NATIONAL
TREASURY

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAXATION LAWS AMENDMENT BILL, 2012

5 JULY 2012

DRAFT

[W.P. –- '12]

TABLE OF CONTENTS

EXPLANATION OF MAIN AMENDMENTS

1. INCOME TAX: INDIVIDUALS, SAVINGS AND EMPLOYMENT

1.1. ADDITIONAL MEDICAL EXPENSES CONVERTED TO MEDICAL TAX CREDITS

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

I. Background

A. Medical scheme contributions made by individual taxpayers

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

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

All additional medical (e.g. out-of-pocket) expenses potentially qualify for deductions (as opposed to credits). These medical costs include a variety of out-of-pocket costs, such as doctor fees, ancillary services (e.g. nursing costs) and medicines.
Currently, taxpayers of 65 years of age and above are entitled to a full deduction against taxable income in respect of any qualifying medical expenses. Taxpayers below 65 years of age who have a disability or whose spouse or child has a disability, fall into a special category. These taxpayers are entitled to a deduction of all qualifying medical expenses as well as the value of the medical scheme contributions that in aggregate exceed 4 x the credit allowed for medical scheme contributions.
However, taxpayers under the age of 65 (who fall outside the above category) are subject to a floor. More specifically, the taxpayer is entitled to a deduction equal to the aggregate of qualifying medical expenses and the medical scheme contributions in excess of 4 x the allowed credit that exceeds 7.5 per cent of the taxpayer's taxable income.

II. Reasons for change

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

III. Proposal

A. Overview

1

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

B. Taxpayers of 65 years of age and above

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

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

Example:

Jack is 65 years old. For the year of assessment commencing on 1 March 2014, he made contributions to a medical scheme of R2 000 per month on behalf of himself and his wife. By 28 February 2015, he had incurred R20 000 in qualifying medical expenses.

Type of deduction	Expense	Calculation	Value of credit
Standard monthly medical scheme credits	R2 000 p.m. x 12 = R24 000 p.a.	(R230 + R230) = R460 p.m. R460 x 12	R5 520 p.a.
Excess medical scheme fees		(R24 000 – (3 x R5 520)) = R7 440 R7 440 x 33.3%	R2 478 p.a.
All qualifying medical expenses	R20 000	R20 000 x 33.3%	R6 660 p.a.
Total	R44 000		R14 657 p.a.

Therefore, Jack's tax liability for the 2014/2015 tax year would be reduced by R14 657.

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

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

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

Example:

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

Type of deduction	**Expense**	**Calculation**	**Value of credit**
Standard monthly medical scheme credits	R2 000 p.m. x 12 = R24 000 p.a.	(R230 + R230 + R154) = R614 p.m. R614 x 12	R7 368 p.a.
Excess medical scheme fees		(R24 000 – (3 x R7 368)) = R1 896 R1 896 x 33.3%	R631p.a.
All qualifying medical expenses	R20 000	R20 000 x 33.3%	R6 660 p.a.
Total	R44 000		R14 659 p.a.

Therefore, Lerato's tax liability for the 2014/2015 tax year would be reduced by R14 659.

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

Like current law, a separate calculation exists for taxpayers below 65 years of age in the residual category (if the taxpayer, spouse or children are not persons with a disability).

These credits will generally be set at a 25 per cent level. More specifically, these medical credits will be calculated as follows:

- The standard monthly medical scheme credits for the taxpayer, spouse and dependants; and
- 25 per cent credits of the value of the amount by which the aggregate of the medical scheme fees that exceed four times the standard medical scheme credits, and all qualifying medical expenses (other than medical scheme contributions), exceed 7.5 per cent of the taxpayer's taxable income.

Example:

> Curwin is 30 years old. For the year of assessment commencing on 1 March 2014, he made contributions to a medical scheme of R2 000 per month on behalf of himself, his wife, and his child. By 28 February 2015, he had incurred R50 000 in qualifying medical expenses. Curwin's taxable income for the 2015 year of assessment is R200 000.

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

Therefore, Curwin's tax liability for the 2014/2015 tax year would be reduced by R14 659. If Curwin's taxable income was R300 000 for the 2015 year of assessment, he would not be able to claim an additional credit, since 7.5% of his taxable income (R22 500) would exceed his qualifying medical expenses.

IV. Effective date

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

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

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

I. Background

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

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

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

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

II. Reasons for change

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

III. Proposal

In view of the above, non-deductible contributions will be exempt from income tax in respect of retirement interests, regardless of whether these interests are withdrawn as part of a lump sum or by way of compulsory annuity.

