative to running "stand alone" pension funds. However, owing to financial constraints, some employers are often unable to pay over contributions to the umbrella fund. Many of these employers eventually cease to participate in the umbrella fund. This process whereby an employer exits from an umbrella fund (with the fund otherwise remaining intact) is referred to as a "partial wind-up."

II. Reasons for change

In a partial wind up, impacted employees may elect to:

- have the benefits paid in cash (unattractive because the payment triggers immediate tax, albeit with some relief from the special rates tables);
- transfer their benefits tax-free to an approved stand-alone retirement fund established by the employer (this option is often impossible if the employer is in financial difficulty);
- transfer their retirement benefits to a retirement annuity fund (unattractive since the retirement benefits are "locked in" until the age of 55); or
- transfer their retirement benefits to a pension preservation or provident preservation fund.

However, the last option may not be technically available to employees because the pension preservation fund and provident preservation fund definitions do not specifically allow for the receipt of amounts resulting from a partial wind-up of a pension or provident fund; only from a full wind-up. This technical anomaly places the retention of retirement benefits in potential jeopardy because a cash election seems to be the only option. This cash option is not conducive to a culture of savings.

III. Proposal

Given the above, pension preservation funds and provident preservation funds should be expressly allowed to receive payments or transfers of fund benefits pursuant to a partial wind-up. This clarification will strengthen the option of preserving employer-provided retirement savings.

IV. Effective date

This proposal will apply to all "transfers" of retirement benefits pursuant to a partial wind-up that occurs on or after 1 March 2011.

2.8. RETIREMENT FUND PAY-OUTS TO NON-MEMBERS

[Clause 83; Applicable provision: paragraph 4(1) of the Second Schedule]

I. Background

When a member resigns or withdraws from a retirement benefit fund, there are different periods of accrual. Accrual under the Income Tax occurs at the earliest of: the date the member elects to have retirement fund benefits paid in cash, the date on which fund benefits are transferred to another retirement fund, or the date of the member's death.

Accrual under the Pension Funds Act is determined by the rules of the retirement fund, usually upon resignation. The Pension Funds Act does not expressly determine when retirement fund benefits accrue.

II. Reasons for change

On occasion, employer-provided retirement savings (such as pension or provident fund savings) may be paid by a retirement fund administrator directly to third parties. For example, a member may be indebted to the employer for the settlement of a housing loan guaranteed by the employer or for damages inflicted upon the employer. The full array of allowable third party payouts is listed under section 37D(1)(a) of the Pension Funds Act.

For tax purposes, these payouts create a gross income event that triggers a tax accrual only sometime after the cash payout. The net result is a delayed SARS tax directive for the payment. This timing mismatch places retirement fund administrators at risk during the interim period because remaining sums within a retirement may not be sufficient to cover the tax liability associated with the third party payout (nor should remaining funds be so applied as a matter of governance; instead, tax should be subtracted from the payout itself).

III. Proposal

It is proposed that the tax rules for lump sum benefits be revised to specifically account for third party payouts contemplated in section 37D(1)(a) of the Pension Funds Act. More specifically, these payouts will now trigger a tax accrual event at the moment of payout. Therefore, the timing of required tax directives will coincide with these third party payouts.

IV. Effective date

This proposal will apply to all deductions under section 37D(1)(a) arising on or after 1 March 2011.

2.9. DISCONTINUATION OF STANDARD INCOME TAX ON EMPLOYEES

[Clause 8; Applicable provision: Section 6(4)]

I. Background

The Standard Income Tax on Employees (SITE) system is a component of the Pay as You Earn (PAYE) method of paying income tax and is in effect a final withholding tax levied on the first R60 000 of remuneration. The Standard Income Tax on Employees (SITE) was introduced in 1988 to limit the number of personal income tax returns filed annually, freeing up resources to deal with more complicated returns.

II. Reason for Change

The reasons provided for the elimination of the SITE system are the administrative sophistication and increased modernisation of tax collections systems; at the time of introduction, more resources needed to be freed up to deal with more complicated returns; and the fact that the tax threshold for taxpayers younger than 65 years is approaching R60 000. The 2010/11 income tax thresholds for individuals younger than 65 is R57 000 and for individuals 65 or older is R88 528.

Technological improvements have overtaken the need for the SITE system. The implementation of e-Filing for employees' tax returns now allows for taxpayers earning up to R120 000 per annum with a single employer and no additional income or deductions not to file an income tax return, although they are liable to register as taxpayers.

III. Proposal

An important corollary announcement in the 2010 budget is that in the process of abolishing SITE, "administrative relief measures will be considered for low-income taxpayers with multiple sources of income".

The discontinuation of SITE will potentially result in an increased tax liability for some low-income taxpayers with more than one source of income. Therefore SITE will be phased out over a three year period in order to limit any potential hardship to such taxpayers.

The application and unintended consequences arising from the abolishment of the SITE system can be illustrated by two individuals with the same aggregated total amount of multiple source incomes and one of these individuals having an income stream that breaches the tax threshold and the SITE ceiling. The 2010/11 tax threshold is R57 000 for those under 65 years. Currently, there would be an anomaly in the tax treatment with a tax benefit for the "site only" taxpayer.

Example 1 - multiple source income individuals (2010/11)

			A	B	C	**Total**
Person X	1	Income	42 000	52 000	54 000	**148 000**
No registration		SITE	-	-	-	-
		PIT				**-**
Person Y	2	Income	42 000	36 000	70 000	**148 000**
Registration		SITE	-	-	540	540
		PAYE			1800	1 800
		PIT				**16 940**
		Additional				**14 600**

In terms of the existing tax regime, person X will not be required to pay any form of taxation, whereas person Y will be liable for taxation of R16 940. Under the new rules, person X will be treated in the same manner as person Y. An obvious result of the discontinuation of SITE is an “immediate” hardship (at least in cash flow and added liabilities) for the multiple income source SITE only individual.

A phasing-out approach in implementing the discontinuation of the SITE system is recommended in order to ease and lighten the consequential burden for some low income individuals with more than one source of income / more than one job.

The illustration below is an example which considers one person with three income sources under current legislation and the anticipated consequence with the aggregation of the person’s income after the phasing out of SITE.

Example 2 - old and new regime

			A	B	C	**Total**
Current No Registration	1	Income	39 000	58 000	40 000	**137 000**
		SITE	-	180	-	180
"New"	2	Income	39 000	58 000	40 000	**137 000**
Aggregation		SITE	-	180	-	180
		PIT				**14 400**
		Additional				**14 220**

Normal tax payable with phasing-out relief

- 1/3rd of the aggregated tax payable amount calculated will be payable in the 2011/12 tax year,
- 2/3rds of the aggregated tax payable amount calculated will be payable in 2012/13 tax year, and
- 3/3rds (the whole) of the aggregated tax payable amount calculated will be payable in the 2013/14 tax year.

The affected multi-source income earners will be liable to pay income tax for the first time, but at an initial reduced rate. This option seems to be the most feasible in terms of simplicity of systems design and equity.

The discontinuation of SITE has also highlighted a problem experienced by individuals with multi-source incomes that are separately below R60 000, but in aggregate, are above the R60 000 threshold. At the time of assessment, some of these individuals experience a cash flow problem as too little PAYE has been deducted in aggregate. Mechanisms to mitigate this cash flow problem through education or requiring some employers to deduct additional PAYE during the year will be explored

IV. Effective date

SITE to be phased-out over three years as from 1 March 2011.

3. INCOME TAX: MISCELLANEOUS SPECIAL CIRCUMSTANCES

3.1. PBO, SECTION 10(1)(d) AND CLUB TERMINATIONS

[Clause 53(d), (e) & (f), 54(b), (c), (d) & (e); Applicable provision: sections 30(6), 30(6A), 30(7), 30A(2)(a)(iii), 30A(7), 30A(7A), 30A(8)]

I. Background

Public benefit organisations, section 10(1)(d)(iii)/(iv) organisations and clubs enjoy partial or complete exemption from income tax due to their non-profit motive. Some of these entities undertake a shared responsibility for the social and developmental needs of the country, thereby indirectly relieving financial burdens of the State. Others merely entail a sharing of expenses.

In view of the fact that assets of these non-profit entities enjoy partial or complete exemption, various rules exist to prevent the use of these assets for non-permissible purposes (e.g. general profit-making). In line with this purpose, entities of this kind are only allowed to transfer remaining assets upon dissolution or withdrawal of exemption to other entities that retain their partial or complete exempt status.

II. Reasons for change

The rules relating to permissible transfers upon entity dissolution or withdrawal of exempt status differ for public benefit organisations, section 10(1)(d)(iii)/(iv) entities and clubs. No rationale reason can be discerned for these differences. Differences also exist for dissolutions versus withdrawal of exempt status. Ideally, all of these transfers should be synchronized so that the flow of assets moves to exempt entities with a non-profit purpose that is at least equal to the non-profit purpose for which these entities were employed before the transfer.

III. Proposal

It is proposed that permissible transfers upon entity dissolution or withdrawal of exempt status should be synchronised. Permissible transfers should generally flow according to an ordering paradigm. More specifically, upon entity dissolution or withdrawal of exemption, public benefit organisations should be permitted to transfer assets to other public benefit organizations, section 10(1)(cA)(i) parastatals or the three spheres of Government. Section 10(1)(d)(iii)/(iv) entities should be permitted to transfer assets to other section 10(1)(d)(iii)/(iv) entities, public benefit organisations, section 10(1)(cA)(i) parastatals or the three spheres of Government. Clubs should be permitted to transfer assets to other clubs, public benefit organizations, the three spheres of Government or to section 10(1)(cA)(i) parastatals.

IV. Effective date

The proposed amendment will be effective on or after the date of Presidential promulgation.

3.2. DONATIONS TO TRANSFRONTIER CONSERVATION AREAS

[Clause 37(c) ; Applicable provision: section 18A(1C)(a)(i)]

I. Background

Donations made by a taxpayer represent expenditure of a private and philanthropic nature and are accordingly not deductible as a general matter. However, a special dispensation exists for certain categories of donations. This dispensation allows deductible donations to be made to registered Public Benefit Organisations (PBOs) that conduct one or more public benefit activities as listed in Part II of the Ninth Schedule.

Deductible donations to transfrontier parks contain a number of additional restrictions that do not apply to donations made to other PBOs. Most of these restrictions seek to ensure that deductible donations are limited to funding activities within South Africa. Deductible donations to transfrontier parks are also subject to a sunset clause expiring on 31 March 2010.

II. Reasons for change

The sunset clause for deductible donations to transfrontier parks was enacted at a time (i.e. in 2002) when the rules for PBOs were very new and largely untested. In addition, deductible donations to transfrontier PBOs deviated from the norm in that donation's to environmental PBOs were not deductible.

Since the sunset clause's enactment, history has proven that transfrontier parks have been a success. Donations to environmental PBOs are also now deductible as a general matter. The only unique feature of transfrontier parks is their cross-border nature, but special safeguards already exist in this regard. Therefore, the continued need for a sunset clause in respect of deductible donations to transfrontier parks is questionable.

III. Proposal

It is proposed that the 31 March 2010 sunset clause be deleted. Deductible donations to transfrontier PBOs will now become a permanent feature of the Income Tax Act.

IV. Effective date

The proposed amendment will be effective to donations made on or after 1 April 2010.

3.3. PROFESSIONAL SPORT SUBSIDISATION OF AMATEUR SPORT

[Clause 6(l), 21, 45, 129; Applicable provision: sections 1(lA) of the definition of "gross income", 11E, 24E, 125(10) of the Revenue Laws Amendment Act 2007]

I. Background

Under current law, amateur sports is treated as a public benefit activity that is exempt from income tax if undertaken by an approved public benefit organisation (PBO). PBO's may engage in both public benefit and trading activities, the latter being taxable. Therefore, if a PBO engages in both amateur and professional sports, the amateur sports arm will be exempt while the professional sports arm will be taxed.

As a general matter, donations to amateur sport PBOs are not deductible. However, if a PBO has both a professional sports arm and an amateur sports arm, the professional arm is eligible to deduct the subsidisation of amateur sports. Given the fact that the deduction for subsidisation exists only for professional subsidisation of amateur sports within a single entity, the tax rules allow for a tax-free amalgamation of sporting bodies. This form of tax-free amalgamation was permitted only for a transitory period (i.e. until the close of 2009).

II. Reasons for change

Professional sport is ultimately dependent upon amateur sports to develop the next generation of skilled athletes and fans. Subsidisation may occur during the year in which professional sports income is earned. However, more often than not, professional sports income comes on an irregular basis with funds from prosperous years being used to cover the lesser years.

Even though the tax rules provide some guidance to facilitate subsidization of amateur sports by professional sports, the current rules are too restrictive. The model of a single combined professional and amateur entity is too simplistic, especially considering that the model requires current amateur sporting costs to be subsidised by current professional sports income.

III. Proposal

A. Extended amalgamation window period

As discussed above, Government enacted a transitional window period to allow for the tax-free amalgamation of professional and amateur sports so as to promote subsidisation. The effective date for this form of amalgamation came to an end for "disposals" occurring on or before 31 December 2009.

Unfortunately, some sporting organisations have been unable to complete the amalgamation process within the prescribed window period due to unexpected internal and external problems. Therefore, all amalgamations of this kind have come to halt due to the lapsing of the window period.

In order to renew the process of amalgamations still outstanding, the window period will be extended to the close of 31 December 2012. Furthermore, the current wording refers to a 'disposal' that occurs on or before the effective date. This approach is too restrictive because the "disposal" relating to an amalgamation may occur over an extended period of time. Therefore, it is proposed that wording should focus on the "conclusion of agreements" occurring on or before 31 December 2012 (with subsequent disposals being freely permitted).

B. Subsidisation among entities

The current tax focus on single entity subsidisation of amateur sports by professional sports has proven to be unrealistic. While many amateur sports and professional sports organisations may seek to amalgamate for tax and other commercial reasons. Many other sports bodies may seek to remain independent while having one entity subsidise another. For instance, combining national and regional sports into a single entity is largely impractical.

In view of these concerns, it is proposed that the subsidisation model be extended. Under the revised model, cross-funding between similar sports entities will be allowed. In other words, the deduction for an entity carrying on a trade in sports will now be available when the expenditure is: (i) for the development of sport within the same entity, or (ii) for another entity similarly engaged in sport. However, none of these amounts will be deductible if the funds are ultimately deducted for capital expenditure.

Cross-funding among entities comes at a price. The receipt of this funding is automatically includible in income. The recipient entity can then deduction this amount if expended for the development and promotion of sport (or further shifted to another entity carrying on a trade in sport).

Example
Facts: National Sports Body (an association established in South Africa) transfers R100 000 to Regional Sports Body (another association established in South Africa). Regional Sports Body transfers R60 000 for amateur sports games under its direct control. Regional Sports Body transfers R40 000 to Local Sports Body (a public benefit organisation). Local Sports Body spends the full R40 000 on training amateur athletes.

Result: The R100 000 transfer to Regional Sports Body is deductible by National Sports Body. Regional Sports Body has R100 000 of gross income, but the R60 000 and R40 000 transfers are fully deductible. Local Sports Body has R40 000 of gross income, but again this R40 000 is deductible.

C. Deductible reserves for the future development and promotion of amateur sport

As stated above, current legislation only allows a deduction for subsidies against direct current expenditure for the development and promotion of amateur sports. However, professional sports income comes in cycles. Large amounts of income are generated during particular years with lower amounts in other years (depending on the success of the teams and whether a tournament is held locally). Years with large inflows are accordingly used to fund the survival of the sport over the next several years. None of this multi-year funding is deductible despite the ultimate use of the funds for promotion and development of amateur sport.

In view of these concerns, it is proposed that an allowance be created to facilitate the reserve of funds for the future expenditure relating to promotion and development of amateur sport. Unexpended amounts are added back in the following year (and deducted again as reserves if still dedicated to future amateur sport).

IV. Effective date

Extended amalgamation window period: The proposed amendment will apply retrospectively from 1 January 2008.

In the case of cross-subsidisation among entities and in the case of deductible reserves for the future development and promotion of amateur sport, the proposed amendments will apply retroactively for years of assessment ending on or after 1 January 2011.

3.4. TERMINATING SECTION 10(1)(d) ENTITIES

[Clause 18(d) & (e), 55; Applicable provision: sections 10(1)(d)(iii), 10(1)(d)(iv), 30B]

I. Background

Section 10(1)(d) exempts miscellaneous entities from Income Tax. The first category of exemption covers: mutual loan associations, fidelity or indemnity funds, trade unions, chambers of commerce and local publicity associations. The second category of exemption covers companies, societies or associations established to promote common interests of a group of persons. All of the above organisations fall outside the scope and structure of the tax rules for public benefit organisations and clubs.

Conditions for approval in respect of the above section 10(1)(d) entities are outlined solely in regulation (Government Gazette No. 31614, dated 21 November 2008). Pursuant to these regulatory conditions, the founding document of these entities must comply with certain requirements relating to ownership, financial control, permissible activities and payment of employees.

II. Reasons for change

Public benefit organisations and clubs are subject to a special tax charge when these entities terminate and the funds flowing there from are transferred outside certain parameters (are not transferred to public benefit organisations, clubs, etc…). If this charge applies, the public benefit organisation or club at issue is deemed to have taxable income equal to the market value of remaining assets less liabilities (i.e. net asset value).

Section 10(1)(d) lacks any exiting tax charge of this nature for impermissible transfers. Regulatory authority exists only for approval criteria. These entities can accordingly shift terminating transfers to profitable use without penalty.

III. Proposal

It is proposed that an exit charge be levied against a section 10(1)(d)(iii) and (iv) entity that undertakes an impermissible transfer. This exit charge will mirror the exit charges for public benefit organisations and clubs (i.e. the section 10(1)(d)(iii) and (iv) entity will be deemed to have taxable income equal to the entity's remaining asset value less liabilities). Procedural rules for withdrawals of approval will also be added that match the current rules for public benefit organisations and clubs.

IV. Effective date

The proposed amendment will be effective for transfers occurring on or after the date of Presidential promulgation.

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4. INCOME TAX: BUSINESS

4.1.1. DIVIDENDS TAX: ONGOING REFINEMENTS

I. Background

In 2008, Government announced its intent to switch from the Secondary Tax on Companies in respect of dividends to a new system known as the Dividends Tax. Initial legislation was enacted in 2008 with substantial modifications in 2009 based on public comment.

The Dividends Tax will become effective three months after a date set by the Minister. The Minister will set this date once the tax treaty renegotiation process is complete. Renegotiation will focus on the Dividends Article for a number of tax treaties so that adjustments are made to ensure that South Africa receives a minimum 5 per cent rate on dividends flowing offshore.

II. Reasons for change

Although most of the issues relating to the Dividends Tax have been resolved, a few issues remain. Some of these issues are being resolved under the present cycle as outlined below. Further small modifications can be expected as the proposed legislation nears implementation once many taxpayers interact more closely with the legislation and adjust operational systems.

