DRAFT RESPONSE DOCUMENT

DRAFT TAXATION LAWS AMENDMENT BILL & TAX ADMINISTRATION LAWS AMENDMENT BILL

Standing Committee on Finance

Presenters: National Treasury and SARS | 15 October 2015

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National Treasury
REPUBLIC OF SOUTH AFRICA

Consultation process

- The 2015 draft Taxation Laws Amendment Bill (TLAB) and draft Tax Administration Laws Amendment Bill (TALAB) were publicly released on 22 July.
- National Treasury and SARS briefed the Standing Committee on Finance (SCoF) on 4 August.
- National Treasury and SARS received written comments from 52 commentators by deadline of 24 August.
- Workshops were held on 2 September for Business Tax and International Tax, on 3 September for Individual Tax and Value-Added Tax and on 4 September for Tax Administration to discuss the proposed amendments.
- SCoF's deadline for written comments was 14 September and oral presentations were made at a hearing that was held on 16 September.
- Further meetings were held after the workshops and the public hearings to discuss specific amendments in more detail.
- National Treasury and SARS today present a draft document to SCoF containing a summary of responses to the comments received on the two draft Bills.

Contents – Main issues raised during consultation process

- The proposed tax amendments contained in the draft TLAB 2015 that received the most comments included:
    1. measures to close loopholes that allow for the circumvention of estate duty,
    2. tax relief for certain collateral transactions,
    3. the alignment of the tax treatment of insurance companies (both short-term and long-term insurers) with the SAM initiative, and
    4. the withdrawal of special foreign tax credits for service fees sourced in South Africa.
- The proposed tax amendments contained in the draft TALAB 2015 that received the most comments included:
    1. procedure when legal professional privilege is asserted,
    2. reduced assessments,
    3. period of limitations for issuance of assessments, and
    4. liability of third party appointed to satisfy tax debts.
- In addition, concerns about the administration of the R & D tax incentive were raised.

TAX POLICY – DRAFT TLAB

Closing loopholes that allow for the circumvention of estate duty

- Some financial service providers have been marketing a scheme to avoid estate duty by transferring assets into a retirement fund immediately before death. This loophole arose due to two previous amendments in 2008 and 2009 to eliminate the maximum age for retirement annuities and after the exemption of retirement fund assets from estate duty.
- The 2015 amendment mitigates the avoidance by including contributions to a retirement fund that did not receive a deduction as a dutiable part of the estate.

- The main concern raised regarding the proposed amendment is that contributions made by members to retirement funds prior this announcement would be affected. It is being argued that this proposal is not aligned with the Davis Tax Committee's recommendation and would prejudice taxpayers who acted based on current law.
- In order to address this concern changes will be made so that the proposed amendments should apply only to <u>contributions that are made after 1 March 2015.</u>

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Tax relief for certain collateral arrangements (1)

- The transfer of collateral in a securities lending arrangement provides the lender with confidence that they will not lose the underlying value of the securities lent to the borrower. The provision on non-cash collateral can take two forms, namely, (i) a pledge (where there will be no transfer of beneficial ownership of the pledged asset from the borrower to the lender and tax implications arise) and (ii) outright transfer (where there will be an out and out cession of beneficial ownership of the ceded asset from the borrower to the lender and such a transaction will attract both Capital Gains Tax (CGT) and Securities Transfer Tax (STT).

- In light of regulatory changes affecting the financial sector and the liquidity levels in that sector, a review of the tax consequences on the outright transfer of collateral was undertaken. The 2015 draft TLAB introduced relief in the form of a deferral of both CGT and STT in respect of outright transfer of collateral provided that this transaction will be returned to the owner within a period of 12 months. This 12 month requirement mirrors the requirement currently available in the Security Transfer Tax Act for securities lending arrangements.

Tax relief for certain collateral arrangements (2)

- Taxpayers are of the view that the limitation of the collateral arrangement to a period of 12 months without the ability to repost the collateral is unduly restrictive. This would have the effect that the <u>outright transfer</u> can only be applied in the context of short term debt and would restrict the ability of banks to benefit from collateral arrangement in order to meet the new regulatory capital requirements.