The structure of the exemption will be as follows:

1. The exemption will only be available in respect of a compulsory annuity acquired by a person after that person's retirement. Therefore, the exemption will not be available to subsequent holders of the annuity.
2. According to the structure of the Income Tax Act, all non-deductible contributions are aggregated in respect of an individual. Restated, all non-deductible contributions to retirement funds are pooled, and can be applied against a person's retirement interest, regardless of the fund that the interest was withdrawn from.
3. The value of the available aggregated contributions will be reduced by a deduction in terms of section 11(n), the proposed exemption in section 10C, and the deductions in respect of paragraphs 5 and 6 of the Second Schedule. Only the balance of the aggregate non-deductible contributions will be available in the case of the a lump sum, when the tax directive is applied for, and in the case of the section 10C exemptions, and the section 11 deductions, upon assessment.
4. As a default rule, the proposed exemption will apply on a "first come, first serve" basis; therefore, regardless of whether the aggregated non-deductible contributions are applied against a lump sum in terms of paragraphs 5 or 6 of the Second Schedule, in terms of an exemption under the proposed section 10C, or a deduction in terms of section 11(n) against the person's taxable income.
5. Lastly, the exemption will apply regardless of whether the entire retirement interest or only two-thirds thereof was used to purchase the annuity.

<u>Example 1 – one fund contribution, one annuity</u>

Seelan belongs to a pension fund. He has R200 000 in non-deductible contributions accumulated when he retires from the fund. He decides not to take a lump sum, and acquires a guaranteed life annuity with the R1 000 000 retirement interest at retirement. The first R200 000 in annuities received from the living annuity will be exempt from income tax.

<u>Example 2 – two funds, one annuity</u>

Nhlanhla belongs to a retirement annuity fund and a pension fund. His contribution history is as follows:

Year	**Contributed**		**Deducted**		**Balance of non-deductible contributions**	
	PF	**RAF**	**PF**	**RAF**	**PF**	**RAF**
1	100 000	20 000	70 000	10 000	30 000	10 000
2	100 000	20 000	70 000	10 000	60 000	20 000
3	100 000	20 000	70 000	10 000	90 000	30 000
4	100 000	20 000	70 000	10 000	120 000	40 000
5		20 000		15 000		45 000

At the end of year 4, Nhlanhla retires from the pension fund, but continues contributing to the retirement annuity fund. His pension fund retirement interest at the time is R450 000. He takes a lump sum of R150 000, and acquires a living annuity with the 2/3rds (R300 000) remaining.

When he withdraws the lump sum, the balance of the total non-deductible contributions up to date (maximum of R160 000 = R120 000 + R40 000) will be deducted from the lump sum prior to calculating the tax payable in terms of the retirement lump sum tax table.

The result is that no tax is payable (R150 000 less R150 000, with R10 000 in non-deductible contributions remaining).

In year 5, Nhlanhla receives R5 000 in annuity payments. At the end of the year of assessment, a nondeductible contribution balance of R20 000 (R10 000 + R5 000) is available to set off against the R5 000 amount received in annuities.

<u>Example 3 –</u>
Nomfanelo contributes to 2 retirement annuity funds. Her contribution history is as follows:

Year	**Contributed**		**Deducted**		**Balance of non-deductible contributions**	
	RAF1	**RAF2**	**RAF1**	**RAF2**	**RAF1**	**RAF2**
1	10 000	20 000	5 000	10 000	5 000	10 000
2	10 000	20 000	5 000	10 000	10 000	20 000
3	10 000	5 000	5 000	**15 000**	15 000	**10 000**
4	10 000	20 000	5 000	10 000	20 000	20 000
5		20 000		15 000		25 000

At the end of year 4, Nomfanelo retires from retirement annuity fund 1, but continues contributing to retirement annuity fund 2. Her retirement annuity fund 1 retirement interest at the time is R45 000. She takes the full amount as a lump sum. The balance of the total non-deductible contributions up to date (maximum of R40 000 = R20 000 + R20 000) will be deducted from the lump sum prior to calculating the tax payable in terms of the retirement lump sum tax table. The result is that R5 000 is taxable.

IV. Effective date

The proposed amendments are effective for receipts and accruals as from 1 March 2013.

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

[Applicable provisions of the Income Tax Act: Deleting the definition of "formula C" in paragraph 1, and amending paragraphs 2(1)(b)(iA), 2A and 2B of the Second Schedule]

I. Background

A. Current policy

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

B. Current position for private sector funds

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

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

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

- The non-member ex-spouse had to wait until the member ex-spouse exited (as a result of resignation, retiring, or death) the fund in order to have access to the retirement interest assigned in terms of the divorce order; and
- The non-member ex-spouse was not afforded any growth or interest on the amount assigned in terms of the divorce order.