4.1.2. DIVIDENDS TAX: WITHHOLDING BY TRANSFER SECRETARY

[Clause 70(1)(c); Applicable provision: section 64D; Addition of paragraph (f) of the definition of “regulated intermediary”]

I. Background

Under the proposed Dividends Tax system, two sets of withholding rules apply. As a general rule, the company paying a dividend is subject to withholding. However, if a dividend is paid to a regulated intermediary, the regulated intermediary must withhold the dividends tax. Regulated intermediaries include central securities depository participants, brokers (i.e. authorised users or approved nominees), collective investment schemes in securities and linked investment services providers.

Parties subject to withholding can eliminate or reduce the Dividends Tax payable based on statements of exemption/reduction by the beneficial owners of the dividends. This elimination/reduction requires timely statements. If the statements are late, the excess Dividends Tax becomes refundable largely out of the Dividends Tax otherwise payable in respect of future dividends. One benefit of being an intermediary is the aggregation of dividends from various companies. As a result, the refunds allowable for a regulated intermediary can be made against dividends from any company, not just dividends from the company that paid the dividend from which the tax was withheld.

II. Reasons for change

Many smaller and mid-size companies directly undertake their own transfer secretarial work (i.e. through an employee). This work includes the recording of ownership of the issuing company's shareholdings. The holding of listed company electronic shares is largely recorded and controlled by regulated intermediaries. However, many listed companies have outstanding dematerialised (i.e. paper) shares, which may be small in percentage terms but still large in absolute amounts.

In order to ease the burden of maintaining a share register for dematerialised shares, many listed and larger unlisted companies outsource the transfer secretary function to an agent. The main function of the external "agent" transfer secretary involves the recording of share ownership and the processing of dividend payments. The outsourcing of the transfer secretarial function results in lower costs for the issuer (e.g. mailings).

Although external agent transfer secretaries perform similar functions to a regulated intermediary, these agents are not regarded as a regulatory intermediary. As a result, companies seeking to shift the dividend processing function to an external "agent" transfer secretary remain directly responsible for Dividends Tax withholding.

III. Proposal

It is proposed that a transfer secretary may be regarded as a regulated intermediary for the purposes of Dividends Tax withholding subject to SARS approval. This potential treatment is limited only to external juristic persons or partnerships transfer secretaries (e.g. not to employees). In determining whether regulatory treatment should be granted, SARS should take into account the diversity of clients (so that centralisation of the withholding function saves time in respect of SARS compliance). SARS should also take into account the financial sustainability of the transfer secretary in view of the fact that the transfer secretary is not subject to any regulatory capital adequacy or liquidity requirements.

IV. Effective date

The amendment becomes effective on the date when the Dividends Tax is implemented.

4.1.3. DIVIDENDS TAX: WITHHOLDING BY REGULATED INTERMEDIARIES

[Clauses 73(1) and 74(1): Applicable provisions; section 64G(2)(a)(ii)(bb); section 64G(3)(b)(ii); section 64H(2)(a)(ii)(bb) and section 64H(3)(b)(ii)]

I. Background

Under the Dividends Tax system, a company paying a dividend is primarily liable to withhold the 10 per cent Dividends Tax. However, the company's liability to withhold the tax shifts if the dividend is paid to a regulated intermediary (e.g. a central securities depository participant). The company or intermediary need not withhold if the beneficial owner of the dividend is exempt. In other cases, the company or intermediary need only withhold a reduced amount if a tax treaty applies.

Exemption or reduction from withholding requires a declaration from the beneficial owner. This declaration must generally be submitted by a date specified by the company (or the intermediary). The declaration of an exempt beneficial owner (or one that is entitled to a reduced rate) must be submitted for each and every dividend paid.

II. Reasons for change

As already stated above, timely declarations of exemption are required for each and every dividend paid. Taking into account the fact that a company may have a multitude of shareholders (and intermediaries may have a multitude of clients acting as shareholders of multiple companies), repeated declarations pose a large administrative burden. In effect, many parties subject to withholding will be overwhelmed with paper or excess data. It is also questionable whether all of these declarations will be of assistance in the audit process.

III. Proposal

It is proposed that a declaration of exemption is valid for all future dividends paid by the intermediary until the beneficial owner advises the intermediary of a change in tax status. Failure to advise of a change in tax status should trigger a penalty for the beneficial owner (see Second Amendment Bill for the penalty).

IV. Effective date

The amendment becomes effective on the date when the Dividends Tax is implemented.

4.1.4. DIVIDENDS TAX: TRANSITIONAL ISSUES

[Clauses 148, 149(1) Applicable provision: sections 53 & 54 of the Taxation Laws Amendment Act, 2009]

I. Background

The Secondary Tax on Companies ("STC") is levied on declaration of a dividend. On the other hand, the Dividends Tax will be levied on the date that the dividend accrues. The date of payment is deemed to be the date on which the dividend accrues to the shareholder.

Certain amounts are also treated as deemed dividends for STC purposes (such as loans, advances and releases from obligations measurable in money). With the introduction of the Dividends Tax, the Value Extraction Tax ("VET") will also be introduced to replace the deemed dividend system. The VET seeks to levy tax on any value extraction effected by resident companies. Like the STC system, the VET imposes the charge on the company. The VET will be effective on the date on which the Dividends Tax becomes effective.

II. Reasons for change

The date on which a dividend accrues to a shareholder (i.e. record date or date of registration) is often not the date on which the dividend is declared. As a result, a single dividend could be declared before the effective date of the Dividends Tax and accrue to the shareholder after that effective date. This creates a possibility of the double taxation.

A possibility for double taxation also exists in respect of deemed dividends and VET. For instance, a loan may be granted and treated as a deemed dividend before the effective date. If that same loan remains outstanding after the effective date, the time value of loan will also be subject to VET (based on an annual market related interest rate).

III. Proposal

In respect of dividends (as defined), the Dividends Tax will apply in respect of dividends declared and paid on or after the effective date of the Dividends Tax. The STC will only apply in respect of dividends arising before these dates.

Similarly, the VET will generally apply in respect of value extractions effected on or after the effective date of the VET. However, the VET will not apply to financial assistance (e.g. loans) if that financial assistance was previously subject to the deemed dividends charge.

IV. Effective date

The amendment becomes effective on the date when the Dividends Tax is implemented.

4.2. COMPANY LAW REFORM

[Clause 6(a), (b), (c), (e), (f), (g), (q) & (zG), 11, 13, 14, 16(c), 18(b), (f), (l), (o), (q) & (v), 21, 23(1)(a), 39(b), 40, 53(a), 54(a), 59, 60, 61(c), (e), 63(b), (c) & (d), 64(c), 65(a), 68(a), (f) & (g), 69(a), (b), (d), (f) & (g), 71(b), 76, 78, 80(d), 93, 96, 108(a), (c) – (k), (l), (m) & (n), 110, 111, 116, 138 (a) & (b), 139, 140, 141, 142, 143, 145(b), 154; Applicable provision: sections 1 deletion of definition of "capitalization shares", 8B, 8E, 9D(1)(a), 10(1)(cA)(i), 10(1)(e)(i)(kk), 10(1)(k)(cc)(i), 10(1)(k)(ii)(aa), 10(1)(k)(ii)(dd), 10(1)(x)(iv), 11E(1)(i)(a), 12E(4)(a) definition of "small business corporation", 22(8)(b)(iii), 22B(2)(b)(ii), 22B(2)(c)(i), 30(1)(i)(a) definition of "public benefit organization", 30A(1) definition of "recreational club", 38(2)(a)(iii), 38(2)(b)(i), 38(4)(a)(v), 38(4)(c)(ii), 38(4)(d), 40A(1), 41(1)(bb)(i) definition of "group of companies", 41(1)(b)(i) definition of "prescribed proportion", deletion of 44(9A), 44(10), 44(14)(c), 45(4A), deletion of 46(6), 64B definition of "declared", deletion of 64B(5)(c), 64B(5)(f)(i), 64C(1)(a), deletion of 64C(1)(b) definition of "share incentive scheme", 64C(2)(f), deletion of 64C(4)(a), 64C(4)(c), 64E(3)(a)(ii), 64Q(3)(a), paragraph 11(c)(iii) of the First Schedule, paragraph 2(1)(a)(ii) of the Second Schedule, paragraph

2(2)(b) of the Eighth Schedule, paragraph 29(3) of the Eighth Schedule, paragraph 64B substitution of title, paragraph 64B(2)(a), paragraph 64B(2)(a)(i), paragraph 64B(2)(a), paragraph 64B(3)(a), paragraph 64B(3)(b), paragraph 64B(3)(c)(i), paragraph 64B(3)(c)(ii), paragraph 64B(3)(c)(iii), paragraph 64B(4)(b), paragraph 64B(5), paragraph 64B(5)(a), paragraph 64B(6)(a) of the Eighth Schedule, paragraph 74(1) definition of "date of distribution" & "share" of the Eighth Schedule, paragraph 78(1) of the Eighth Schedule, paragraph 6(1)(a), paragraph 6(1)(b) of the Tenth Schedule, deletion of section 4(1)(d) Revenue Laws Amendment Act 2008, section 4(2) Revenue Laws Amendment Act 2008, section 47(2) Revenue Laws Amendment Act 2008, 49(5) Revenue Laws Amendment Act 2008, section 50(2) Revenue Laws Amendment Act 2008, section 52(3) Revenue Laws Amendment Act 2008, section 85(2) Revenue Laws Amendment Act 2008, section 7(3) Taxation Laws Amendment Act 2009, section 78(2) Taxation Laws Amendment Act 2009]

I. Background

Company law in South Africa has recently undergone major transformation with the enactment of the Companies Act, 2008 (Act No. 71 of 2008). The Department of Trade and Industry is currently preparing regulations and legislative technical corrections in preparation of the Act's implementation. The new Companies Act modernises company law in line with evolving economic and international trends. This far reaching modernisation includes: (i) the removal of capital maintenance rules for determining dividends in favour of market value solvency and liquidity tests, (ii) modernisation of reorganisation rules, and (iii) the facilitation of business rescue procedures.

II. Reasons for change

Many provisions within the Income Tax Act directly or indirectly depend upon company law principles and definitions. The new Companies Act has fundamentally changed the company law arena. In view of these sweeping changes, consequential amendments to the Income Tax Act have become imperative. Some of these changes are technical while others seek to align the Income Tax Act with revised company law principles.

III. Proposal

A. Dividend definition

Under current company law principles, company dividends must come from profits and reserves. Current tracking mechanisms are impacted by stated capital, share premium, share capital and other similar mechanisms. When shares are issued for no par value, the entire amount received in respect of that issue of shares constitutes stated capital. Where shares are issued with a par value, the amount received in respect of that issue is allocated to share capital and share premium accounts. One purpose of these rules is to ensure that company distributions do not strip company assets so as to wrongfully deprive the company's creditors. In line with modern trends, the new Companies Act completely jettisons these mechanical concepts in favour of a more commercial approach. Under the revised rules, distributions are generally tested to determine whether these dividends reduce assets below liabilities (the solvency test) and whether the dividends will deprive the company of urgently needed cash (the liquidity test).

The current dividend definition in the Income Tax Act relies heavily on the capital maintenance concepts set to expire in short order. In anticipation of this change, a new dividend definition was enacted in 2008 (with refinements in 2009) that will come into effect in due course (i.e. 1 January 2011).The proposed dividend definition generally treats any amount transferred (or applied) by a company as a dividend unless that dividend comes from contributed tax capital. Contributed tax capital is solely a tax concept – determined without regard to company law. In essence, contributed tax capital represents the tax consideration contributed to the company in exchange for the issue of shares.

Even though implementation of the new Dividends Tax is delayed pending tax treaty renegotiation, no reason exists to delay implementation of the revised dividend definition. The new definition, like the new Companies Act, is wholly divorced from previously existing capital maintenance concepts. It is accordingly proposed that the new dividend definition comes into effect once the new Companies Act comes into effect. This new dividend definition will apply for purposes of the normal income tax as well as the secondary tax on companies. (Note: a new definition for foreign dividends will also be added – see related explanatory memorandum). All the elements associated with the old dividend definition will also be removed (e.g. reference to profits, reserves, par value and nominal value).

The current deemed dividend rules also contain some concepts that depend on the expiring capital maintenance provisions. Net profit and other limitations will accordingly be removed in favour of net asset limitations.

B. Equity share capital/equity shares

The Income Tax Act contains a series of rules for debt and another series of rules for shares. Shares have some tax benefits, such as exemption for shareholders and participation in the reorganisation rollover rules. Many tax benefits associated with shares apply only to "equity shares" or "equity share capital" – terms that stem from the soon-to-be-terminating Companies Act.

Under current tax law, the term "equity share capital" (and "equity shares") literally means a company's "issued share capital and in relation to a close corporation, its members' interest, excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution". In essence, preference shares with limited dividend rights fall outside the definition.

It is proposed that the concept of equity shares be retained without reference to the obsolete concepts of capital. Moreover, the interchangeable use of the terms "equity shares" and "equity share capital" will be removed. Although similar, both terms have a slightly different connotation creating unintended anomalies. Under the tax law as revised, the sole term will be "equity shares."

C. Contributed tax capital (CTC)

The concept of contributed tax capital was introduced in 2008 and was set to become effective when the new Dividends Tax regime is implemented. CTC is a tax law concept. As a general rule when dealing with resident companies, CTC consists of either stated capital (in the case of no par value shares) or the sum of the share capital and share premium (in the case of par value shares) that form part of the company's financial books immediately prior to the effective date. Furthermore, the CTC of a resident company will be increased by any consideration received by the company for the issuance of shares on or after the effective date.

A special rule applies to foreign entities that become resident companies on or after 1 January 201. When calculating CTC in these circumstances, the starting point for the CTC calculation begins with the market value of all shares immediately prior to that entity becoming resident. The CTC of the entity will further be increased by any consideration received by the entity if received in exchange for shares issued after the entity obtains resident status.

D. General reference

The Income Tax Act contains numerous references to the current Companies Act, 1973. All these references will be updated to reflect the Companies Act, 2008.

IV. Effective date

The amendment becomes effective as of 1 January 2011.

4.3. DEVALUED FINANCIAL INSTRUMENTS HELD AS TRADING STOCK

[Clauses 39(1)(a), 61(1)(a): Applicable provisions; section 22(1)(a); definition of “allowance asset” in section 41; section 11(a) section 11(i) and section 11(j)]

I. Background

Financial accounting recognises inventory as a balance sheet asset equal to the lesser of cost or net realisable (market) value. The tax rules for trading stock are consistent with financial accounting, effectively allowing a net deduction on devalued trading stock prior to disposal.

This “lower of” rule generally applies inclusive of financial instruments. For instance, individual share-dealers are permitted to value the closing stock at lower of cost or market value. However, a specific exclusion from the “lower of” rule exists for company held shares. Valuation of company held shares can only be taken into account at cost.

II. Reasons for change

Any form of financial instrument should be excluded from the “lower of” cost or market value rule, not just company-held shares. The original trading stock rule was enacted at a time when all forms of inventory (including financial instruments) fell within the same accounting paradigm. In recent years, however, financial instruments have become subject to a wholly different set of rules. These revised rules (known as “mark-to-market” accounting) often recognise both appreciations and devaluations of financial instruments at year-end (whether disposed of or retained). Meanwhile, the current trading stock rules for tax purposes account only for a reduction in market value, but not appreciation.

The Income Tax Act already recognises the distinction between regular assets and financial instruments. To this end, the Income Tax Act affords companies dealing in instruments, interest rate agreements or option contracts an opportunity to use alternative methods to determine their market value. This limited form of adjustment recognises that any market value adjustments must account for both depreciation and appreciation.

III. Proposal

It is proposed that all financial instruments be excluded from the trading stock "lower of" cost or market value rule (meaning that cost will be the only allowed methodology). This exclusion applies regardless of the nature of the holder (e.g. regardless of whether the holder is a company, trust or natural person).

Two collateral considerations must be taken into account as a result of the exclusion, as provided below.

(i) *Bad and doubtful trading stock debts:* The "lower of" rule currently utilised for trading stock implicitly accounts for bad and doubtful debts. The removal of financial instruments from the trading stock rule eliminates this implicit reduction. However, bad debt write-offs for money-lenders will still be allowed under section 11(a).

(ii) *Bad and doubtful trading stock in corporate re-organisations:* Corporate reorganisations have always enjoyed roll-over relief in respect of allowance assets, which include debts (that become bad or doubtful before or after the re-organisation). An allowance asset is defined as a capital asset (but does not currently include a trading stock). Therefore allowance assets will be specifically extended to include all bad or doubtful debts, regardless of whether those debts qualify as capital assets or trading stock.

IV. Effective date

The proposed removal of the "lower of" trading stock rule for financial instruments will be effective from years of assessment beginning on or after 1 January 2011. The proposed amendment in respect of the transfer of bad or doubtful debts in corporate re-organisations will be effective for transfers occurring on or after 1 January 2010.

4.4. DEFAULT ELECTIONS INVOLVING INTRA-GROUP ROLLOVERS

[Clause 64(1)(a), (d) and (e): Applicable provisions; section 45(4)(a); section 45(6)(g)]

I. Background

The Income Tax Act provides for roll-over relief in respect of assets transferred in an intra-group transaction. An intra-group transaction is a transaction in which a company disposes of assets to another company within the same group of companies.

The assets transferred may constitute either trading stock or capital assets. These assets retain their nature in the hands of the transferee. The roll-over relief is effectively reversed if the group relationship between the transferor and transferee ceases to exist within 6 years of the transfer of the assets (known as a de-grouping charge).

The intra-group transaction roll-over relief provisions apply automatically unless both the transferor and the transferee elect that the provisions should not apply.

II. Reasons for change

Previously, taxpayers had to make an election into the intra-group transaction roll-over relief provisions. The presumption was reversed in 2009 to ease the enforcement or compliance burden when taxpayers conduct intra-group transactions. However, some taxpayers now contest that it is difficult to trace inventory regularly transferred under an intra-group transaction.

As a side matter, no procedure (i.e. form) exists for the election-out option in respect of intra-group transactions. The election-out is also administratively burdensome for taxpayers who engage in the intra-group transfer of trading stock on a daily basis.

III. Proposal

Regular and continuous trading stock will be excluded from the de-grouping charge. This exclusion from the de-grouping charge will largely eliminate any issues of concern (i.e. six year tracing). Moreover, the election mechanism will be replaced by an agreement mechanism. In terms of the latter mechanism, the transferor and the transferee companies should simply agree that the roll-over provisions would not apply to the transaction. The agreement should be made in writing at the time of conclusion of the agreement for the transfer of assets. This revised mechanism will apply to all roll-overs in Part III of the Income Tax Act, not just intra-group roll-overs.

IV. Effective date

The amendment must apply to transactions occurring during the year of assessment ending on or after 1 January 2011.

4.5. LISTED SHARE-FOR-SHARE REORGANISATIONS

[Clause 62(1)(a), (c) and (d) : Applicable provisions; section 42(1)(b), (2)(b) and (2)(bA)]

I. Background

The Income Tax Act contains various roll-over provisions designed to defer gain when corporate entities reorganise. In listed share-for-share reorganisations, relief is granted to transactions involving the disposal of target company shares by one or more target shareholders to an acquiring company in exchange for newly issued acquiring company shares. In a listed context, the target company, the acquiring company or both companies may be listed on the JSE.