- It should be noted that the 2015 draft TLAB amendment already moves away from the common law principles that govern ownership and disposals which are the core concepts governing the CGT framework.

- The 12 month period will be retained. This limited relief period is important to ensure that the CGT system is not undermined.

The alignment of the tax treatment of insurance companies with the SAM initiative

- The insurance industry is undergoing changes to its regulatory and financial reporting regime. In 2016, the new Insurance Act will come into force and the Financial Services Board (FSB) will introduce a Solvency Assessment and Management (SAM) framework which will replace the current regulatory regime for short-term and long-term insurers. It is also anticipated that as from 1 January 2018, the standard for insurance contained in International Financial Reporting Standards (IFRS) known as IFRS 4 Phase II will be applied.

- As SAM is not a suitable basis for determining tax calculation, the 2015 amendments proposes changes that is based on IFRS for short term insurers and adjusted IFRS for long term insurers. These measures and practical implications have been discussed with both the FSB and the industry and are acceptable to al parties. Only minor consequential adjustments will be made to the draft Bill.

The withdrawal of special foreign tax credits for service fees sourced in South Africa (1)

- A special foreign tax credit for service fees was introduced in 2011 for withholding taxes imposed on South African residents by foreign countries in respect of service fees from a South African source (i.e. services rendered in South Africa by a South African resident to a foreign resident). These withholding taxes are often imposed by other jurisdictions that were not in accordance with the provisions of tax treaties between South Africa and those countries. This concession - with good intention - was aimed at alleviating the compliance burden on South African taxpayers to apply for a refund of the taxes paid to foreign jurisdictions that were incorrectly imposed.

- However, some taxpayers are abusing this relief by claiming it even for other income streams, such as royalties and interest, that were not intended to be covered by this special tax credit. Further, the Davis Tax Committee Interim Report on *Action 6: Prevent Treaty Abuse* in its discussion of section 6*quin* entitled "*Base erosion resulting from South Africa giving away its tax base*" states that "*South Africa has effectively eroded its own tax base as it is obliged to give credit for taxes levied in the paying country*".

The withdrawal of special foreign tax credits for service fees sourced in South Africa (2)

- The 2015 draft TLAB repeals the special foreign tax credit for service fees. Although taxpayers understand the rationale relating to the repeal of this provision, they, however, strongly oppose the repeal. Taxpayers submit that South African multinationals face serious obstacles when they invest in some African countries as these countries levy withholding taxes contrary to tax treaties. They argue that the relief provided in terms of section 6*quin* mitigates for double taxation faced by taxpayers in doing business with some African countries and is <u>an incentive to help make South Africa attractive as regional service hub</u>.

- Section 6*quin* of the Income Tax Act is a departure from international tax rules and tax treaty principles in that it indirectly subsidies countries that do not comply with tax treaties. South Africa is the only country in the world that provides for this kind of tax concession. The mutual agreement procedure (MAP) available in tax treaties is the appropriate mechanism to resolve disputes of double taxation assist in this regard. As a concession to mitigate double taxation faced by South African taxpayers in doing business with the rest of Africa, amendments will be made in the current provisions of section 6*quat* (1C) to clarify that a withholding tax in a foreign jurisdiction will qualify for a tax deduction but not a tax credit.

Research and Development tax incentive (1)

- KMPG raised concerns about the administration and effectiveness of the R & D tax incentive in their presentation to SCoF on 16 September 2015.

- These include:
  - The incentive should apply as from 1 October 2012 regardless of the date of application,
  - Companies are prejudiced because of administrative delays,
  - There is no recourse mechanism (objection and appeal) if an application is denied,
  - Definition of innovation required – we should not set the threshold to high,
  - Need clarity of the intention of the R & D tax incentive.

Research and Development tax incentive (2)

- The Department of Science Technology (DST) briefed SCoF on 4 August 2015 on progress with the administration of the R & D tax incentive. The DST also mentioned steps that are being taken to deal with the backlog in processing applications for this tax incentive.