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

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

D. Divorce orders issued before 13 September 2007

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

II. Reasons for change

A. Private sector funds

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

B. The GEPF and other public sector funds

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

III. Proposal

A. Private sector funds

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

B. The GEPF and other public sector funds

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

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

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

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

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

= R509 091 (taxable lump sum)

C. Divorce orders issued before 13 September 2007

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

IV. Effective dates

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

1.4. STREAMLINED TIMING FOR CERTAIN FORMS OF VARIABLE CASH REMUNERATION

[Applicable provisions: Inserting section 7B, substituting section 23E]

I. Background

A. Receipts and accruals as gross income

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

B. Employer deductions

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

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

C. Monthly withholding of employee remuneration

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

II. Reasons for change

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

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

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

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

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

III. Proposal

A. Policy objective

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

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

- Employee-income and employer-deductions for employment-related income.

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

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

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

IV. Effective date

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

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

[Applicable provisions of the Income Tax Act: Amending paragraphs 7 of the Seventh Schedule to the Income Tax Act)]

I. Background

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

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

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

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

II. Reason for change

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

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

III. Proposal

It is proposed that the on-going rental value be utilised as the starting point for fringe benefit taxation if: (i) the employer provides vehicles to employees for business use, and (ii) the vehicle is being rented from unconnected third parties at an arm's length price. This rule is limited to rentals under an operating lease as opposed to a finance lease (i.e. indirect ownership).

In order for the vehicle rental arrangement to be viewed as an operating lease (see the term "operating lease" contained within the ring-fencing provisions relating to finance leases (so as to be excluded)), the lease arrangement must contain the following elements:

- The employer must rent the vehicle from a lessor in the ordinary course of the lessor's business (other than a bank, financial services business or insurer);
- The vehicle may be leased by the general public for a period of less than a month;
- The costs of maintaining the property must be borne by the lessor (including any repairs to the vehicle necessary due to normal wear and tear); and
- The risk of loss or destruction of the property must not be assumed by the lessee.

In the circumstances above, the monthly value of the rental vehicle will be based on the actual costs incurred by the employer (i.e. the rental contract and related costs). These costs can then be reduced for proven business use (i.e. using business-use-over-total-use formula based on the distances travelled).

The cost of fuel is not reflected in the rental value calculation and fuel benefits (via a petro card) can freely be utilised for other vehicles so fuel benefits. Therefore, if the employer bears the cost of fuel (e.g. a petro-card), that taxable benefit must be reflected separately as a travel allowance.

IV. Effective date

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

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

[Applicable provisions: Section 10(1)(gH), section 11(w), and section 23B(5)]

I. Background

A. General

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

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

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

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

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

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

B. Employer deduction of premiums

1. Section 11(w) qualifying policies

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

2. Examples of non-qualifying policies

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

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

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

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

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

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

II. Reasons for change

A. Deduction limitation for employer premiums

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

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

2. Employment-related policies

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

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

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

III. Proposal

A. Deduction in respect of employer premiums

1. General rule

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

2. Employment-event policies

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

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

It must be noted that the fringe benefit rules in respect of employer-provided insurance will also apply to these policies to the extent that the employer is making payments under the policy directly or indirectly for the benefit of the employee or his or her spouse, child, dependant or nominee. Furthermore, pay-outs from the policy will be taxable for the employer upon pay-out except to the extent that the employer was not eligible for deductions when paying premiums in respect of this policy.

B. Taxable linkage for policy pay-outs to employers

1. General rule

The linkage between taxable pay-outs and deductible premiums will be realigned with the initial intention. Under the adjusted regime, the proceeds in respect of an insurance policy held by the employer relating to the death, disability or severe illness of an employee will be exempt if no deduction was previously available in respect of premiums paid or incurred.

2. Transitional rule

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

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

IV. Effective date

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

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

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

I. Background

A. Employer contributions to retirement funds

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

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

B. Deferred compensation policies

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

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

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

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

II. Reasons for change

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

III. Proposal

A. Cession to pension or provident funds

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

B. Cession to a retirement annuity fund

In instances where an employer cedes the policy to a retirement annuity fund that is individually associated with an employee, standard principles would apply (i.e. the explicit inclusion in the employee's income will be removed). Employee fringe benefit treatment would apply as in pre-existing law. Nonetheless, the employer contribution will be deemed to be made by the individual to the retirement annuity fund (again, as under pre-existing law). The net result is a corresponding deduction (thereby being deductible within the R1 750, R3 500 or 15 per cent limits).

C. General policy

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

IV. Effective date

The proposed amendment is effective as from 1 March 2012.