The rollover nature of the relief generally implies that the company acquiring the target company shares obtains the same (i.e. rolled-over) tax cost in the shares as previously held by the target shareholders. However, if an asset is acquired by a listed company in a company reorganisation, the tax cost of the asset in the hands of the listed acquiring company is the market value of the asset (i.e. as if the asset were acquired by the acquiring company for cash). This deviation from the roll-over of tax cost exists because the acquiring company cannot be realistically expected to know the tax cost of the target shares held by the target shareholders in a listed context.

II. Reasons for change

The rollover rules for share-for-share reorganisations contain a number of requirements. One requirement is that the asset (i.e. the target shares transferred) must generally be acquired by the acquiring company in the same character as held by the transferor (i.e. the target shareholder surrendering the shares). In other words, if the target shareholder holds the target shares as trading stock before the reorganisation, the acquiring company must hold the target shares as trading stock immediately afterward the reorganisation.

While essential to prevent certain forms of anti-avoidance, the requirement that the transferee company should acquire the asset in the same character as the transferor can be problematic. It is practically impossible for the transferor to ascertain or trace the character in which a wide array of target shareholders holds shares in a listed context. In essence, the same practical problem exists in this instance as previously existed for determining the tax cost of the target shares held by the target shareholders before the listed market value rule was introduced.

Furthermore, while the market value rule for tax cost provides necessary relief for listed share-for-share transactions, the threshold requirements for this relief are not entirely appropriate. At the present stage, one of the key threshold requirements is for the acquiring company to be listed; whereas, the problem of tracing really only exists if the target company is listed (i.e. has a wide array of shareholders).

III. Proposal

A. General overview

In view of the above, a unified special regime for listed share-for-share reorganisations is proposed that covers both the character tracing problem as well as the rollover tax cost tracing problem. The trigger for these relief mechanisms will be adjusted so that the criteria more closely fit the practical problem.

B. Revised rules

The listed requirement will henceforth be based on the status of the target company as opposed to the acquiring company. More specifically, relief will apply if the target company is listed but only for target shareholders not holding more than 20 per cent of the target company before the transaction. Moreover, the relief applies only if the acquiring company obtains a controlling interest in the target company as a result of the reorganisation. At the end of the share-for-share transaction, the acquiring company must generally hold at least 35 per cent of the shares in the listed target company. This threshold can be reduced to 25 per cent if no other shareholder holds an equal or greater shareholding in that target company as held by the acquiring company. These control requirements stem from the previous share-for-share reorganisation rules, which were subsequently merged into the asset-for share reorganisations several years ago (i.e. previously contained in section 43).

If the relief criteria apply, the requirement that the transferee company must generally acquire the target shares in the same character as the transferor will be eliminated. As a result, the acquiring company can hold the target shares as trading stock or as capital without regard to the previous target shareholders. The tax cost of the target company shares in the hands of the acquiring company will remain at market value (as under prior law for listed reorganisations). Thus, in the listed context, the acquiring company again does not step into the shoes of the target shareholder. The acquiring company instead treats the expenditure as if acquired for cash (resulting in a market value tax cost and a date for the acquisition of the shares being the date on which the reorganisation was entered into).

Example
Facts:
- *Before the share-for-share reorganisation:* One million shareholders hold the shares of Company 1 worth R100 million (and have an aggregate tax cost of R20 million in those shares). Three million shareholders hold the shares of Company 2 worth R300 million. Company 1 and Company 2 are both listed companies, and no shareholder holds more than 5 per cent of the shares in either company.
- *Impact of the share-for-share reorganisation:* The target shareholders transfer all of their shares in Company 1 to Company 2 in exchange for newly issued Company 2 shares. This transfer occurs pursuant to a share-for-share reorganisation in terms of Section 42. Upon completion, Company 1 will be wholly owned by Company 2.

Result: The former one million target shareholders have a tax cost of R20 million in their newly received Company 2 shares. Company 2 has a tax cost of R100 million in the Company 1 shares. In determining whether the transaction qualifies as a section 42 transaction, no regard is had as to whether the target shareholders previously held shares as trading stock or capital.

IV. Effective date

This provision will apply to transactions entered into on or after promulgation date (i.e. 1 October 2010).

4.6. CORPORATE REORGANISATIONS INVOLVING PLANTATIONS

[Clause 6(1) (zI) and 61(1) (i): Applicable provision; paragraph (a) of the definition of “trading stock” in section 1, section 41(1), section 41(7) and paragraph 14(1) of the First Schedule]

I. Background

A. Character of plantations

Plantations receive a tax preference (like mining). All of the expenditure incurred by a farmer in establishing, maintaining or acquiring the plantation is immediately deductible, subject to a ring-fencing of losses. However (like mining), this incentive comes at a price. All proceeds from the disposal of a plantation are included in gross income, not just the prior amount allowed as a deduction.

Most plantations are capital in nature by virtue of the common law. However, as discussed above, all amounts received or accrued from the disposal of plantations are included in gross income (and are deemed not be of a capital nature). This automatic gross income treatment results in plantations being treated as trading stock without regard to the common law.

B. Plantations and corporate reorganisations

The Act provides roll-over relief for assets (i.e. as trading stock, as a capital asset and/or as an allowance asset) transferred as part of a company reorganisation. This roll-over relief defers gains, recoupments and gross income otherwise realised. Rollover treatment also deems the transferor and transferee to be one and the same person in relation to any allowances and any deductions that may be claimed by the transferee in respect of the assets transferred.

II. Reasons for change

A. Character of plantations

The treatment of plantations as trading stock (whether by virtue of the deeming rules or by virtue of the common law) is problematic in the context of the reorganisation rules. Company reorganisation roll-over relief for trading stock hinges on the closing stock and opening stock adjustments associated with that trading stock.

This focus on closing and opening stock, however, is ineffective for plantations treated as trading stock. Because plantations are fully deductible upon acquisition, establishment and maintenance and fully includible upon disposal, plantations simply do not have closing and opening stock adjustments. Plantations operate more like allowance assets.

B. Plantation recoupments

The non-recoupment rule for allowance assets applies only to the extent of prior allowances. This relief is only partially effective for plantations because the inclusion of proceeds from the disposal of plantations does not bear any relation to prior allowances or deductions.

III. Proposal

A. Character of plantations

Plantations will no longer be treated as trading stock per se despite the realisation of gross income upon disposal. The common law distinction between capital and revenue will prevail for general purposes of the Income Tax Act (while receipts and accruals will remain gross income). In addition, plantations will always be treated as allowance assets for purposes of the company reorganisation rules. The latter treatment will simplify company rollover relief for plantations.

B. Plantation recoupments

The non-recoupment rule for allowance assets will be put on par with mining capital expenditure. All gross income associated with the plantations will be deferred, even if that gross income exceeds the prior deduction.

IV. Effective date

The amendment is applicable to transactions occurring on or after date of promulgation.

4.7. IMPROVEMENTS ON GOVERNMENT LAND

[Clause 29: Applicable provisions; section 12I (1A), section 12N, section 13 (1) (d), section 13bis (1A), section 13ter (2A), section 13quat (2A) section 13quin (1A), section 13sex (1) and section 36 (11) (d)]

I. Background

An allowance exists for expenditure actually incurred by a lessee for obligatory improvements undertaken on leased land or buildings. The amount of the allowance is generally equal to the amount of the expenditure divided by the lease period (or 25 years if sooner). If the allowance is not fully exhausted by the termination of the lease, the remaining amount is deductible by the lessee upon lease termination.

However, the allowance is not available if the lessor is tax exempt unless the improvement is undertaken:

- in terms of a Public Private Partnership, or
- on land owned by government (national, provincial or local) or by an exempt government controlled body if the land is leased for a period of at least 20 years.

II. Reasons for change

The general denial of the improvement allowance in respect of leased land or buildings of an exempt lessor was enacted in the early 1980's to prevent tax avoidance. At that time, a number of lease financing schemes existed so that financiers could obtain artificial write-offs for improvements on leased property as if these financiers had directly owned and operated the underlying property. These schemes were particularly prevalent in the case of exempt parties seeking finance because these entities lacked a tax base from which a depreciation allowance could be utilised. The purpose of the lease finance schemes was to shift the depreciation allowance to financiers that had a tax base upon which the allowance could be utilised.

The artificial shifting of depreciation allowances from exempt persons to taxable persons remains of concern. On the other hand, the general prohibition of depreciation allowances in respect of improvements undertaken by lessees of government-owned property runs contrary to overall Government policy. The three spheres of Government (as well as certain Government-owned institutions) enter into various arrangements to provide underlying land with the private sector constructing buildings or improvements thereto. These arrangements are necessary because the three spheres of Government (and certain Government-owned entities) sometimes lack the cash funds to directly undertake this desired construction and (as a matter of policy) often prefer not to permanently part with ownership of the underlying land).

In view of these concerns, a straight-line writes off was allowed for improvements in the case public private partnerships and in the case of Government-owned land (as long as the lease period lasted at least 20 years). However, this write-off is sometimes less favourable than write-offs in the case of improvements made to directly-owned land. For instance, the owner of land within an urban development zone can write-off a building or improvement at an accelerated rate (e.g. five years in the case of improvements and 17 years in the case of new buildings). This accelerated write-off is unavailable to lessees undertaking improvements in the case of an exempt government lessor.

III. Proposal

A. Revised depreciation allowance

1. Qualifying criteria

The new depreciation rules will apply to holders of rights of use or of occupation that undertake obligatory improvements undertaken on property in the case of public private partnerships, the three spheres of Government and certain exempt Government-owned exempt entities (e.g. parastatals and universities). Furthermore, the lessee should use the property for purposes of earning income there from (e.g. rental income from the building).

2. Application

The current straight-line regime will be replaced for improvements on land owned by one of the three spheres of Government, a Government-owned exempt entity or as part of a public private partnership. Obligatory improvements by lessees in these circumstances will be eligible for depreciation allowances as if the lessee owned the underlying property directly (i.e. the lessee will be deemed to be the owner). The net effect of this change is to allow for accelerated write-offs to the extent these accelerated write-offs are allowed for owned property (e.g. for purposes of sections 12D, 13ter, 13quat and 36). If the applicable depreciation provision at issue requires the improvement to be new and unused, the revised regime will deem the improvement by the lessee to be new and unused.

The new depreciation allowance for improvements made on leased property will not apply in the case of: (i) a lessee carries on banking, financial services or insurance business, or (ii) financial leases. In terms of the latter, the lessee must not generally sublease the property unless the sublease to a group company member of that lessee. Moreover, the leases will only be permitted if the cost of maintenance and repair is borne by the lessee and the potential risk of destruction or loss is borne by the lessee.

Example 1
Facts: Company X enters into a contract with the Municipality in terms of which the Municipality leases a building to Company X to undertake business activities. It is agreed that Company X would effect improvements on the building in the amount of R100 000. The building is situated on a piece of land that is located in a designated urban development zone.

Result: Although Company X is not the actual owner of the land in which the building is constructed, nor is Company X the owner of the building, the new provisions deem Company X to be the owner of the building. Therefore, Company X will be able to depreciate the building in terms of the accelerated depreciation regime for property located within an urban development zone. Thus, Company X will be eligible for a 20 per cent per annum depreciation of the building.

Example 2
Facts: Provincial Government leases land to a Bank. Bank constructs an office apartment in the amount of R20 million in terms of the lease agreement. Bank leases the office apartment to Provincial Government.

Result: The Bank will not be allowed to depreciate the value of the office apartment as it is sublet to the Provincial department.

If an improvement has not been fully written off by lease termination, any remaining cost can be written off by the lessee at that time. However, a lease will be viewed as not terminating if the lessee is obligated to renew, holds a right or option to renew or is reasonably likely to renew as of the date on or immediately before the date of termination.

A deemed disposal event for the lessee arises on the later of the date when right of use/occupation terminates or use/occupation ends. Renewed or extended rights of use/occupation will be deemed as part of the initial rights of use/occupation. The disposal event will most likely trigger a capital loss in respect of any remaining tax cost in the improvement on the date of cessation.

B. Collateral changes

The current straight-line write off for improvements in the case of underlying property leased by public private partnerships, the three spheres of government and certain exempt parastatals will be eliminated. The new regime will become the exclusive write off for these circumstances. The straight-line write off will continue for lessee improvements on the land of other parties (i.e. largely private sector leasing).

As a collateral matter, the current straight-line write off for improvements for these other parties also needs to be adjusted for more basic considerations. For instance, the write-off needs to be more in line with the lease premium rules (i.e. to extend the lease period for rights or options to renew). Certain obsolete rules also need to be modified.

IV. Effective date

The amendment applies in respect of expenditure incurred in respect of leases entered into on or after the date of promulgation.

4.8. ISLAMIC FINANCING

[Clause 48: Applicable provision; insertion of section 24JA, section 3A of the Transfer Duty Act, section 8A of the Value Added Tax Act and section 8A of the Securities Transfer Tax Act]

I. Background

Islamic finance involves financial transactions and instruments that comply with Shari'a or Islamic law. Islamic finance is based on certain principles that impact transactional form, including:

- The prohibition of riba (interest);
- The prohibition of gharar (i.e. the removal of asymmetrical information from contracts and the encouragement of full disclosure);
- Risk-sharing (i.e. sharing profit or losses); and
- Materiality (i.e. financial transactions must be linked to a real economic transaction).

Islamic finance is still in its infancy within South Africa. The Islamic products offered by the South African banking industry are still fairly new and diverse. South African collective schemes are also just entering the market. Some of the more common forms of Shari'a compliant products within the South African market are as follows:

- Mudarabah: The Mudarabah is mostly used as an investment or transactional account offered to clients. More specifically, the client deposits savings in an account with a bank. The bank invests the funds in Shari'a compliant ventures or products. The profits from the underlying Shari'a compliant ventures or products offered by the bank are shared with the client at a pre-agreed ratio. The client bears all the risk of financial losses and the bank bears operational losses (e.g. management fees).

- Murabaha: The Murabaha is a mark-up financing transaction generally offered by a financial institution (i.e. bank or collective investment in securities) so that a client can obtain financing for various assets (shares, fixed property and equipment). In this form of financing, the financial institution purchases an asset (from a third party) at the instruction of the client and sells the asset to the client at a pre-agreed price. The mark-up on the resale by the financial institution creates a profit for the financial institution, and this profit is calculated with reference to the time value of money. The client pays the marked-up price on a deferred basis (similar to an installment sale agreement). The marked-up price cannot exceed the initial amount agreed to between the parties.

- Diminishing Musharaka: Diminishing Musharaka is a partnership arrangement generally used for project financing. The client and the bank jointly acquire various assets. Alternatively, the bank acquires an ownership interest in an asset that is owned by the client in return for financing of a development or refurbishment project. The Bank's share in the asset is further divided into smaller units. The bank and the client enter into another agreement in terms of which the client undertakes to purchase the bank's proportionate interest over time through the periodic purchase of individual units. The bank may earn rent from its proportionate interest in the asset and/or sell the individual units to the client at cost plus mark-up. In all cases, the bank's proportionate interest in the asset diminishes over time. The rent and/or mark-up payable by the client represent the financing charge (largely similar to an interest charge in respect of traditional western financing arrangements).

II. Reasons for change

As a general matter, the starting point for determining the tax consequences of any transaction is form. While the tax acts provide both statutory and common law principles in certain instances to overcome this starting presumption, these substance-over-form rules are largely employed to protect the fiscus against avoidance transactions. Few rules exist to overcome form for the benefit of taxpayers because taxpayers largely have control over form.

However, the concept of form in the arena of Shari'a compliant products largely works against taxpayers because taxpayers lack this full freedom of control as a result of religious principles. These deviations in form often deprive investors of certain tax benefits available to traditional Western finance. In other instances, Islamic form can actually act as a tax barrier to tax cost-effective finance that can readily be performed by Western counterparts.

Given these concerns, tax has become a hindrance to a vibrant and growing Islamic financial market. This lack of access not only prejudices Islamic finance but also works against South Africa's financial role in non-Western markets, thereby undermining South Africa as a regional financial centre. From a tax policy vantage point, it is also questionable whether Islamic forms of finance should be treated differently than their Western counterparts given the fact that the substance is largely the same.

III. Proposal

A. Background

It is proposed that specific provisions be added to the various tax acts so that Islamic finance is placed on equal footing with traditional western finance. Given the diversity of Islamic finance, the current proposal focuses on certain more commonly used *Shari'a* compliant arrangements within South Africa. At this stage, the following three arrangements will be covered: (i) Mudaraba, (ii) Murabaha, and (iii) Diminishing Musharaka.

B. Mudaraba

1. Qualification criteria

In order for the bank to offer tax qualifying Mudarabah, the arrangement must be advertised as Shari'a compliant and offered as such to the general public. Most notably, the savings or investment arrangement must also satisfy the following requirements:

- Funds must be deposited with a bank by the client;
- The anticipated return in respect of the investment must be based on the time value of the funds deposited by the client (i.e. time-value principles);
- The bank must invest the funds deposited by the client in Shari'a arrangements;
- The client must incur the sole risk of loss in respect of the funds invested by the bank in Shari'a arrangements; and
- The return in respect of the funds invested by the bank in Shari'a arrangements must be divided between the bank and the client on pre-agreed proportions.

2. Tax relief for individual savings

The Mudarabah acts like a partnership in form and in substance while the yield is roughly comparable to interest. Partnership sharing of profits in unequal proportions is common. What is unique about the Mudarabah form of financing is client access to *Shari'a* underlying compliant profits (usually mirroring interest). This form of relationship is also the most common mechanism that banks use to access retail investors.

Given this purpose, any profit earned by natural persons in terms of a Mudarabah arrangement will be eligible for the same threshold interest exemptions as their Western counterparts investing in interest-yielding products. At the present time, the exemption amounts to R22 300 for individuals under age 65 and to R32 000 for individuals age 65 and older.

C. Murabaha

1. Qualification criteria

In order for natural persons to access finance in respect of bank offered Murabaha arrangements, the product must be offered to the general public and advertised to the general public as a Shari'a law compliant by the bank. Most notably, the bank offered arrangement must satisfy the following requirements:

- The asset must be purchased by the bank from a third party for the benefit of the client based on terms and conditions agreed upon between the client and the third party seller;
- The client must acquire the asset from the bank within 30 days after the acquisition of the asset by the bank from the seller;
- The client must agree to pay an amount that exceeds the consideration paid by the bank for the acquisition of the asset from the seller;

- The aggregate amount payable by the client must be based on the time-value of money (i.e. amount paid by bank in combination with duration of the arrangement); and

- The aggregate amount payable by the client must not exceed the amount agreed to when the arrangement is initially entered into.