- The Minister of Science and Technology hosted a business breakfast on 21 August 2015 to update industry on progress and some of the administrative challenges with the R & D tax incentive. (Yet KMPG did not acknowledge either of these events in their presentation to SCoF on 16 September 2015.)

- The Minister explained the policy objective of the scientific and technological R & D tax incentive as well as the nature of activities that the incentive seeks to encourage. DST used the opportunity to provide a status update and explain the measures that are being put in place to clear the backlog and improve administrative efficiency.

Research and Development tax incentive (3)

- Industry representatives indicated that the design of the incentive, as per the text in the legislation, matches global standards in terms of eligible activities and the exclusions. They appreciated the legislative clarification that was provided with respect to clinical trials and multisource pharmaceutical products and a decision taken by DST to wait for such clarification before processing applications involving these activities.

- The following concerns were raised:
  - A requirement on 'innovativeness' is unnecessary. It presented additional hurdle over and above requirements for undertaking scientific and technological R & D. It was felt that this requirement was interpreted too strictly, setting the bar too high and resulting in some of the activities that would qualify in similar incentive in other countries being rejected in South Africa.
  - It takes too long for applicants to receive a final decision.
  - The interface between SARS and DST should be improved to address uncertainties for approved applicants to successfully claim the deduction.
  - SMEs finds it difficult to access the incentive, particularly where they lack initial funding for their R & D.

Research and Development tax incentive (4)

- In response DST committed that it would continue with the following actions that were already underway to improve administrative efficiency:
  - Introduce a new IT system: An online submission system with back-office improvements will be launched in November. This will replace the paper based application forms.
  - Publish new guidelines (Done late September 2015)
  - Update the information on the DST website: A process has been initiated to draft the webpage layout with DST-Communication.
  - Appoint additional external experts to increase capacity and enable a step change in clearing the backlog.
  - Host a dedicated session for ICT related activities (During November 2015).

- In addition to the actions listed above, the Minister agreed to a suggestion from the floor to establishment a Task Team to review the comments that were raised during the breakfast meeting and make recommendations to the Minister about measures to improve the administration and advance the impact of the R & D tax incentive. It is envisaged that this Task Team will complete its work during the first half of 2016.

Research and Development tax incentive (5)

- Over the three year period (2009/10 to 2011/12) for which reasonably good data is available the estimated tax revenue forgone was R996, R1 153 and R964 million respectively (R3.1 billion over the three years) . These estimates are updated annually as more data becomes available. (See page 134 of the 2015 Budget Review).

- This is an indication that many companies are accessing / benefitting from the R & D tax incentive.

- It should also be noted that an incentive of this nature is intended to encourage additionality – R & D that might not have occurred but for the incentive. Although such an additionality is not always easy to measure / quantify it is an important policy departure point. If the R & D is likely to have happened without the R & D tax incentive there is no or for little to argument for an incentive of this nature.

- Thus the R & D tax incentive is not intended for run of the mill R & D spend, it is not an automatic right.

TAX ADMINISTRATION – DRAFT TALAB

Procedure when legal professional privilege is asserted

- In the context of information requests, interviews and field audits, legal professional privilege is often asserted in respect of information required by SARS. The 2015 draft TALAB provides for a procedure to deal with such assertions.

- Commentators raised the concern that the level of detail required to justify an assertion of privilege would undermine such privilege.

- In order to address the concern the details required have been rationalised and restated.

- Suggestions that the assertions of privilege simply be referred to an independent attorney or the courts have not been accepted, since this would be a more cumbersome mechanism and would not assist SARS in deciding whether or not it agreed with the decision reached and wished to take the matter further.

Reduced assessments

- A provision was inserted to allow taxpayers a less formal mechanism to request corrections to their returns and so obtain reduced assessments. In order to limit the risks associated with this provision the 2015 draft TALAB limited the period during which a request for correction may be submitted from three years to six months from date of assessment, with the possibility of an extension to a year under exceptional circumstances.

- Commentators suggested that this shorter period was inconsistent with the proposed shift to self-assessment and power of SARS to extend the period of limitations for issuance of assessments under certain circumstances.