The Murabaha arrangement can also be used by a Collective Investment Scheme in Securities ("CIS") as a lender for the acquisition of securities for the benefit of a bank. For instance, this situation may arise when the CIS acquires securities from a third party seller for the benefit of the bank, and the bank acquires the securities from the CIS at a marked-up price. The qualification criteria in respect of Murabaha arrangements offered by a CIS are basically the same as the criteria for banks

2. Conceptual equivalence

The substantive impact of the Murabaha mark-up can readily be recharacterised as traditional interest. This resale mark-up by a bank is based on time-value principles amounting to interest generated for the bank and interest incurred by the client. In essence, the client is acquiring property from a third party seller with the bank acting as agent (and lender) to facilitate the transaction without violating Islamic law. More specifically, bank offered Murabaha will be recharacterised as described below for purposes of Income Tax, Value-added Tax and Transfer Duty. The principles applicable in respect of bank offered Mudaraba arrangements also apply in respect of CIS arrangements.

a. Income Tax

For purposes of the Income Tax Act, bank offered Murabaha will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have acquired or disposed of the property that is the object of the Murabaha arrangement.

ii. The client is deemed to be acquiring property directly from the seller: (a) for an amount equal to the consideration payable by the bank to the seller, and (b) to have acquired the property at the time that the seller disposes of the property.

iii. The mark-up differential by the bank is deemed to be interest. Technically, to achieve this result, the Income Tax Act will deem the Murabaha arrangement as a whole to qualify as a section 24J "instrument", the mark-up to constitute a "premium payable or receivable" (thereby qualifying as section 24J "interest"), and the bank consideration payable to the seller to constitute the "issue price" (thereby being taken into account as a section 24J "initial amount").

Similar principles apply in respect of CIS offered arrangements.

b. Value-added Tax

For purposes of the Value-added Tax Act, bank offered Murabaha will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have acquired or supplied of the property that is the object of the Murabaha arrangement.

ii. The client is deemed to be acquiring property directly from the seller: (a) for an amount equal to the consideration payable by the bank or CIS to the seller, and (b) to have acquired the property at the time that the seller supplies the property.

iii. The mark-up differential by the bank is deemed to be interest. Interest treatment means that the mark-up is deemed to be (an exempt) financial service. However, financial service treatment will not apply to the extent the bank is providing management services (instead of interest-bearing capital).

c. Transfer Duty/Securities Transfer Tax

For purposes of the Transfer Duty, bank offered Murabaha will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have undertaken an acquisition of the property that is the object of the Murabaha arrangement.

ii. The client is deemed to be acquiring property directly from the seller: (a) for an amount equal to the consideration payable by the bank to the seller, and (b) to have acquired the property at the time that the seller disposes of the property.

Similar principles apply to a CIS in respect of the Securities Transfer Tax.

Example 1

Facts: Individual identifies a printing machine from an equipment dealer for use in the individual's business enterprise. Individual then approaches Bank for Murabaha finance. Bank agrees to purchase the equipment for R9, 000 in its own name and to on-sell the equipment to Individual at R17, 000, all of which is payable by Individual in one lump sum at the end of a 24 month period. Bank acquires the printing machine on 5 June 2011, and Individual acquires the printing machine from Bank on 12 June 2011.

Result - Income Tax:

- For income tax purposes, Individual is deemed to have acquired the printing machine directly from the dealer at a cost of R9 000 on 12 June 2011. Bank is deemed not to have acquired or disposed of the printing machine.

- For section 24J purposes, the marked-up amount of R8 000 (i.e. R17 000 less R9 000) constitutes a "premium payable" by the client, and the R9 000 amount constitutes the "issue price."

Result – Value-added Tax:

- For value-added tax purposes, Individual is deemed to have directly acquired the printing machine directly supplied from the dealer at a cost of R9 000 on 12 June 2011. Bank is deemed not to have acquired or disposed of the printing machine.

- The R8 000 mark-up is deemed to be an exempt financial service offered by Bank. Note: To the extent that the R8 000 includes a management/administrative fee, the fee portion will fall outside financial service treatment.

Example 2

Facts: Bank identifies securities from a seller. Bank then approaches the CIS for Murabaha finance. CIS agrees to purchase the securities for R10 million in its own name and to on-sell the securities to Bank for R13 million. The R13 million is payable by the Bank in one lump sum at the end of 30 months. CIS acquires the securities on 01 June 2011, and Bank acquires the securities from the CIS on 15 June 2011.

Result – Income Tax:

- For income tax purposes, the Bank is deemed to have directly acquired the securities from the seller at a cost of R10 million on 01 June 2011. The CIS is deemed not to have acquired or disposed of the securities.

- For section 24J purposes, the marked-up amount of R3 million (i.e. R13 million less R10 million) constitutes a "premium payable" by the bank, and the R10 million amount constitutes the "issue price."

Result – Securities Transfer Tax:

- For Securities Transfer Tax purposes, the bank is deemed to have acquired the securities for R 10 million on 01 June 2011.

D. Diminishing Musharaka

1. Qualification criteria

In order for natural persons to access finance in respect of the Diminishing Musharaka, the product must be offered to the general public and advertised to the general public as a Shari'a law compliant. The qualification requirement depends on the manner of acquisition of the asset by the bank (i.e. through a third party or by acquiring an interest in the asset owned by the client). Most notably, the arrangement must satisfy the following requirements:

- If the asset is acquired from a third party seller, the bank and the client must jointly acquire the asset. Alternatively, if the bank provides refinancing or financing for a development project in respect of pre-existing land, the bank must acquire an interest in an asset owned by the client;

- The client must purchase all of the bank's proportional interest in the asset previously acquired in terms of the arrangement; and

- The amount paid by the client for the acquisition of the bank's proportionate interest in the asset must be paid over a period of time as agreed to between the client and the bank.

2. Conceptual equivalence

The substantive impact of the Musharaka joint purchase/cross purchase can readily be recharacterised as ordinary revenue. Assuming the client purchases proportionate interests from the bank at the bank's cost, any amount paid by the client to the bank will be treated as amounts of a revenue/ordinary nature in the hands of the bank according to the normal rules. In essence, the client will be treated as repaying the capital (i.e. amount financed by bank), with the excess being viewed as a finance charge.

a. Income Tax

For purposes of determining the tax on income of the client in respect of Diminishing Musharaka, the impact for the bank differs from the impact for the client. The impact for the client also depends on whether the bank is offering finance for a new asset (i.e. acquired from a third party) or provides refinancing/project development financing.

i. From the bank's perspective, all the amounts received by or accrued to the bank over and above the capital portion of the finance in exchange for the disposal of the asset will be included in the bank's gross income in terms of the normal rules. In essence, the bank is engaging in a part disposal of trading stock (i.e. assets purchased with the intent to sell) and should be taxed accordingly. These principles apply irrespective of whether the bank jointly acquires the asset with the client from a third party or acquires an interest in the asset from the client.

ii. (a) If the bank and the client acquire joint ownership in an asset, the client is deemed to acquire the bank's interest in the asset for an amount of consideration paid by the bank for the bank's interest in the asset. The client is also deemed to acquire the bank's interest at the time the bank acquired its ownership interest in the asset from the seller of the asset. Each payment by the client to the bank must be allocated to the capital portion and the finance charge. The allocation is based on a pro rata formula (i.e. the initial amount paid by the bank as measured against the total installments payable by the client).

(b) If the bank acquires an interest in the asset from the client who is already the owner of the asset, the client is deemed not to have disposed of an interest in that asset or acquired any interest therein from the bank. Each payment by the client to the bank must be allocated to the capital portion and the finance charge. The allocation is based on a pro rata formula (i.e. the initial amount paid by the bank measured against the total installments payable by the client).

b. Value-added Tax

For purposes of the Value-added Tax Act, Diminishing Musharaka will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or supply of the property. This treatment means that the bank is deemed not to have acquired the bank's proportionate interest in the property that is the object of the Diminishing Musharaka arrangement. If the bank has acquired on interest in the asset from the client, the bank is also deemed not to have acquired that interest from the client.

ii. (a) If the bank jointly acquires the asset with the client, the client is deemed to be acquiring the banks proportionate interest in the property directly from the seller: (1) for an amount equal to the consideration payable by the bank to the seller, and (2) to have acquired the proportionate interest at the time that the seller disposed of the interest to the bank.

(b) If the bank acquires an interest in an asset from the client, the client is also not deemed to have subsequently acquired the interest in the asset from the bank. In other words, the client is deemed to have retained the asset all along.

c. Transfer Duty

For purposes of Transfer Duty, Diminishing Musharaka will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have acquired the bank's proportionate interest in the property that is the object of the Diminishing Musharaka arrangement. If the bank has acquired on interest in the asset from the client, the bank is also deemed not to have acquired that interest from the client.

ii. (a) If the bank jointly acquires the asset with the client, the client is deemed to be acquiring the banks proportionate interest in the property directly from the seller. This direct acquisition from the seller is deemed to occur at an amount equal to the consideration payable by the bank to the seller and at the time that the seller disposed of the interest to the bank.

(b) If the bank acquires an interest in an asset from the client, the client is deemed not to have subsequently acquired the interest in the asset from the bank. In other words, the client is deemed to have retained the asset all along.

Example

Facts: Individual identifies a residential property worth R2 million and approaches the Bank for finance through the use of Diminishing Musharaka. Bank agrees to purchase property jointly with the Individual from the seller on condition that:

- Individual pays R400 000 of the purchase price and the Bank pays R1.6 million; and

- Individual will purchase 10 per cent of the Bank's proportionate interest in the property each year over a period of 8 years for R300 000 per year.

Result – Income Tax:

- For income tax purposes, Individual is deemed to have directly acquired the residential property directly from the dealer at a cost of R2 million (R400 000 + R1 600 000). Bank is deemed not to have acquired or disposed of the residential property.

- Each payment by the client is viewed as representing part capital and part finance charge. The capital portion of each R300 000 installment is 2/3rd capital (R1.6 million/R2.4 million) and 1/3rd finance charge ((R800 000/R2.4 million).

- The bank will report any gains or losses made on each disposal of the interest in the property to the client as trading stock in accordance with the normal rules for trading stock.

Result – Transfer Duty:

- For Transfer Duty purposes, Individual is deemed to have directly acquired the residential property directly from the seller at a cost of R2 million at the time the bank acquired the asset from the seller.
- The bank is also not deemed to have acquired the asset or an interest therein in terms of the arrangement.

IV. Effective date

The proposed amendment will be effective from a date to be announced by the Minister.

4.9. SHORT-TERM INSURER LIABILITY CALCULATIONS

[Clause 51: Applicable provisions; section 28 (2) (cA), (7) and (9)]

I. Background

Insurance premiums received by short-term insurance companies are includable in gross income. Short-term insurance businesses also incur liabilities in respect of potential claims lodged by policyholders. Specific offsetting deductions are allowed against premium income for these liabilities.

In the main, these deductible liabilities would be in respect of claims incurred by policyholders, but not yet reported ("IBNR"), and in respect of unearned premiums as calculated pursuant to the Short-Term Insurance Act, 1998 (Act No. 53 of 1998).

The latter calculation takes into account the ‘best estimate value’ required by the Financial Services Board in order to maintain sustainable reserves against future commitments. SARS is empowered to make adjustments in respect of this calculation.

II. Reasons for change

The Financial Services Board is currently undertaking a review of the reserving requirements for short-term insurance companies. The proposed new rules are likely to evolve over the next few years before final resolution. This review may require flexibility in enforcement during this interim period.

A close reading of the short-term insurance provisions also reveals an overlap relating to IBNR and unearned premiums. Technically, this overlap could lead to a double deduction if left unresolved.

III. Proposal

In view of the pending changes to the short-term insurance system of liability reserves being undertaken by the Financial Services Board, it is proposed that current discretion by SARS to adjust deductible reserves be extended. This revised discretion will cover all short-term insurance deductions otherwise allowed against premiums. This expanded discretion will remain in force until a more objective set of rules can be established after completion of the pending changes underway by the Financial Services Board.

In addition, the current overlap between deductible IBNR and estimated unearned premiums will be eliminated in the context of both the onshore and offshore short-term insurance businesses, and will not include expenses relating to liabilities incurred in respect of claims.

IV. Effective date

The proposed amendment will be effective for years of assessment commencing on or after date of promulgation.

4.10. TERMINATING COMPANIES AND SMALL/MICRO-BUSINESS RELIEF

[Clause 23 (1) (f): Applicable provisions; section 12E (4) (a) (ii) and paragraph 3 (f) (iii) of the Sixth Schedule]

I. Background

Special income tax dispensations exist for small business companies and micro businesses. In the case of certain micro businesses, taxpayers may elect a simplified turnover basis of taxation in lieu of normal income tax. In the case of certain small business companies not utilising the turnover basis of taxation, a graduated tax structure applies (0%, 10% and 28%) in lieu of the standard 28 per cent rate. An immediate 100 depreciation is also available for certain assets.

A key pre-condition common to both dispensations is the anti-multiple shareholder rule. The anti-multiple shareholder rule is designed to prevent small businesses from obtaining relief by splitting a single large (ineligible) business into multiple small (qualifying) businesses. More specifically, businesses are denied relief for a particular business under both dispensations if the ultimate owners hold equity in any other company at any time during the relevant year of assessment.

II. Reasons for change

By 2009, it became apparent that the existence of certain dormant shelf companies was hindering small business company or micro business relief due to the anti-multiple shareholding rule. From a practical perspective, this problem arose because the seller of a dormant shelf company usually holds shares in many other dormant shelf companies (i.e. shelf-company sellers typically hold dormant shelf companies on hand for sale). The anti-multiple shareholding rule was accordingly suspended in these commercially-driven circumstances.

During the 2009 hearings, some commentators argued that the anti-shareholder prohibition should also be dropped if the company at issue had taken steps to terminate but remained in existence solely due to regulatory reasons outside of taxpayer control. This set of circumstances was effectively viewed as commercially driven, much like the shelf-company circumstances.

III. Proposal

Connection (e.g. ownership or some other form of connected person relationship) to a terminating company will no longer be grounds for preventing small business company and micro business relief. In order for a terminating company to be excluded in this manner, the terminating company must have either: (i) submitted a resolution authorising the voluntary liquidation or winding up of the company, or (ii) submitted a statement of deregistration. In the case of a liquidation or wind up, no assets and liabilities must exist in relation to the terminating company (other than residual assets to pay certain regulatory or administrative liabilities). In the case of a de-registration, the terminating company must have ceased business and have no assets or liabilities.

Admittedly, circumstances may arise that may cause a desired revival of the terminating dormant company. If steps are taken to revive a terminating dormant company, the connected small or micro business will lose the relief from the year of assessment in which revival occurs (and onward). No special recoupment or other retrospective charge-backs will be required.

Example 1
Facts: Individual owns Company X, which has run into economic trouble. Individual accordingly begins to shut down the business and reduce business assets and corresponding liabilities. In 2011, Individual forms Company Y to start a new business venture.

Result: Assuming Individual and Company X have taken appropriate steps to terminate before the 2011 year of assessment, Company Y will not be prevented from claiming small business company or micro business relief due to the anti-multiple shareholding rule. In other words, Company X can be disregarded for this purpose.

Example 2
Facts: The facts are the same as Example 1, except that a new business opportunity becomes available for the former Company X operations. Individual accordingly takes steps to revive Company X in 2015.

Result: The anti-multiple shareholder rule will apply from the 2015 year of assessment onward. Hence, Company Y will lose the ability to claim small business company or micro business relief from this year onward. No recoupment or charge backs will be required for any relief claimed between 2011 through 2014.

IV. Effective date

This provision will apply to small business companies and micro businesses for years of assessment commencing on or after 1 January 2011.

4.11. TERMINATING RESIDENTIAL ENTITIES

[Clause 105: Applicable provision; insertion of section 64 (kA), insertion of paragraph 51A of the Eighth Schedule, section 9 of the Transfer Duty Act]

I. Background

Before 2001, certain individuals used companies or trusts to purchase residences so as to avoid the imposition of transfer duty. In 2002, this scheme was curbed by a transfer duty anti-avoidance rule that treats the transfer of a residential property entity as equivalent to a direct transfer of residential property. Additionally, a dual capital gains tax charge came into effect so that both a company and its shareholders effectively became subject to tax on the same residential property appreciation. As a result, a company with residential property became subject to tax (i.e. the capital gains tax and the secondary tax on companies) on the realised appreciation. The shareholders of the company also became subject to the capital gains tax on the same notional gain when the shareholders disposed of the company holding the residential property.

In 2002, a two-year window period was granted to provide taxpayers with an opportunity to transfer certain residences out of pre-existing companies or trusts. Under this window period, the capital gains tax, secondary tax on companies and transfer duty liabilities for these pre-existing companies and trusts (along with their owners or beneficiaries) were eliminated. It has since become apparent that many taxpayers failed to utilise the prior relief period. In 2009, relief was therefore granted to taxpayers under a restored window period. Under this restored window period, taxpayers qualified for relief similar to that previously allowed. However, a rollover relief mechanism was utilised in place of the market value step-up used in 2002 (the step-up being allowed in 2002 because minimal taxable appreciation was at stake in respect of the capital gains tax, which was introduced only as of 2001).

II. Reasons for change

Upon review, it has become apparent that various problems exist with the renewed relief initiated in 2009. Part of the purpose of this relief was to eliminate unnecessary companies and trusts. However, the 2009 relief fails to require termination of the entity. Some taxpayers are even seeking to use the continued entity as a means of undermining the estate duty and other tax charges.

Furthermore, the 2009 relief provisions do not take into account factual circumstances. For example, a residential property company may have been transferred to new shareholders after formation as part of a cash sale. The 2009 relief additionally failed to address certain common practical realities (such as use of the residence by relatives after the death of the initial investor).

III. Proposal

A. Overview

It is proposed that the 2009 window relief period for residence entities be amended to remedy current inadequacies (as well as extended for another year in light of the proposed amendments). However, this revised relief retains the same core objective – to assist taxpayers in simplifying their structures where the residence was placed in a company or trust mainly to avoid transfer duty. These rules will apply to disposals that occur from 1 October 2010 and before 1 January 2013.

B. Company structures

1. Qualifying criteria

The most common form of residential entity involves the use of a company to hold a residence on behalf of one or shareholders. In these instances, it is proposed that the relief should apply to transfers that satisfy two sets of key requirements: one pertains to use of the residence and the other pertains to liquidation of the company holding the residence. These requirements are outlined in detail below:

- <u>Use</u>: In order to qualify for relief, the primary residence which is disposed of should have been used by individual shareholders of the company or their relatives during the window period (i.e. the period between 11 February 2009 and the date of disposal on or before 31 December 2012). This requirement is intended to limit the relief in respect of structures used for non-commercial purposes.

- <u>Liquidation</u>: The company must dispose of the residence in anticipation of, or in the course of, the company's liquidation, winding up or deregistration. The company must have taken steps to liquidate, wind up or deregister within six months of the disposal of the residence. The purpose of this requirement is to ensure that the relief facilitates Government's objective of eliminating unnecessary entities from the company register, thereby simplifying enforcement.

2. Impact of relief

If the disposal qualifies for relief, no taxable gain or loss will apply to the company when disposing of the residence. However, all other assets disposed of by the company are taxable, including residence-related assets, such as a golf membership in the common-use area. This relief applies regardless of whether the residence is disposed of in exchange for shares or cancellation of debt (all that is required is that the residence must be disposed of to the shareholders and/or their relatives).

Persons receiving the residence will not have any gain or loss on the company shares surrendered, even if a small portion of value associated with those shares represents taxable non-residence assets. Disposal of the residence will also be exempt from transfer duty, the secondary tax on companies (or the new dividends tax if the disposal occurs after the new dividends tax comes into effect).

The base cost of the residence in the hands of the recipients varies depending on whether the residence is disposed of to the company's original shareholders or to persons other than the original shareholders of the company:

- If the residence is disposed of: (i) to persons who acquired all the shares after the company acquired the residence, and (ii) the value of the residence constituted 90% or more of the value of the value of the company during the window period, the base cost is adjusted. In this instance, the base cost in the residence is to be kept largely in line with the current shareholder cost (and date) of acquiring the shares. This cost must be adjusted for subsequent improvements to the property (not for subsequent depreciation).
- In all other cases (e.g. disposals to original shareholders), the base cost of the residence is the same as that held by the company. This base cost will equal the company's purchase price plus possible adjustments (improvements and some depreciation for partial business use).

The above relief mechanism will be available even if the residence is transferred to a company or trust. However, if the residence is disposed of to a company, that recipient company should take steps to liquidate, wind-up or deregister within six months of the disposal. If the residence is transferred to a trust, an application must be made to a competent court for the trust's revocation or the founder, trustees and beneficiaries of the trust should have agreed in writing to revoke the trust. The agreement or application should be made within six months of the date of disposal of the residence.

Example 1

Facts: Husband and Wife form a company in 1995. The company purchases a house in the same year for R360 000. The amount was paid from a bank loan with the full amount guaranteed by the couple (who will pay off the loan plus interest in exchange for a loan account with the company). The couple stays in the house with their children. In 2010, the couple liquidates the company and transfers the house jointly into their own names. By 2010, the company owes R200 000 to the bank and R420 000 to the couple; the house is worth R920 000.

Improvements costing R50 000 were made to the house during the 10-year period.

Result: The liquidation does not give rise to any capital gains tax, transfer duty or secondary tax on companies. The initial R360 000 cost of the house (plus the R50 000 of improvements) will be deemed incurred by the couple as if the couple incurred those costs directly (with the same 2001 capital gains transition rules applying).

Example 2
Facts: Husband and wife form a company in 1995. The company purchases a house in the same year for R360 000. The couple stays in the house with their children. In 2004, the couple sells the company to an unrelated individual for R650 000. In 2010, the individual liquidates the company and transfers the house into the individual's own name. In 2010, the house is worth R920 000. Improvements costing R25 000 were made to the house before the 2004 sale, and another R25 000 of improvements were made afterwards.

Result: The liquidation does not give rise to any capital gains tax, transfer duty or secondary tax on companies. The individual's base cost in the house equals the R675 000 (the R650 000 amount paid for the house by individual plus the R25 000 improvements made after the acquisition).

C. Trust structures

1. Qualifying criteria

In addition to company structures outlined above, the other form of residence entity involves the use of a trust. In these instances as with companies, it is proposed that the relief should apply to transfers that satisfy two sets of requirements: one pertains to the use of the residence and the other pertains to revocation of the trust. These requirements are similar to those of companies, except for the fact that the key parties control the trust through means other than share ownership. These requirements are outlined in detail below:

- <u>Use</u>: In order to qualify for relief, the primary residence which is disposed of should have been used by relatives connected to the trust during the window period (i.e. the period between 11 February 2009 and the date of disposal on or before 31 December 2012). This requirement is intended to limit the relief in respect of structures used for non-commercial purposes.

- <u>Revocation</u>: The trust must dispose of the residence in anticipation, or in the course, of the termination of the trust's existence. The trust is deemed to be terminating if an application has been made to a competent court for the trust's revocation or the founder, trustees and beneficiaries of the trust have agreed in writing to revoke the trust. The agreement or application should be made within six months of the date of disposal of the residence.

2. Impact of relief

If the disposal qualifies for relief, the transaction will be eligible for rollover relief (much like a company). As such, no taxable gain or loss will apply to the trust when disposing of the residence. However, all other assets disposed of by the trust are taxable, including residence-related assets, such as a golf membership in the common-use area. Disposal of the residence will also be exempt from transfer duty.

On disposal of the residence, the base cost of the residence to the transferees is the same as that held by the company. This base cost will equal the trust's purchase price plus possible adjustments (improvements and some depreciation for partial business use). There is no rule for subsequent owners as it is not possible under common law to sell the interest in a discretionary trust.

Example 3
Facts: Husband and wife form a trust in 1995. The couple creates a loan account in terms of which they lend the trust R60 000. The trust takes a loan from the bank of R300 000 and purchases a house in the same year for R360 000 with the loan being guaranteed by the couple. The couple stays in the house with their children. In 2010, the couple revokes the trust and transfers the house jointly into their own names. In 2010, the house is paid up and is worth R920 000. Improvements costing R50 000 were made to the house during the 10-year period.

Result: The liquidation does not give rise to any capital gains tax or transfer duty. The initial cost of the house (plus improvements) will be deemed incurred by the couple as if the couple incurred those costs directly (with the same 2001 capital gains transition rules applying).

Example 4
Facts*:* A couple is a potential beneficiary in a discretionary trust. The trust holds all the shares in a company. In 1998, the company purchased a house which is occupied by children of the couple. On 16 January 2011, the company liquidates and transfers the house to the trust. The trust transfers the house to the couple on 1 March 2011. On 2 April 2011 the couple makes an application to the court for revocation of the trust.

Result: The transfer of the house from the company to the trust qualifies for the proposed relief. Similarly, the transfer of the house from the trust to the couple qualifies for the relief.

IV. Effective date

Given the extensive changes to the initially proposed 2009 relief, the relief for terminating residence entities will be extended until the close of 2012. More specifically, the revised relief will apply to disposals from 1 October 2010 and ending before 1 January 2013. The current relief will apply to disposals before 1 October 2010.

4.12. MICRO-BUSINESS TURNOVER TAX

[Clause 23(g), 85, 86, 87, 88, 89; Applicable provision: sections 12E(4)(d), paragraph 1 insertion of "investment income" definition & substitution of "professional service" definition, paragraph 3(b), paragraph 5, paragraph 6, paragraph 7 of the Sixth Schedule]

I. Background

The turnover tax system seeks to encourage the informal sector and other small businesses to enter the tax system so as to regularise their tax affairs. This system effectively provides for low entry into the tax system as opposed to the traditional gamut of taxes facing many micro businesses. For electing micro businesses, the turnover tax essentially replaces the normal tax on income, capital gains tax and the secondary tax on companies. This simplification was designed to reduce tax compliance costs, which tend to be regressive for micro and small businesses.

In essence, small businesses under the turnover tax system are subject to a low rate of tax on a gross basis without deductions. The turnover tax potentially applies to businesses with an annual turnover of up to R1 million. Taxpayers utilising the turnover tax may not register for the value-added tax.

II. Reasons for change

The turnover tax became operational only as from 1 March 2009. Given its recent implementation, unanticipated technical difficulties have inevitably come to light requiring remedial legislation. These problems relate to entry criteria, the turnover calculation, and transition from the normal tax into the turnover tax and the relationship of the turnover tax in connection with the value-added tax.

III. Proposal

Proposal #1: Refinement of the professional services exclusion

[Applicable provisions: section 12E(4)(c) and (d) (definitions of "investment income" and "personal service"); paragraphs 1 "professional service" definition", 3(a) and 3(d) of the 6th schedule)]

A. Background

Taxpayers cannot utilise the turnover tax system if engaged in "professional services" as defined. The current rule is a total prohibition. This prohibition specifically exists because professional services are generally rendered by more sophisticated, high income earning taxpayers, with profit margins that are significantly higher than those assumed in the design of the turnover tax. Examples of these services include the fields of accounting, actuarial sciences, law, draftsmanship, entertainment, commercial arts, performing arts, journalism, secretarial services, broking and consulting. In addition, taxpayers will not qualify for turnover tax treatment if more than 10 percent of their total receipts during that year of assessment consist of investment income. Investment income includes any proceeds derived from investment or trading in financial instruments or from immovable property.

B. Reasons for change

The total prohibition against professional services is impractical. Some micro businesses perform activities with an element of incidental professional services. The definition also includes certain professions that lack the high profit margins and sophistication of concern.

C. Proposal

The exclusion for professional services will be adjusted to match the exclusion utilised in the case of small business companies. Like the exclusion for small business companies, professional services and investment services cannot exceed a combined 20 per cent of total turnover. This change will allow for incidental services. For instance, if a construction business also does building drafting, the drafting activities should not disqualify the construction business if receipts from latter do not exceed 20 per cent of total turnover.

It is also proposed that the disqualification of certain services be eliminated from the impermissible list associated with the tax relief for small business corporations. For instance, certain entertainment-related services will no longer be impermissible.

Proposal #2: Private refunds by and to micro businesses

[Applicable provisions: paragraph 5 and 7 of the 6th schedule]

A. Background

In terms of the turnover tax system, micro businesses are subject to tax on gross receipts without any deductions. This focus on pure receipts is much simpler than the net accrual calculation required by the normal income tax payable by most taxpayers.

B. Reasons for change

While the simplified nature of the turnover tax naturally gives rise to distortions, these distortions are largely offset by the special rate system employed. However, a situation could arise whereby a micro business purchases goods (and services) and then returns those goods (and services) for a full or partial refund. The subsequent refund accordingly constitutes an amount received that is includible in taxable turnover receipts, even though the refund merely restores the taxpayer to the taxpayer's initial position.

Similarly, another situation could arise whereby a micro business receives an amount in the course of its trade in one year for goods and services but is under an obligation to refund part of or the whole amount in the following year. In the end, the micro business is still taxed on the amount despite the subsequent refund. Tax is payable a second time under the turnover system even though the micro business has no net receipts.

C. Proposal

The receipts in both situations above should be neutralised because the micro business has no net “economic” receipts. Both forms of receipts are effectively offset by a refund.

It is accordingly proposed that micro businesses be allowed an exclusion from taxable turnover (in the current tax year) when the micro business receives a refund (e.g. for faulty goods and services). It is also proposed that micro businesses be allowed a deduction from taxable turnover when the micro business refunds amounts that were included in taxable turnover during a prior year of assessment.

Proposal #3: Investment income versus business use disposals

[Applicable provisions: paragraphs 3(b), 3(e), 6(a), 6(b) and 7(a) of the 6th Schedule]

A. Background

The turnover tax system replaces the taxation of ordinary revenue and capital gains within the normal tax system. The main purpose of the turnover tax is to simplify the taxation of core business receipts (e.g. trading stock and services) by micro businesses.

In terms of entry criteria, a micro business may not qualify for the turnover tax if more than 10 per cent of the micro business’ total receipts consist of “investment income”. Investment income includes ordinary or capital proceeds from the disposal of financial instruments or immovable property. A micro business is also disqualified if proceeds from the disposal of business-related immovable property and capital assets exceed R1.5 million over a three year period.

In lieu of capital gains taxation, the turnover tax system requires a person to include 50 per cent of capital receipts from the disposal of business-related immovable property and business-related capital assets. In respect of companies, investment income forms part of taxable turnover (with investment income including proceeds from the disposal of financial instruments or immovable property). However, in relation to individuals, the same investment income is excluded from taxable turnover.

B. Reasons for change

In terms of entry criteria, the limitation of receipts from the disposal of business-related immovable property and capital assets exceeding R1.5 million overlaps with the 10 per cent investment income limitation. This overlap exists because investment income includes these forms of receipts (i.e. immovable property receipts and capital receipts from disposals). As a result, business-related immovable property and capital asset receipts are further limited to R100 000 (i.e. 10 per cent x R1 million) by virtue of the investment income limitation. Technical application of this latter rule effectively nullifies the specific R1.5 million threshold for certain capital assets.

The same duplication exists in relation to the taxation of business-related capital receipts in the hands of a company. For instance, if a company sells business-related assets generating capital receipts, the company has to include 50 per cent of these receipts in the turnover calculation. However, the company should also include these receipts as investment income. Ultimately, the combined application of both rules technically results in a 150 per cent inclusion of business-related capital proceeds.

In the case of the turnover calculation for natural persons, the overlap between investment income and business-related capital receipts results in a technical conflict. On the one hand, natural persons can exclude investment income, which technically includes business-related capital proceeds. On the other hand, business-related capital proceeds are specifically subject to a 50 per cent inclusion.

C. Proposal

The overlap between the investment income limitation and the inclusion of capital receipts will be eliminated. The proceeds from the disposal of financial instruments will be regarded as investment income and will be removed from the R1.5 million rule. The new R1.5 million rule will be limited to gains derived from the sale of capital assets and immovable property mainly used for business purposes. Therefore the two portions will be distinctly separated.

Note that the financial instruments therefore fall outside the R1.5 million rule. For the purposes of determining turnover tax, proceeds from the disposal of capital assets will be subject to a 50 per cent inclusion. Proceeds from the disposal of immovable property other than trading stock and assets used mainly for business purposes will be included in taxable turnover at a rate of 50 per cent. Financial instrument receipts will be fully includable in the income of companies and will be exempt for individuals.

Proposal #4: Transition from normal tax to the turnover tax

[Applicable provision: paragraphs 6(a) and (c) of the 6th schedule]

A. Background

Allowances granted to a pre-existing micro business during periods in which the micro business was previously subject to the normal tax are not carried over into the turnover tax system. However, if the micro business had any allowances for which there is a potential recoupment, this recoupment is included in the taxable turnover of the micro business if the recoupment arises after entry into the turnover tax system.

Assessed losses stemming from periods in which the micro business was previously subject to the normal tax are not carried over into the turnover tax system. However, these losses can be used to offset recoupments during periods in which the micro business is subject to the turnover tax on these amounts (as discussed above).

B. Reasons for change

The main advantage of the presumptive tax is simplicity. Hence, transitional rules from one system to another should be avoided as much as possible, especially if the transitional rules require the tracking of events over several years. The transitional rules for recoupments (and offsetting loss carryovers) overly complicate the system.

C. Proposal

The recoupment rules and assessed loss rules should be eliminated. Stated differently, both recoupment and assessed losses should not carry over into the presumptive tax system. Any policy advantages or disadvantages are too small to justify the added complexity. Hence, the disposal of business use capital assets will attract a 50 per cent inclusion into taxable turnover without regard to the capital gain versus recoupment distinction (see Proposal #3: Investment income versus business use disposals).

Proposal # 5: Transition from VAT to the turnover tax

A. Background

The turnover tax takes precedence over the VAT. If a person or entity is registered for the turnover tax; that person or entity is not permitted to be registered for VAT.

B. Reasons for change

The cross-over between the turnover tax and the VAT is potentially problematic. If a partnership is registered for VAT, the partner or partners in that partnership are permitted (subject to certain requirements) to register for the turnover tax. No person should be simultaneously subject to the VAT and the turnover tax either directly or indirectly through a partnership. Therefore, any person or entity that is registered for VAT and intends to register for turnover tax will have to first deregister from the VAT system and thereafter register for turnover tax.

C. Proposal

It is proposed to reverse the requirement that a person or entity cannot register for VAT if that person or entity is already within the turnover tax regime. The VAT will now take precedence over the turnover tax. More specifically, no person can register for the turnover tax if already registered for VAT. Similarly in the case of a partnership, the partner can only register for the turnover tax if that partnership is not registered for VAT.

IV. Effective date

The proposed changes will be effective for years of assessment commencing on or after 1 March 2011.

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5. INCOME TAX: INTERNATIONAL

5.1. CROSS-BORDER INTEREST EXEMPTION

[Clause 58; Applicable provisions: Insertion of Part IA in Chapter I]

I. Background

The tax system currently provides a blanket income tax exemption in respect of interest payable to foreign residents. This exemption is part of an overall effort to attract foreign debt capital. The interest exemption is subject to two exceptions generally applicable to foreign residents actively participating in the domestic economy. Firstly, foreign residents who conduct business in South Africa through a permanent establishment may not receive the exemption. Secondly, the exemption does not apply to foreign resident individuals that are physically present within South Africa for more than 183 days during the relevant year of assessment.

II. Reasons for change

There is a continued need for South Africa to attract foreign lending and remain competitive within the international debt capital markets. However, the current blanket interest exemption does not proper a fair balance between the attraction of foreign debt capital and the need to protect the tax base against potential erosion. The exemption is also not in line with global practice.

Most developed and emerging economies currently exempt cross-border interest relating to mobile portfolio debt (and possibly incidental trade finance). Other forms of cross-border debt remain fully taxable (and subject to a flat form of withholding). More generous forms of exemption typically exist only through tax treaties where both countries believe that the cross-border interest will remain subject to a relatively high-level of global tax. Hence, the current blanket exemption employed via domestic South African tax legislation appears to be overly generous from a competitive point of view. Moreover, the exemption arguably provides foreign debt with a tax advantage over local debt, the latter of which is fully taxable.

In addition, the blanket exemption cross-border interest often results in cycle schemes solely designed to undermine the tax base. At the core of these schemes is the payment of interest offshore so as to generate a deduction without corresponding taxable income (thereby undermining the domestic tax base). These payments are then indirectly retained or controlled by the relevant parties, with the funds coming back tax-free (e.g. as exempt dividends via the participation exemption). The latest variations were previously described by the National Treasury in a prior Media Statement, dated 20 March 2008.

Other concerns arise in the context of closely-held cross-border situations. In this case, the interest exemption provides foreign investors with an incentive to fund businesses with a disproportionate amount of debt as opposed to equity. Although the current thin-capitalisation anti-avoidance rules limit some of this excess debt, these rules only act as a partial remedy.

III. Proposal

A. Overview

In view of the above concerns, the cross-border interest exemption needs to be narrowed without effecting portfolio debt capital. In line with global tax practice, the narrowing will limit the exemption of cross border interest to highly mobile instruments or debt incidentally associated with cross border trade. Therefore South Africa will stay within a dominant global paradigm while protecting the tax base against undo risk.

As an initial matter, all interest received by foreign residents (other than controlled foreign companies) will now be taxed at a final withholding tax rate of 10 per cent. CFCs are naturally excluded because their interest flows already fall within the tax net as tainted section 9D income. However, this 10 per cent withholding charge will be subject to some notable exemptions.

B. Portfolio interest exemption

Interest from domestic debt paid to foreign portfolio investors will remain wholly untaxed. More specifically, these exemptions will apply to interest received or accrued by foreign residents in respect of or from:

- bonds issued by any sphere of Government;
- listed debt instruments (i.e. debt listed on the JSE or a foreign exchange);
- any debt owed by a domestic bank or the South African Reserve Bank
- domestic dealer and brokerage accounts; and
- domestic collective investment schemes;

The exemption of interest owned by domestic banks does not include back-to-back loan agreements designed to circumvent the 10 per cent withholding tax. For instance, the exemption will not apply if the bank acts as an intermediary to facilitate the unlisted borrowing of funds by a domestic company from a foreign lender. Many of these back-to-back schemes would most likely violate the general anti-avoidance rule, but a specific anti-avoidance rule is being proposed to remove any dubious arguments to the contrary.