- In order to address these concerns, the three year period will be maintained. The risk of late requests for correction will be managed internally by SARS while the risk of taxpayers attempting to bypass the objection and appeal process will be addressed by requiring that the request for correction be in respect of a readily apparent and undisputed error.

Period of limitations for issuance of assessments (1)

- A lot of SARS's resources are currently spent on information entitlement disputes, as opposed to conducting the audit within the period that additional assessments, if required, may be issued. This results in insufficient time to ensure SARS has all relevant information at its disposal to ensure correct assessment before the period of limitations expires (prescription).
- Additionally, some matters subject to audit may be so complex that it is impossible to issue assessments before prescription, particularly in the context of audits requiring SARS to consider the application of a general anti-avoidance rule (GAAR), or transfer pricing audits. Transfer pricing audits are fundamental to counteracting the erosion of the South African tax base and the shifting of profits to other jurisdictions.
- The draft 2015 TALAB, therefore, proposes that prescription be extended for a period appropriate to cater for a failure to provide information within a reasonable period, the time required to resolve a dispute as to SARS's entitlement to information or for up to three years if the application of a GAAR, transfer pricing or similarly complex matter is involved. The extension must take place before the existing prescription period comes to an end. Commentators strongly opposed these proposals.

Period of limitations for issuance of assessments (2)

- Concerns were raised with respect to a lack of finality for assessments, lack of clarity as to what an appropriate extension period would be, lack of clarity as to what a similarly complex matter would be and the excessive period of the extension for complex matters.
- The response with respect to the lack of finality is that this is a targeted proposal which responds to taxpayer behaviour and deals with a small number of cases. Taxpayers will be given notice of the extension at least 30 or 60 days before prescription occurs.
- The concern with respect to the extension period for failure to provide information will be dealt with by providing that it will approximate the delay in SARS obtaining the information.
- <u>The concern with respect to a similarly complex matter will be addressed by specifically listing the key matters of concern.</u> These will be (a) the application of the doctrine of substance over form, (b) GAAR, (c) taxation of hybrid entities or instruments and (d) transfer pricing.
- The period of extension for these matters will be shortened to two years in the case of self-assessment, which means the prescription period will be six years in total for SARS assessments and seven years for self-assessments. This is aligned with the seven years applied in Australia and the six or seven years applied in Canada to transfer pricing.

Liability of third party appointed to satisfy tax debts (1)

- A recent case in the High Court with respect to garnishee orders on employees' salaries placed a renewed focus on SARS' powers to appoint third parties, e.g. banks or employers, to pay over monies they hold on behalf of a taxpayer in satisfaction of the taxpayer's tax debts. The current wording of the provision does not provide for a process for the taxpayer to request changing the payment appointment to allow for basic living expense before the amount is paid over to SARS. The draft 2015 TALAB, therefore, proposes that the third party preserves the amount required to be paid over for 72 hours to allow the taxpayer time to approach SARS to do so.

- Commentators, relying on the judgement of the High Court, argued that the power to appoint third parties should be made subject to judicial oversight to be consistent with the Constitution. Banks stated that preserving the amount for 72 hours for the number of third party appointments made was not administrable. Other businesses thought the period was too short.

Liability of third party appointed to satisfy tax debts (2)

- The argument that judicial oversight is required has not been accepted in view of the distinction between civil debts and statutory tax debts. Prior judicial oversight is not required under the Tax Administration Act nor is it required in most jurisdictions with similar powers. The OECD Tax Administration 2015 report on 56 jurisdictions indicates that tax administrations in 50 are permitted to collect taxes from third parties and only one requires a court order to do so.

- The other concerns will be addressed by requiring that a final demand be sent before a third party is appointed. The final demand will set out the consequences of not complying within the time specified, as well as the mechanisms for debt relief, for example by an instalment payment agreement – as already provided for in the Tax Administration Act, or a reduction of the amount to be paid over by the third party based on basic living expenses or, in the case of business, serious financial hardship. Prior notice will not be given if a senior SARS official is satisfied that to do so would prejudice the collection of the tax debt (e.g. risk of dissipation of assets).

Thank you

- Questions