> ***Example:***
> ***Facts*****:** South African Company seeks to borrow R10 million from Foreign Lender. Instead of making a straight cross-border loan, Foreign Lender places a R10 million deposit with South African Bank with the deposit being legally (or practically) tied to a second loan from South African Bank to South African Company. The cross-border bank deposit generates a 9 per cent yield while the loan from South African Bank generates a 10 per cent yield (with the 1 per cent differential largely acting as a hidden service fee).
>
> ***Result:*** Even though interest from foreign holdings of South African bank deposits is generally exempt, the exemption does not apply in this circumstance because of the back-to-back arrangement. The South African Bank is merely a conduit for the real loan between South African Company and Foreign Lender. The interest differential should be ignored (e.g. as a mere hidden service fee). It should also be noted that this arrangement probably operates in violation of the GAAR.

C. Other exemptions

In addition to the exemption for mobile portfolio debt capital, cross-border interest withholding contains three additional exemptions. These exemptions apply to: (i) trade finance, (ii) certain foreign payors and foreign payees, and (iii) certain forms of debt owed by a headquarter company.

i. *International trade finance:* Interest relating to bills of exchange, letters of credit and similar debt instruments used to secure imports will be exempt from withholding if certified as such by an authorised dealer. This exemption ensures that the withholding tax does not create an undo administrative burden on debt interest that is largely incidental to profits on the underlying imported goods.

ii. *Foreign payors and foreign payees:*

a. *Foreign payors:* Interest received or accrued by a foreign resident payee from a foreign resident payor will be largely exempt. This form of cross-border interest simply lacks any sufficient South African nexus from an international tax policy perspective. However, this exemption does not apply if the foreign payor has significant South African presence from an economic or physical viewpoint. This significant presence exists if the foreign resident has either a permanent establishment within South Africa or 183 days of South African physical presence.

b. Foreign payees: Payments to foreign payees are largely subject to 10 per cent withholding with exemptions as outlined elsewhere in this explanatory memorandum. However, this withholding regime additionally does not apply if the foreign payee has significant South African presence from an economic or physical viewpoint. This significant presence exists if that foreign resident has either a permanent establishment in South Africa or 183 days of South African physical presence. This additional withholding exemption exists because (as with current law) foreign payees in this circumstance must already treat their receipts and accruals as ordinary revenue (like a domestic resident).

iii. *Headquarter companies:* Interest paid by a headquarter company will also be exempt. However, this exemption will be limited to interest received or accrued from a loan that is part of a back-to-back arrangement with the headquarter company acting as cross-border intermediary borrower and on-lender. For further information, refer to comments on the application of the thin capitalisation rules in respect of headquarter companies.

IV. Effective date

The proposed amendment will be effective for interest received or accrued on or after 1 January 2013.

5.2. FOREIGN DIVIDEND PARICIPATION EXEMPTION

[Clause 6 (1)(i); Applicable provisions: Amendment of section 1 “foreign dividend” definition]

I. Background

As a general rule, foreign dividends are taxable as ordinary revenue unless those dividends qualify for the participation exemption. The purpose of this exemption is to encourage the repatriation of dividends and to avoid economic double taxation. The capital gains regime for foreign shares operates in similar fashion (i.e. general taxation with a participation exemption).

In order to qualify for the participation exemption, the recipient of the foreign dividend must hold at least 20 per cent of the total equity share capital and voting rights in the distributing company. When determining the 20 per cent participation interest, certain forms of preference shares and other shares with debt-like characteristics are excluded.

The participation exemption also has a specific anti-avoidance provision aimed at preventing the arbitrage of incurring deductible expenses to generate exempt dividends (hereinafter referred to as cycle schemes). More specifically, the exemption is lost if the foreign dividend forms part of any transaction, operation or arrangement in terms of which any receipt or accrual is exempt while any corresponding expenditure is deductible by the taxpayer (or any connected person). Stated differently, the rules seeks to disallow tax planning wherein a deductible expenditure is arranged for the specific purpose (or effect) of directly or indirectly generating exempt foreign dividend income.

II. Reasons for change

Even though anti-avoidance rules exist with the aim of preventing cycle schemes, these anti-avoidance rules appear to be largely ineffective. By manipulating specific characteristics of foreign instruments and adding additional entity layers, taxpayers continue to generate deductible expense for the purpose (or effect) of shifting deductible funds offshore so as to cycle those funds back into South Africa as an exempt foreign dividend. In a nutshell, these schemes involve various forms of collusion involving interest or other deductible expenses (such as guarantee fees or deductible derivative payments) paid offshore without corresponding taxable income within South Africa (e.g. as exempt foreign dividends). These payments are often indirectly retained or controlled by the payor with the assistance of various special purpose vehicles, many of which are not technically connected persons.

III. Proposal

In view of this practice, the anti-cycle scheme rules within the participation exemption need to be strengthened. In line with the CGT provisions, the proposed amendment will also remove foreign financial instrument holding companies from the participation exemption.

A. Closure of cycle schemes

The proposed amendment tightens the current anti-avoidance rules so as to prevent the offshore cycling of funds. Under the revised rules, the participation exemption will not apply if: the foreign dividends at issue are (i) directly or indirectly determined with reference to, (ii) or arises (directly or indirectly) from a South African deductible payment that is not subject to tax in the hands of the recipient (or that is not taken into account in determining direct or indirect shareholder income in the case of a CFC). The test therefore seeks to disqualify relief where the foreign dividend received is preceded by any loosely-related payment that is deductible by the payor without being subject to tax on the other side.

Example
Facts: Parent owns Subsidiary 1 and Subsidiary 2, all three of which are South African tax residents. Subsidiary 1 pays interest to Foreign Special Purpose Vehicle X in respect of an outstanding loan amount. Foreign Special Purpose Vehicle Y pays dividends to Subsidiary 2. Subsidiary 2 owns 25 per cent of the shares of Foreign Special Purpose Vehicle Y.

Result: Subsidiary 2 cannot claim the participation exemption in respect of the dividends from Foreign Special Purpose Vehicle Y if the dividends are (directly or indirectly) determined with reference to or arises (directly or indirectly) from the deductible interest paid by Subsidiary 1. This denial of the exemption exists even if the relationship between these entities is attenuated by virtue of various entities or agreements.

B. Dividends from Foreign Financial Instrument Holding Companies

Under the proposed amendment, the participation exemption will not apply to foreign dividends received from foreign financial instrument holding companies. This proposed amendment achieves two objectives. Firstly, the proposal aligns the foreign dividend participation exemption with the capital gains tax participation exemption. Secondly, the proposed amendment matches international practice, which limits the participation exemption to amounts received in respect of foreign active businesses. Foreign active business are typically subject to a relatively high level of tax in the home country, thereby justifying the participation exemption from double tax point of view (as opposed to relying on the more complex indirect tax credit mechanism).

IV. Effective date

The revised anti-cycle scheme rules will apply to foreign dividends received or accrued during any year of assessment commencing on or after 1 January 2011. The proposed exclusion of foreign financial instrument holding companies will come into operation on 1 October 2011 and apply in respect of dividends received or accrued during years of assessment commencing on or after that date.

5.3. TRANSFER PRICING

[Clauses 16 (f), 56, 69(1)©, 6(1)(zH); Applicable provisions: Amendment of section 31]

I. Background

A. Legislative transfer pricing

The current transfer pricing rules may be applied to a supply of goods or services effected between connected parties at a price that is not at arm's length if (i) one party is a resident and the other is a foreign resident, (ii) one party is a foreign resident and the other is a South African permanent establishment of a foreign resident, or (iii) one party is a resident and the other is an foreign permanent establishment of a resident. A price is not at arm's length if that price differs from the price that the goods or services would have been expected to fetch if the parties were independent.

If the transfer pricing rules apply, SARS is empowered to adjust the consideration in respect of the transaction to reflect an arm's length price for those goods or services. This adjustment may be further subject to the secondary tax on companies (as if value were distributed from the company). The further taxation of the adjustment under these circumstances is known as a secondary adjustment and is discussed in Chapter IV of the OECD Transfer Pricing Guidelines.

B. Tax treaty transfer pricing

Tax treaties address the concept of transfer pricing so that profit can be properly allocated between treaty partners. Under the associated enterprises article of tax treaties (Article 9 of the OECD and UN Model Tax Conventions), transfer pricing adjustments arise if the terms and conditions of transactions between associated enterprises differ from the terms and conditions that would have occurred between independent enterprises. Once triggered, tax treaties allow for profits to be adjusted to reflect the profits that would have arisen had arm's length terms and conditions been applied. Adjustments may be made irrespective of any contractual obligations undertaken between the associated enterprises or any intention to minimise tax.

C. Thin capitalisation

The thin capitalisation rules apply if a foreign resident has granted financial assistance to a resident connected person (or a resident person in whom the foreign resident is entitled to participate in 25 per cent or more of the dividends, profits, capital or voting rights). The thin capitalisation rules include back-to-back arrangements with independent third parties or co-investors.

The thin capitalisation rules empower SARS to deny the interest or other finance charges to the extent that they relate to excessive lending compared to the fixed capital of the resident. The total amount of the excessive interest will also be deemed to be a dividend. SARS Practice Note 2 states that as a general guideline the rules will not apply where the financial assistance to fixed capital ratio does not exceed 3:1.

II. Reasons for change

The current wording of the South African transfer pricing rules is causing structural problems and uncertainties. More specifically, the literal wording focuses on separate transactions, as opposed to overall arrangements driven by an overarching profit objective. This narrow focus gives rise to artificial arguments by certain taxpayers seeking an excessive emphasis on literal terms of the transaction, as opposed to a focus on the overall economic substance and commercial objective of the arrangement. Further, although as a general matter the transfer pricing provision should allow for all appropriate transfer pricing methodologies recognised by the OECD, there are arguments that the current language emphasises the comparable uncontrolled price method over other transfer pricing methodologies, which may be more reliable under the particular circumstances of a case. Lastly, the emphasis on "price" as opposed to "profits" does not neatly align with tax treaty wording, potentially creating difficulties in the mutual agreement procedures available under tax treaties.

With regards to the thin capitalisation rules, these rules apply only to financial assistance granted by a foreign resident investor to certain residents. The rules do not apply to financial assistance by a foreign resident to another foreign resident, even if the latter has a South African permanent establishment. Some taxpayers have sought to exploit this loophole by having a foreign company utilise a wholly owned foreign subsidiary with most or all its operations conducted in South Africa through a permanent establishment. The foreign company would then capitalise the foreign subsidiary with excessive debt, thereby using the interest deductions associated with the excessive debt to offset income attributable to the South African permanent establishment.

Finally, the current thin capitalisation rules parallel the transfer pricing rules. The OECD and UN Model Tax Conventions deal with thin capitalisation as part of the associated enterprises article, so thin capitalisation rules are merely seen as an extension of the transfer pricing rules. The cohesion provided by the international paradigm offers greater certainty and minimises the scope for interpretational difficulties both domestically and under mutual agreement procedures.

III. Proposal

A. Modernised transfer pricing rules

In order to eliminate the above uncertainties, it is proposed that the South African transfer pricing rules be modernised in line with the guidance provided by the OECD. The current focus on goods and services will be revised. The focus will instead be on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

If terms or conditions made or imposed in transactions, operations, schemes, arrangements or understandings differ from the terms and conditions that would have otherwise existed between independent persons acting at arm's length, and the difference confers a South African tax benefit on one of the parties, the taxable income of the parties that have benefited must be calculated as if the terms and conditions had been at arm's length. Taxpayers are therefore required to account for transfer pricing on an arm's length basis, without SARS intervention. SARS also has the power to adjust the terms and conditions of a transaction, operation, scheme, arrangement or understanding to reflect the terms and conditions that would have existed at arm's length.

The new transfer pricing rules are closely aligned with the wording of the OECD and UN Model Tax Conventions and are in line with tax treaties and other international tax principles. Accordingly, South Africa will continue to follow the OECD Transfer Pricing Guidelines closely both with respect to transfer pricing in general and the power to recharacterise transactions in the application of the transfer pricing rules.

B. Merged and extended thin capitalisation rules

In line with the associated enterprise article in the OECD and UN Model Tax Conventions, the thin capitalisation rules will be merged directly into the transfer pricing rules. The transfer pricing rules will henceforth be used to deny deductions for interest that would not have existed had the South African entity not been thinly capitalised with excessive debt. SARS will amplify its interpretation of the rules in this context by way of Interpretation Note or other published guidance.

As part of the merger, lending (i.e. foreign financial assistance) from a foreign person to a foreign person with a South African business establishment will now become subject to the thin capitalisation rules.

Example

Facts: A foreign holding company forms a wholly owned foreign subsidiary and capitalises that foreign subsidiary with R10 million of equity and R490 million of loan capital. The foreign subsidiary conducts most of its operations through a South Africa branch.

Result: The foreign subsidiary will be subject to thin capitalisation rules via transfer pricing principles. These thin capitalisation rules will be applied by measuring the foreign outstanding equity versus outstanding debt of the foreign subsidiary (as opposed to making this measurement at the South African branch level).

IV. Effective date

The amendment will come into effect on 1 October 2011 and will apply in respect of any transaction, operation or scheme concluded on or after that date.

5.4. REGIONAL HEAD-QUARTER COMPANY REGIME

[Clauses 6(o), 16 (a),(d), (e), 38, 47 (a), (b), (c), 50(c), 61(f),68(b),(c),(d), (e), 71(a), 100(b), 108(b), Applicable provisions: Amendment of section 1 insertion of the “headquarter company” definition; section 9D; section 10; insertion of section 20C; section 24I; section 25D; section 41; section 64B; section 64D and amendment of paragraphs 43 and 64B of the eighth schedule]

I. Background

In the main, South Africa taxes income of residents on a worldwide basis. This worldwide tax system includes proportionate interests of tainted income of a controlled foreign company (CFC). Roughly speaking, a CFC is a foreign company that is more than 50 per cent owned by South African residents. Tainted income of a CFC generally includes passive income and diversionary income (the latter of which reflects income arising in circumstances likely to lead to transfer pricing).

Moreover, the secondary tax on companies is imposed on a South African resident company when that company declares dividends (including dividends stemming from foreign sourced income). Going forward, dividends taxation will be charged at the shareholder level (as opposed to the current charge at company-level). Tax treaties will be available to reduce the new dividends tax.

Thin capitalisation rules also exist to prevent the flow of interest offshore to the extent that the foreign debt of a South African company is excessive in relation to the company’s equity. This excessive determination is a facts and circumstances test. Thin capitalisation may even apply if the foreign funds borrowed are immediately on-lent to offshore operations.

II. Reasons for change

South Africa is the economic powerhouse of Africa. South Africa’s location, sizable economy, political stability and overall strength in financial services make South Africa an ideal location for the establishment of regional holding companies by foreign multinationals.

Furthermore, South Africa's network of tax treaties provides ready access to other countries in the region. South Africa is therefore a natural holding company gateway into the region.

However, in order to serve as an ideal holding company jurisdiction, three sets of South African tax rules were identified as significant barriers: (i) the CFC rules, (ii) the charge on outgoing dividends, and (iii) the thin capitalisation rules.

- Firstly, application of the CFC regime means that foreign shareholders of a South African holding company will be exposed to a double administrative tax burden if their home country also has CFC rules. It is also questionable whether the application of South Africa's CFC rules makes any sense if the bulk of the holding company's funds originate from abroad.

- Secondly, effective holding company jurisdictions do not add another layer of cost when profits pass-thru that jurisdiction. The current Secondary Tax on Companies adds a 10 per cent charge if profits are repatriated from the holding company to foreign investors even if those funds originate from abroad (e.g. from a foreign subsidiary of a holding company).

- Thirdly, if the South African holding company is financed with debt capital, the thin capitalisation rules serve as another critical barrier. Many foreign investors mainly fund their holding companies with back-to-back loans. In essence, the foreign investor makes loans to the holding company with the holding company on-lending those funds to another foreign location. Application of thin capitalisation to this arrangement would most likely leave the holding company with non-deductible interest payments owed to the foreign investor while being saddled with corresponding includible interest income from the on-lending.

III. Proposal

A. Overview

In view of the above, it is proposed that qualifying holding companies become eligible for tax relief. This tax relief would generally entail the following:

- Foreign subsidiaries of a qualifying holding company will not be treated as a CFC merely because the holding company has significant equity interests in those foreign subsidiaries:

- Dividends declared by a holding company will generally be exempt from the secondary tax on companies (or the new Dividends Tax once the new Dividends Tax comes into effect);

- The holding company will not be deemed to violate the thin capitalisation rules merely because of the existence of back-to-back cross-border loans involving the holding company; and

- Foreign creditors of the qualifying holding company will be exempt from the pending withholding tax on interest in respect to back-to-back loans (see the discussion of **CROSS-BORDER INTEREST** in this explanatory memorandum).

B. Qualifying criteria

As a starting point, it is proposed that a definition of qualifying holding company be introduced. South African companies satisfying these criteria (as described below) will receive all three sets of tax relief outlined above.

- Minimum participation by shareholders: Each shareholder of the holding company must hold at least 20 percent of the equity shares in that holding company. This requirement must be satisfied throughout the tax year.

- 80-20 tax value: Eighty per cent of the tax value (i.e. cost) of the holding company must represent equity, debt or intellectual property investments in foreign subsidiaries in which the holding company holds at least 20 per cent of the equity shares. Compliance with this requirement will be measured at the end of the tax year. It should be noted that the status of a foreign subsidiary is measured at the end of a tax year without regard to prior years. Therefore, if a holding company owns 10 per cent of a foreign subsidiary in one year and 20 per cent in a later year, the foreign subsidiary counts against the holding company in the first year but is counted favourably in the later year.

- 80–20 receipts and accruals: Eighty per cent of the total receipts and accruals of the holding company must be derived from foreign subsidiaries in which the holding company holds at least 20 per cent of the equity shares. These qualifying receipts and accruals include fees, interest, royalties, dividends and sale proceeds derived from those foreign subsidiaries. This requirement will be measured at the end of the tax year.

- Uninterrupted compliance: The holding company must have always complied with the minimum participation shareholding and the 80-20 tax value requirements in respect of each year of assessment since the company's inception. This uninterrupted requirement will apply to existing companies seeking to enter the holding company regime as of the effective date of this regime and to new companies established after the effective date. This uninterrupted compliance test does not apply in respect of the 80-20 receipts and accruals test.

In order to discourage artificial entry into the holding company regime (so as to artificially avoid the uninterrupted compliance requirement), qualifying holding companies will be deemed to be foreign residents for purposes of the reorganisation rollover rules. As a result, holding companies generally cannot benefit from reorganisation rollover relief.

C. Controlled Foreign Company impact of foreign subsidiaries of a qualifying holding company

For purposes of determining whether a foreign company is a CFC in relation to a qualifying holding company, it is proposed that the qualifying holding company be deemed to be a foreign resident. This change will mean that the CFC status of a foreign subsidiary of a qualifying holding company will be determined based on the indirect ownership of the qualifying holding company's shareholders. Only if these indirect owners are more than 50 per cent South African will the foreign subsidiary qualify as a CFC. If the foreign subsidiary qualifies as a CFC, the attribution of the tainted income of CFC will take place at the shareholder-level of the qualifying holding company.

Example 1:
Facts: Holding Company (a resident that meets all of the qualifying holding company criteria) is 70 per cent owned by Majority Parent Company and 30 per cent owned by Minority Parent Company. Majority Parent Company is a foreign resident, and Minority Parent Company is a resident. Holding Company owns all the shares of Foreign Subsidiary 1, and Foreign Subsidiary 1 owns all the shares of Foreign Subsidiary 2.

Result: For purposes of the CFC determination, Holding Company is viewed as a foreign company, meaning that CFC status for both foreign subsidiaries is based on the status of Holding Company's shareholders. In this case, neither foreign subsidiary is a CFC because these subsidiaries are only 30 percent indirectly owned by South African residents (i.e. indirectly by Minority Parent Company).

Example 2:
Facts: The facts are the same as Example 1, except that Majority Parent is a resident and Minority Parent a foreign resident.

Result: Both foreign subsidiaries qualify as CFCs because both subsidiaries are 70 per cent indirectly owned by South African residents. For attribution purposes, 70 percent of the tainted income of both CFCs will be taxable in South Africa in the hands of Majority Parent. The 30 per cent tainted income indirectly attributable to the Minority Parent will remain outside the South African tax net.

D. Taxation of dividends distributed by qualifying holding companies

A qualifying holding company will be deemed to be a foreign resident when making distributions to qualifying holding company shareholders. Foreign resident treatment means that qualifying holding companies making dividends will not be subject to STC (nor the proposed Dividends Tax) and that these dividends potentially qualify for the participation exemption. Note: For purposes of determining whether a distribution by a holding company is a dividend or a capital distribution as so defined in the Income Tax Act, proposed domestic dividend concepts apply (e.g. not foreign dividend concepts).

Example:
Facts: Holding Company is a resident with a single class of ordinary shares outstanding. Holding Company is 70 per cent owned by Majority Parent Company and 30 per cent owned by Minority Parent Company. Majority Parent Company is a foreign resident, and Minority Parent Company is a resident. Holding Company receives R3 million of receipts and accruals from the following sources: R2 million of domestic interest, R7 million of dividends from a wholly owned foreign subsidiary, and R1 million of management fees from the wholly owned foreign subsidiary. Holding Company declares dividends of all net proceeds to its shareholders pro rata.

Result: The dividends by Holding Company are not subject to the Secondary Tax on Companies (nor the new Dividends Tax). Both Majority Parent Company and Minority Parent Company qualify for the participation exemption in respect of all the dividends declared (i.e. the participation exemption is not limited to the profits generated by the wholly owned foreign subsidiary).

E. Transfer pricing in respect of qualifying holding company loans

A qualifying holding company is generally subject to transfer pricing principles (including thin capitalisation) in respect of foreign assistance (e.g. foreign loans) to that company. However, for purposes of this determination, a qualifying holding company does not take into account any foreign loans borrowed to the extent:

- the loan proceeds are on-loaned to foreign subsidiaries; and
- the equity shares of those foreign subsidiaries are at least 20 per cent held by the qualifying holding company.

However, this exclusion comes at a price. All interest deductions incurred in respect of all of these foreign loans are ring-fenced against the interest earned from the aggregate of loan proceeds on-lent to the 20 per cent or greater foreign subsidiaries. Unused losses from the excess interest incurred are deemed to be incurred in the following year (until eventually applied against income).

Example:
Facts: Holding Company is a resident with a single class of ordinary shares outstanding. Holding Company is 70 per cent owned by Majority Parent Company and 30 per cent owned by Minority Parent Company. Majority Parent Company is a foreign resident, and Minority Parent Company is a resident. Holding Company borrows funds on loan account from Majority Parent Company and fully applies the borrowed funds as a loan to a wholly owned foreign subsidiary of Holding Company. In Year 1, Holding Company incurs interest of R140 000 from the loan owed to Majority Parent Company, but Holding Company generates no interest from the amount loaned to the wholly owned foreign subsidiary. In Year 2, Holding Company incurs R140 000 of interest from the loan owed to Majority Parent Company, and Holding Company generates R200 000 of interest from the amount loaned to the wholly owned foreign subsidiary.

Result: The back-to-back loan from Majority Parent Company will not be taken into account for purposes of thin capitalisation rules because the loan amount is fully applied as an on-loan to the wholly owned foreign subsidiary. However, the interest incurred is ring-fenced. None of the R140 000 interests can be deducted in Year 1. In Year 2, R200 000 of the cumulative interest incurred of the total R280 000 can be applied against the R200 000 of interest earned from the wholly owned foreign subsidiary, with the R80 000 rolled over to a subsequent year.

Transfer pricing also does not apply in respect of independent foreign assistance (e.g. loans) by holding companies to 20 per cent or greater foreign subsidiaries. Hence, interest-free loans from holding companies to these subsidiaries will be free from transfer pricing adjustment.

IV. Effective date

The qualifying holding company definition will come into effect on 1 January 2011 and will apply in respect of any year of assessment beginning on or after that date.

5.5. REGIONAL INVESTMENT FUND REGIME

[Clauses 6(v) and (zD); Applicable provisions: section 1 insertion of the “qualifying investor” definition and addition of the proviso in the “permanent establishment“ definition]

I. Background

A. Conduit approach to partnerships and vesting trusts

South Africa follows a common law approach to the tax treatment of partnerships. As a general rule, the tax system does not recognise a partnership as a legal entity, looking through the partnership and taxing investing partners directly. If the partners are foreign residents, they are taxed on a source basis like any other foreign investor. South Africa also follows a common law approach to the tax treatment of fully vested beneficiaries in a trust. If the partners are foreign residents, the partners are again taxed on a source basis like any other foreign investor.

B. Foreign investors and passive income

Foreign investors are subject to tax only on their South African sourced income. Interest is generally exempt. However, the exemption for interest does not apply to foreign investors if the interest is attributable to a South African permanent establishment. The rules for tax treaties roughly follow the same paradigm. Once the withholding tax on interest comes into effect, interest received by foreign investors will be subject to a 10 per cent withholding tax unless that interest falls under any of the legislatively prescribed or treaty exemptions.

Dividends paid to foreign investors are largely subject to the Secondary Tax on Companies with the tax falling upon the distributing company. Once the Dividends Tax is enacted, the investor will be subject to tax with foreign investors potentially receiving treaty relief (unless the dividends are attributable to a South African permanent establishment). Capital gains from shares (other than shares of immovable property companies) are generally exempt in the hands of a foreign investor unless the capital gain is attributable to a South African permanent establishment. The rules for tax treaties roughly follow the same paradigm.

C. Foreign investment through a local partnership or trust

Portfolio investments in South Africa may be structured as limited partnerships. In a limited partnership, the general partner carries on the business of the partnership, and the limited partners merely act as passive investors. In this context, if the general partner has a presence in South Africa, this presence will create a permanent establishment for each of the limited partners. As a result, each limited partner will be subject to tax in South Africa in respect of the partner’s proportionate share of passive partnership income. On the other hand, had these same investors invested directly into South Africa, most (if not all) of the same income would fall outside the South African tax net.

Similar principles also apply to trusts organised as a vesting trust. In this instance, the activities of trustees with presence in South Africa will create a permanent establishment foe vested trust beneficiaries. This permanent establishment treatment again exposes these foreign investors to South African tax that would not otherwise exist if the vested trust beneficiaries held the underlying passive assets directly.

D. Foreign investment through a foreign flow through entity

Internationally, portfolio investments are often organised as limited liability partnerships ("LLP") or limited liability companies ("LLC"). As a practical matter, when a LLP/LLC invests in South Africa, that entity may seek to appoint a South African manager in respect of its South African portfolio. As with a general manager of a domestic limited partnership, the South African manager of the LLP/LLC's portfolio will potentially create a permanent establishment for that LLP/LLC. As a result, the LLP/LLC will be subject to tax in South Africa in respect of the profits attributable to that permanent establishment.

II. Reasons for change

As discussed in relation to regional headquarter companies, South Africa's location, sizable economy, relative political stability and overall strength in financial services make South Africa an ideal location for the management of regional investments. Furthermore, South Africa's network of tax treaties and investment protection agreements again provide ready access to other countries in the region.

However, the possibility of creating a taxable South African permanent establishment makes South Africa unattractive to foreign investors seeking to utilise domestic partnerships, domestic trusts or foreign LLPs/LLCs with a portfolio manager within South Africa. This possibility distorts investment decisions with foreign investors often establishing parallel structures. In a typical parallel structure, foreign investors limit their South African partnership (or trust) activities to South African investment with another (more friendly) tax jurisdiction being utilised to invest in the remainder of Africa. This practice creates deadweight costs to the structure and denies South African experts the possibility of managing foreign investment funds associated with the region.

III. Proposal

A. Overview

In view of the above, it is proposed that the concepts of qualifying investor be introduced as a starting point. A qualifying investor includes limited partners and beneficiaries of a trust. Qualifying investors will become eligible for tax relief so that tax does not deter foreign investors from utilising South Africa as a regional investment fund location. Conceptually, the tax measures proposed will have the following effect:

- The proposal places limited partners (or trust beneficiaries) in the same position had these investors invested directly in the underlying assets of the partnership (or trust).

These investors will not be exposed to South African tax merely because of the portfolio management activities carried on in South Africa.

- However, the management fees of the South African manager, general partner (or trustee) will remain taxable in South Africa.

B. Qualifying investors

The proposed amendment provides relief for partners and trust beneficiaries whose economic position is akin to a mere passive shareholder in a company. More specifically, a qualifying investor must satisfy all of the following requirements in respect of the year of assessment at issue:

- Liability towards third parties does not exceed the amount contributed (the partner or trust beneficiary must have limited liability like a shareholder of a company);
- The partner (or trust beneficiary) does not participate in the effective management of the business of the partnership (or trust);
- The partner (or trust beneficiary) does not have the authority to act on behalf of the partnership (or trust); and
- The partner (or trust beneficiary) does not receive any receipts or accruals in respect of services performed for the benefit of the partnership (or trust).

C. Permanent establishment exclusion

For purposes of the Income Tax Act, a partnership or trust will be treated as an independent agent in relation to qualifying investors. Independent agent status means that the activities of a partnership (or trust) within South Africa will not create a permanent establishment status for the qualifying investor. This independent agent status in relation to a qualifying partner (or trust beneficiary) means that the qualifying investor will not be deemed to have a South African permanent establishment solely by virtue of these activities. This independent agent status has the same liberalising impact when applying tax treaties because the South African enabling legislation treats tax treaty rules as if fully incorporated into South African tax law.

However, this independent agent status is limited. Independent agent status applies only in respect of gross receipts and accruals derived from financial instruments or the disposal of those financial instruments. Independent agent status does not exist in respect of other forms of partnership (or trust) income.

D. Foreign LLP/LLCs

In light of the introduction of the definition of foreign partnership, foreign LLP/LLCs will also be entitled to the benefit of this regime. Therefore, a manager of a LLP/LLC's portfolio in South Africa will not create a permanent establishment for the LLP/LLC members. This relief mirrors the relief for qualifying investors of domestic limited partnerships.

IV. Effective date

The proposal will come into operation as from the commencement of the year of assessment commencing on or after 1 January 2011.

5.6. DIVIDEND TAX: DEFINITION OF FOREIGN DIVIDEND

[Clauses 6(1) (i); Applicable provisions: amendment of section 1 "foreign dividend" definition]

I. Background

In general, the current tax rules define a foreign dividend as a distribution of profits by a foreign company. This definition relies on South African tax law and company law in order to determine whether a distribution constitutes a dividend or a capital distribution. The definition applies to both pure equity distributions and distributions from equity instruments with debt-like characteristics. Foreign dividends are either exempt or subject to tax at ordinary rates. Foreign capital distributions are either exempt or subject to tax at capital gain rates.

II. Reasons for change

The current Secondary Tax on Companies has been replaced with a new Dividends Tax regime, the latter of which introduced a new tax definition of a dividend. The new definition generally treats every distribution, other than the reduction of contributed tax capital, as a dividend. The new dividend definition applies only in respect of distributions made by South African resident companies. Foreign companies are not subject to the South African tax regime because foreign companies often cannot practically maintain an account for contributed tax capital (a key component to the new definition).

III. Proposal

For purposes of the new dividend definition, it is proposed that a foreign dividend should be defined with reference to the foreign tax law definition of a dividend or similar payment as determined by the country of incorporation, formation or establishment of the company making payment. This approach is in line with tax treaties. In the event that the foreign country does not have an income tax (or similar tax system), reference must be made to that country's company law.

One implicit advantage of the amendment is the facilitation of consistent global treatment of hybrid instruments, thereby simplifying compliance for multinationals seeking uniformity while also eliminating some forms of tax arbitrage. For example, if a distribution to a South African resident is treated as interest under foreign law, the distribution will no longer be viewed a dividend (thereby losing the potential benefit of the participation exemption in terms of South African tax law).

IV. Effective date

The amendment will come into operation in respect of dividends received or accrued on or after 1 January 2011.

5.7. FOREIGN FISCALLY TRANSPARENT ENTITIES

[Clauses 6(1) (d), (j),(w),(x), (y); 46; Applicable provisions: amendment of section 1 "company" "person" definitions ; insertion of the following definitions in section 1 " foreign partnership definition" " portfolio of a collective investment scheme" "portfolio of a collective investment scheme in participation bonds" "portfolio of a collective scheme in property" " portfolio of a declared collective investment scheme; amendment of section 24H (1), (5)(a)]

I. Background

Internationally, portfolio investments are often organised as a limited liability partnership ("LLP") or limited liability company ("LLC"). An LLP/LLC is preferred as a vehicle to raise investment finance because these hybrid entities combine the characteristics of a partnership and a normal company. These entities generally have a flow-thru tax status in their home jurisdictions, similar to a South African limited partnership. This flow-thru tax status means that the profits of a LLC or LLP are taxed in the hands of the members and not the entity. In relation to other commercial activities, the entities provide limited liability to their members similar to a company.

South African law does not have legislation that mirrors LLPs or LLCs. Depending on the law of the country in which a LLP/LLC is organised, it is arguable whether the entity will be regarded as a company for South African tax purposes.

II. Reasons for change

Taxpayers have long requested certainty about the tax treatment of foreign LLPs and LLCs because of their growing use by South Africans investing offshore and foreigners investing in South Africa. The company status of these entities continues to perpetuate uncertainty in their tax treatment. Company treatment will also cause difficulties for foreign LLPs/LLCs that wish to establish regional investment fund management activities in South Africa.

III. Proposal

In view of the above, it is proposed that LLP/LLCs and similar hybrid entities be encapsulated within a new definition of a "foreign partnership" that will synchronise the South African tax treatment with foreign tax practice. In order to qualify as a foreign partnership, an entity must be a partnership, association or body of persons established or formed under foreign law. In addition, the entity must be fiscally transparent. An entity will be regarded as fiscally transparent in the case where the country of formation or establishment has an income tax system, if the entity is not subject to tax at entity level on the country of formation or establishment. In the case where the country of formation or establishment does not have an income tax or similar tax system, an entity will be regarded as fiscally transparent if amounts received or accrued or incurred are allocated to the members in terms of an agreement on an annual basis

In addition to providing tax flow-thru status to foreign LLPs and LLCs, the definition of a foreign partnership will assist in curbing some forms of cross-border entity arbitrage that often result from the differing treatment of entities under different jurisdictions. An entity that is an LLP/LLC under a foreign jurisdiction will be similarly recognised as transparent under South African tax law. This harmonised treatment will provide greater certainty and consistency for investors in that the entity.

IV. Effective date

The effective date of the proposal depends on when the foreign entity is formed or established. If formed or established on or after 25 August 2010, the status of the foreign entity will be determined under the newly proposed rules. In respect of pre-existing entities, the proposal will come into operation as from the commencement of the year of assessment commencing on or after 1 January 2011.

5.8. MULTIPLE REPORTING CURRENCIES

[Clauses 6(1)(k),(w),(x), (y); 16(g),(i),(j), (l), 46, 47, 50 (a) and (b), 114; Applicable provisions: amendment section 1 “company” “person”; amendment of sections 9D, 24I, 25 and paragraphs 43 and 43B of the Eight Schedule, amendment of paragraph 4 of the Tenth Schedule]

I. Background

The current tax rules relating to the taxation of foreign currency are premised on the assumption that the currency of financial reporting is the starting point for the tax calculation. This starting point simplifies South African taxation of foreign currencies. The currency of financial reporting is not defined because financial reporting may come in different forms.

II. Reasons for change

The current tax regime for foreign currency does not properly cater for situations where: foreign operations: (i) report in various currencies for various purposes, or (ii) report in one currency with a significant part of the underlying economic activities being conducted in another foreign currency. These problems arise for a variety of reasons. For instance, the currency of financial reporting may be dictated by regulations and laws of various countries, a dual listing of a company, a difference between the country of incorporation and country of tax residence and group reporting versus separate company reporting. Moreover, a financial reporting currency may be different than a functional currency, the latter being determined with reference to the primary economic environment in which the entity operates (for example, the currency in which an entity primarily generates and expends cash).

III. Proposal

In view of the concern mentioned above, it is proposed that taxpayers be afforded flexibility for determining the starting point for taxation involving foreign currency translation. Taxpayers will now rely on the functional currency as long as the taxpayer consistently relies on that currency for tax purposes.

As to the meaning of the term functional currency, the functional currency can be determined with reference to the currency of the economic environment in which a significant part of activities are conducted. For accounting purposes, the following primary factors are considered in determining whether a currency is a functional currency:

- The currency in which sales prices are denominated and settled;
- The currency of the country whose competitive forces and regulations determines the price;
- The currency in which costs are determined and settled;
- The currency of financing activities (debt and equity instruments); and
- The currency in which receipts from operating activities are retained.

As an interpretation matter, the tax functional currency determination is envisioned as being effective over an annual period. “Significance” of activities can conceivably be based on the relative relationship of activities throughout all dates during the year or on the basis that the particular currency is the most significant throughout most of the year (despite lesser use during shorter periods of the year).

In order to provide flexibility to the headquarter company regime, a headquarter company can determine its taxable income with reference to its functional currency as opposed to the Rand. Hence, dollar=based headquarter companies can rely on the dollar as their base currency for tax purposes. The taxable income must then be translated into Rands using the average exchange rate for the year of assessment.

IV. Effective date

The amendment will come into effect on 1 January 2011 and will apply in respect of years of assessment ending on or after that date.

5.9. ABANDONED HYPERINFLATIONARY CURRENCIES

[Clauses 16 (1)(h), 101; Applicable provisions: Addition of paragraph I to the proviso of subsection (2A), insertion of paragraph 43B of the Eighth schedule]

I. Background

The current tax rules initially determine gains or losses attributable to a foreign permanent establishment in the reporting currency of the permanent establishment, and those same rules then translate that currency to a Rand amount. If the reporting currency is hyperinflationary, the gain is measured directly in Rand. This overall conceptual framework also applies to controlled foreign companies. (Note: In a related amendment contained in this Bill, all references to reporting currency will be replaced with references to functional currency – see **MULTIPLE REPORTING CURRENCIES**.)

II. Reasons for change

The current tax rules do not properly cater for situations where a foreign country abandons its currency as legal tender due to unfavourable circumstances. Typically, this abandonment will occur after a period of hyperinflation. This period of hyperinflation is often marred by the lack of reliable exchange rate information to determine the tax cost of assets as the official rate rarely reflects the true value. The speed of the currency decline also complicates the currency translation determination because the fixing of a rate at a specified time often becomes impractical due to the increasingly unstable nature of the currency.

Once a foreign currency is abandoned after a period of sharp decline in favour of a new more stable currency, accounting rules often allow for the restatement of assets at market value. While tax rules presently cover hyperinflationary currencies, no special rules exist if a country abandons its currency after a period of sharp decline. In the absence of special rules, the current tax rules require continued use of historic costs (which is impractical as just described).

III. Proposal

In view of the fact that historic cost records become extremely inaccurate once a country abandons its currency after a period of hyper-inflation, a special rule is proposed in respect of the tax cost of assets acquired before the hyper-inflationary currency is abandoned.

In this instance, the tax costs of assets are deemed to be restated at market value. This restatement is based on the market value of the foreign assets at the beginning of the foreign tax year following the year in which the hyper-inflationary currency was abandoned (i.e. market value during the year in which the new currency is adopted). The new starting date and the tax cost rule will apply as if the affected assets were brought into the South African tax net for the first time. This amendment will significantly ease the burden of determining the tax costs of assets for the purposes of determining applicable allowances and for the purposes of determining gains or losses in respect of future disposals.

IV. Effective date

The amendment will come into operation on 1 January 2009 and will apply in respect of assets held on or after that date. The proposed effective date also caters for the change from reliance on reporting currency tax calculations to a reliance on functional currency tax calculations (see **MULTIPLE REPORTING CURRENCIES)**.

6. VALUE-ADDED TAX

6.1. DEBT-BURDENED ASSETS UPON CESSATION OF AN ENTERPRISE

[Clause 119; applicable provision: section 1 definitions of "exported" para (b) and "foreign-going aircraft and foreign-going ship"]

I. Background

In the case of debts created pursuant to an unwritten agreement, vendors (debtors) registered on the invoice basis for VAT may be required to pay-back (claw-back) input tax deductions claimed to the extent these vendors have not paid for the supplies received within a 12 month period.

The pay-back provision aims to create neutrality for the fiscus based on the commercial assumption that the supplier (i.e. a creditor who has paid over the output tax to SARS) can claim an input tax deduction for a bad debt. In other words, the rule is designed to protect the fiscus against the creditor claiming back the VAT paid while the debtor continues to allege that the debt is outstanding without paying the VAT.

Additionally, if a vendor de-registers from the VAT system, the vendor makes a deemed supply of all assets or rights associated with the vendor's enterprise at the time of de-registration. This deemed supply aims to create neutrality based on the premise that the vendor has previously claimed an input tax deduction for the assets purchased.

II. Reasons for change

A vendor that ceases to be a vendor may be liable for VAT under the two different but inter-linked provisions outlined above. This problem would manifest itself in the scenario where the vendor ceasing business has outstanding debts. In these circumstances, the vendor is liable for VAT on the cessation of business and also on the 12-month claw-back of the outstanding debt on the asset. In essence, a double charge of the VAT arises on the same debt-burdened asset.

III. Proposal

It is proposed that the double VAT charge be removed in respect of debt-burdened assets upon cessation of a vendor's business enterprise. More specifically, if a vendor acquires an asset on credit/loan account and fails to fully repay that indebtedness when the business enterprise ceases, the VAT charge-back otherwise arising in respect of the business cessation no longer applies to the extent that the charge-back relates to the indebtedness outstanding. The only charge applicable with respect to this amount will be the 12-month claw-back. In effect, only a single charge should apply in these circumstances.

However, an exception to this waiver of the business enterprise cessation charge-back applies if a vendor has been subjected to the 12-month claw-back provision but subsequently pays back the outstanding amount. Because the vendor in these circumstances can claim input tax on the amount repaid, the 12-month clawback is effectively reversed. With this reversal, the business enterprise cessation charge-back must be re-invoked because the potential double charge applicable has been removed.

Example 1

Facts. Vendor purchases an asset for R114 000 (including VAT) on credit on 1 October 2011 for use in the Vendor's business. Vendor claims the input tax of R14 000. On 1 May 2012, Vendor closes down business because of financial problems. At the time of business cessation, Vendor has paid none of the R114 000 for the asset in question.

Result. Vendor is not liable for VAT in respect of the asset on cessation of Vendor's business. Vendor is only liable for VAT in terms of the claw-back provision for failure to pay the purchase price of the asset (i.e. 14/114 x R114 000 = R14 000).

Example 2

Facts. Vendor purchases an asset for R114 000 (including VAT) on credit on 1 October 2011 for use in the Vendor's business. Vendor claims the input tax of R14 000. On 1 May 2012, Vendor closes down business because of financial problems. At the time of business cessation, Vendor paid R40 000 of the R114 000 purchase price for the asset in question.

***Result*.** The Vendor is liable for VAT of R9 088 on the unpaid amount of R74 000 (14/114 x R74 000). This unpaid portion is excluded from the ambit of the cessation of business rule. Under the cessation of business rule, the Vendor is liable for VAT of R4 912 [(R114 000 – R74 000) x 14/114]. The net result is an aggregate single-charge on the full amount.

Example 3

Facts. Vendor purchases an asset for R114 000 (including VAT) on credit on 1 October 2011 for use in the Vendor's business. Vendor claims the input tax of R14 000. On 1 October 2012, Vendor has not paid any amount of the R114 000 for the asset in question (the 12-month claw-back accordingly applies). Assume that the Vendor subsequently pays the creditor R114 000 on 31 December 2012 for the asset that was subject to the claw-back immediately before closing down business.

Result. The 12-month claw-back in respect of the indebtedness on the asset and the subsequent payment of the indebtedness cancel one another. The cessation of business enterprise charge-back accordingly applies in full.

IV. Effective date

According to general principles, the proposed amendment will apply to all supplies made on or after the date of promulgation of this Bill.

6.2. MICRO-BUSINESS EXIT AND RE-ENTRY INTO THE VAT SYSTEM

[Clause 123 and 124, Applicable Provision: Section 18(4) proviso to symbol B and section 23(8)]

I. Background

A vendor that opts into the turnover tax system must first deregister from the VAT system. When the vendor deregisters for VAT, the vendor is deemed to make a supply of all assets held at the time of deregistration. The vendor is obliged to pay output VAT on this deemed supply. To ease this cash-flow implication, the vendor can exclude R100 000 of this deemed supply.

At a future stage, if that same vendor (now a non-vendor) deregisters from turnover tax and returns to the VAT system, the vendor is entitled to claim input VAT on assets that the vendor brings back into the VAT net. Under these circumstances, a claw-back of the R100 000 relief that was granted to the vendor (on exit from the VAT system) applies to reduce the amount of the input tax that the vendor can otherwise claim.

II. Reasons for change

The VAT Act is silent on whether the R100 000 relief provision is a constant (amount) or a maximum amount. More specifically, uncertainty exists as to whether the full R100 000 can be deducted from the consideration for the deemed supply if this deemed supply is less than R100 000 (thereby creating a negative amount).

In addition, the 100 000 claw-back faced by a non-vendor re-entering the VAT system from the turnover tax system is too cumbersome. Although designed for neutrality reasons, the assets upon re-entry may not have any relation to the assets initially taken out of the VAT net. Moreover, even if VAT is not recaptured at this stage, VAT will apply upon the sale of the asset. Lastly, the claw-back is administratively cumbersome, especially given the small VAT amount of R12 280 at issue.

III. Proposal

It is proposed that the law be clarified to state that the R100 000 relief granted to the vendor on exit from the VAT system by virtue of entry into the turnover tax system is a maximum amount (i.e. the relief may not exceed the potential VAT that otherwise exists). In addition, it is proposed that the R100 000 claw-back for re-entry into the VAT be deleted.

IV. Effective date

According to general principles, the proposed amendments will come into operation on the date of promulgation of this Bill.

6.3. GOODS SUPPLIED TO FOREIGN-GOING MILITARY SHIPS OR AIRCRAFT

[Clause 120(1) (a) and (b), applicable provision section 8(2) proviso]

I. Background

The supply of movable goods by a vendor to the owner or charterer of a foreign-going ship (or foreign-going aircraft) can be zero rated, depending on a few requirements. Firstly, the vendor must deliver the goods to the owner or charterer. Secondly, the ship (or aircraft) must go to a destination outside South Africa. Thirdly, the movable goods must be used or consumed on the ship or aircraft.

A foreign-going ship includes any vessel that is engaged in the transportation for reward of passengers or goods wholly or mainly on international voyages. Comparable rules exist for aircraft. In both cases, the goods supplied will be consumed outside South Africa and should be zero rated in line with the consumption principle of VAT.

II. Reasons for change

The current zero rating for supplies made by a domestic vendor to a locally stationed foreign-going ship (or aircraft) only applies to commercial transport. As a result, certain foreign-going ships (or aircraft) that are temporarily stationed at local ports are not covered by the zero rating provision. For instance, military ships fall outside this rule.

It should be noted that military ships can claim VAT inputs on supplies received under the export incentive scheme. However, this scheme is cumbersome.

III. Proposal

It is proposed that all movable goods supplied to foreign military ships/vessels qualify for zero rating. This proposal will also cover comparable aircraft.

IV. Effective date

According to general principles, the proposed amendments will come into operation on the date of promulgation of

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7. MINERAL AND PETROLEUM RESOURCES ROYALTY AMENDMENTS

7.1. CROSS-BORDER TRANSFER OF MINERAL RESOURCES

[Clause 130 and 131; Applicable provisions, section 1 and section 2 “transfer” definition]

I. Background

The triggering event for the charge imposed by the Mineral and Petroleum Resources Royalty Act is a “transfer” as defined. A transfer of a mineral resource covers a disposal of a mineral resource, the export of a mineral resource as well as consumption, theft, destruction or loss.

The export trigger applies to all exports, even if the export is eventually re-imported by the same party for ultimate sale. The rationale behind the export trigger is to reduce the control risk of audit once the mineral resource has left South Africa.

II. Reasons for change

It has come to Government's attention that certain companies temporarily export mineral resources before returning those mineral resources to South Africa for ultimate disposal. This temporary export may occur to compensate for certain refining activities that are unavailable locally. Many of these entities would prefer to refine locally but have not yet completed construction of the required local facilities. These entities are then left in the unenviable position of facing a higher royalty charge during the interim period.

Moreover, it has become questionable whether the export trigger is necessary. Basic audit can reveal sales abroad as easily as local sales. Therefore, the export trigger adds little while triggering a charge for exports contrary to commercial practice.

III. Proposal

It is proposed that the export trigger for the royalty on the export of mineral resources before ultimate disposal be completely removed. Hence, if a company exports a mineral resource, followed by a sale abroad, the royalty will arise only upon the later sale. It is also proposed that the law be clarified to ensure that the proposal applies only to mineral resources extracted within South Africa.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010 nor will mineral resources export before that date be deemed transferred before that date.

Example 1
***Facts*.** Company X removes various bulk minerals and places those minerals in a residue stockpile. Six months later, Company X exports the residue stockpile to Company Y (a South African company). Company Y then extracts and refines the minerals from the stockpile. Company Y eventually sells the mineral resources so extracted and refined (outside South Africa).

***Result*.** Company X is not subject to the royalty because Company X has never won or recovered the mineral resource. However, Company Y will be subject to the royalty when Company Y undertakes the sale as the mineral resource was extracted from within South Africa.

Example 2
Facts. Zimbabwe Company extracts mineral resources from a mine in Zimbabwe and sends those mineral resources to a South African Company, in South Africa, for refining. Zimbabwe Company thereafter disposes of the mineral resources in South Africa.

***Result*.** Zimbabwe Company will not be liable for the royalty on transfer of the mineral resource in South Africa as the mineral resource was originally extracted from within Zimbabwe and not South Africa.

7.2. NOTIONAL UPLIFTMENT OF EXPENDITURE FOR MINERAL RESOURCES

[Clause 132; Applicable provision: section 5(1) (b) and 5(2) (b)]

I. Background

The Mineral and Petroleum Resources Royalty Act specifies the condition at which mineral resources should be transferred. These rules also ensure that an excessive charge does not arise when beneficiation occurs above a specified level.

Schedule 1 specifies the condition for refined mineral resources, and Schedule 2 specifies the condition for unrefined mineral resources. If the actual specified conditions for both refined and unrefined mineral resources fall outside the conditions stated, a notional adjustment (upwards or downwards) occurs in respect of the "gross sales" base calculations.

II. Reasons for change

If a mineral resource is transferred above the specified condition, both the gross sales amount and expenditure are notionally reduced in line with the notional specified condition. However, if a mineral resource is transferred below the specified condition, clarity in the law only exists for specifying the upliftment of the gross sales amount. The determination for the concomitant expenditure is uncertain. No reason exists to deny the upliftment for concomitant expenditure.

III. Proposal

A. Conceptual proposal

If a mineral resource is transferred below the specified condition, a notional upliftment will apply to the expenditure in respect of the mineral resource. This upliftment theoretically corresponds with the notional expenditure that would have been incurred had the mineral resource been transferred at the specified condition. The above concepts equally apply to refined (Schedule 1) mineral resources and to unrefined (Schedule 2) mineral resources.

Example

Facts. A mineral resource is transferred at a level that is 5% below the specified condition (sales value is R 1 000 000 and the concomitant costs are R 600 000). Assume that the sales price increase by 2% for each percentage increase in mineral content (for a given quantity). Further assume that costs increase by 1% for each percentage increase in mineral content. Both the sales and costs must be adjusted to reflect sales and costs at the specified condition. Note: the calculations and assumptions for sales and costs have to be made separately to indicate progression.

***Result*.**

Sales upliftment: R 1 000 000 + (2% x 0.05% x R 1 000 000)
= R 1 100 000

Cost upliftment: R 600 000 + (1% x 0.05% x R 600 000)
= R 630 000

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.3. ROLLOVER RELIEF

[Clause 135; Applicable provision: taxation of section 8 A]

I. Background

The Mineral and Petroleum Resources Royalty Act applies on an extractor-by-extractor basis in respect of mineral resources transferred. The Royalty Act specifies a minimum condition at which mineral resources should be transferred. If the actual specified condition falls outside the condition stated, a notional adjustment (upwards or downwards) occurs in respect of the "gross sales" calculations and "the earnings before interest and taxes" calculations. In addition, refined mineral resources are subject to a more favourable rates formula than unrefined mineral resources. All of these rules seek to ensure that mineral extractors do not seek to undermine the royalty by lowering the first saleable point.

II. Reasons for change

While South African mineral resource extractors typically engage in refining activities, many smaller and medium-sized extractors do not have sufficient resources to undertake refining activities. These entities often sell to other mineral extractors, and the latter refine the mineral resources to a higher level or to completion.

However, this shift of refining activities comes at a price in respect of the royalty charge. Failure to fully refine triggers a notional uplift. This higher charge disproportionately impacts smaller and medium-sized extractors due to their lack of refining facilities. This disproportionate impact is also questionable from a policy point of view because the full gamut of refining ultimately occurs within South Africa – the only deviation is that the refining is performed by a separate party from the party engaging in the extraction for commercial reasons.

III. Proposal

It is proposed that rollover relief be granted to if: (i) the transferor and transferee who are both registered persons in terms of the Mineral and Petroleum Resources Royalty Act, and (ii) both agree to the rollover. In these circumstances, the royalty is waived in respect of the transfer with the transferee stepping into the shoes of the transferor. The net result is a royalty that is deferred until subsequent transfer. Hence, if a small extractor transfers a mineral resource to a larger extractor with refining facilities, the small extractor can escape the royalty with the larger extractor assuming the potential royalty after having refined the mineral resource.

It should be noted that various persons may elect to be treated as extractors (i.e. registered persons). This election allows parties outside the royalty regime to elect into the regime solely to invoke rollover relief. However, a person electing into the royalty will not be eligible for rollover relief when subsequently transferring mineral resources to other parties. This caveat is designed to prevent an endless string of rollover agreements solely to defer the royalty.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.4. APPLICATION OF SCHEDULE 2

[Clause 134; Applicable provision: taxation of section 6 A]

I. Background

The Mineral and Petroleum Resources Royalty Act specifies the condition (either at a precise point or at a minimum level) at which mineral resources should be transferred. Schedule 1 specifies the condition for refined mineral resources, and Schedule 2 specifies the condition for unrefined mineral resources.

In addition, some unrefined mineral resources (e.g. in concentrate form) are transferred with ancillary mineral resources. As a technical matter, all of these by-products must be treated separately for purposes of the Mineral and Petroleum Resources Royalty Act. The one exception is Platinum Group Metals (PGMs), where by-products are prevalent (technically referred to as “all other metals and minerals contained in the concentrate”). These PGMs are treated as part of PGMs for purposes of the unrefined (Schedule 2) mineral resources calculation.

II. Reasons for change

Some uncertainty appears to exist on how to apply the schedules. The first set of issues relates to how the minimum level test should be applied. The second issue relates to how by-products are treated. By-products are especially problematic due to the unknown nature of embedded minerals.

III. Proposal

In respect of the minimum level test, mineral resources transferred below the minimum level are notionally deemed to be transferred at the minimum level. However, if the mineral resource is extracted and transferred at a higher level, the higher level applies. The purpose of this rule is to ensure that higher grade ores are fully subject to the royalty while ensuring that the royalty does not become an implicit charge on beneficiation of otherwise lower grade ores.

In respect of by-products, the rules will be simplified. If a mineral resource is sold with by-products, the specified condition of concern will only relate to the main mineral resource. No specified level of condition will be required for the by-products.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.5. SCHEDULAR TREATMENT FOR VANADIUM

[Clause 136 and 137 (1) (q); Applicable provisions: schedule 1 and schedule 2 ”vanadium”]

I. Background

Vanadium is viewed as an unrefined mineral under Schedule 2 to the Mineral and Petroleum Resources Royalty Act. The specified unrefined condition for this mineral as a concentrate is more than 1% V_2O_5 equivalent and less than 2% calcium and silica bearing gangue minerals (SiO2 + CaO). According to the Act, this level represents the first saleable point for vanadium in all instances.

II. Reasons for change

It is understood that South African mining houses produce Vanadium in dilute solid solution form in other mineral species (notably Magnetite), typically with a concentration range of 1-to-2% V_2O_5 equivalent. To extract the vanadium, a rigorous beneficiation process takes place, and this process transforms the purity of the vanadium to a higher level of typically above a 98% V_2O_5 equivalent. This level of processing represents the far most common form of vanadium transferred by South African mining houses. It is also understood that a market for vanadium exists for an intermediate or slag form of vanadium (at a minimum purity of 10% V_2O_5).

In view of these findings the required notional calculation is completely out of line with industry practice, thereby creating unnecessary notional pricing adjustments. The current specified condition for vanadium also underestimates typical beneficiation, thereby running counter to Government regulatory policy.

III Proposal

It is proposed that two alternate specified conditions for vanadium be created to reflect the current reality of the general South African market for vanadium. The specified conditions for vanadium in its refined state under Schedule 1 will be a minimum purity level of 10% V_20_5 equivalent. The Schedule 2 unrefined condition will still remain available for Vanadium falling below the specified refined condition.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010