1.8. REVISION OF THE LEARNERSHIP ALLOWANCE INCENTIVE

[Applicable provisions: "registered learnership agreement" definition in section 12H(1), 12H(2)(b) and 12H(6)]

I. Background

The Income Tax Act contains an incentive for employers that conclude learnership agreements with their employees. Under this learnership incentive, employers may claim a deduction in addition to the standard deduction for salary and associated employee costs. This additional deduction seeks to incentivise employers so as to facilitate training and skills development (typically involving new or early entrants to the formal employment sector).

To qualify for the learnership incentive, an employer must register the learnership with the applicable sector education and training authority. The incentive contains two benefits. Firstly, the learnership generates a R30 000 additional allowance for an employer while the agreement is in force. Secondly, an employer obtains another R30 000 additional deduction upon the learner's successful completion.

II. Reason for change

Although the learnership incentive seeks to encourage skills development and employment, the incentive contains certain anomalies that unnecessarily inhibit or reduce the value of the incentive.

- Timing of registration: The additional deduction is available only during the period in which the employer-employee learnership agreement is officially registered with a SETA. However, as a practical matter, registration usually takes a few months due to a variety of reasons (e.g. processing delays between employer and the SETA). This delayed registration means that the value of the incentive is typically reduced.

- Failed learnerships: The incentive does not apply in respect of a learnership if the learner previously failed to complete a prior registered learnership with a similar education and training component. While this information may be available after making a request with the SETA, employers may not be aware of how to access this information and the quality of this information may not be fully reliable (due to the lack of quality inputs from prior employers). Obtaining this information may also slow the process of registration.

III. Proposal

It is proposed that the above hurdles be eliminated or mitigated. More specifically:

- Timing of registration: The registration requirement will be softened. Going forward, learnerships need not be registered from the moment of the learnership agreement's inception. Under the revised rule, a learnership is deemed registered throughout the period of the agreement during the employer's year of assessment if registered within six months after that year of assessment.

- Failed learnerships: The prohibition for failed learnerships will be limited. The main purpose of the prohibition is to prevent an employer from artificially prolonging the incentive by having employees repeat the same training. Therefore, under the revised rule, employers will no longer be required to ascertain information about prior learnerships outside of their control. Learnerships will be forbidden only if the learner failed the same type of learnership under the auspices of the same employer (or associated institution).

IV. Effective date

The proposed amendments will be effective for learnership agreements that are concluded on or after 1 January 2013 in respect of years of assessment commencing on or after that date.

---

2. INCOME TAX: BUSINESS (GENERAL)

2.1. REVISED "SHARE" DEFINITION

[Key provision: section 1("share definition")]

I. Background

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

II. Reasons for change

The revised "share" definition is circular in its reference to "share" and "equity interest". Further the definition appears to cover non-profit entities, even though equity interests do not economically arise in respect of these interests in the traditional sense.

III. Proposal

The definition of share will be revised to eliminate the circularity just described. In the main, the definition will be more closely aligned with the most recent company law definition (see section 1 of the Companies Act, 2008). Hence, a share will now be defined to mean any share or similar proprietary interest in which a (domestic or foreign) company is divided. The definition will also be limited so as not to apply to non-profit entities (e.g. co-operatives or public benefit organisations).

IV. Effective date

Definition applies with effect from 1 January 2013.

2.2. EQUITY SHARE AND HYBRID EQUITY INSTRUMENT DEFINITIONS

[Key provision: Section 1("equity share" definition) and 8E]

I. Background

A. Equity share definition

Under current law, an equity share is any share other than a share that, "neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution." As a practical matter, an ordinary share would typically fall within this "equity share" definition, and preference shares would typically fall outside. The "equity share" definition is important because the existence of "equity shares" is often the basis for various relief provisions (e.g. reorganisation rollovers).

B. Hybrid equity instrument definition

A dividend declared by a company in respect of a "hybrid equity instrument" is deemed to be interest accrued in the hands of the recipient. Interest treatment for a recipient generally means that the amount is taxed as ordinary revenue as opposed to the flat 15 per cent dividends tax rate (or exempt from dividends tax as in the case of company-to-company payments).

Classification of dividends as interest under the hybrid equity instrument definition generally depends on whether the shares qualify as equity shares or fall outside the equity share definition.

- <u>Shares outside the equity share definition:</u> Non-equity shares qualify as hybrid equity instruments if either: (i) the issuer of the share is obligated to redeem the share within three years of the share issue, or (ii) the holder of the share has a right to redeem the share within three years of the share issue.

- Shares within the equity share definition: Equity shares qualify as hybrid equity instruments if these shares satisfy both prongs of a two-prong test. The first prong of the test is similar to the test for non-equity shares. In particular,

    - Equity shares fall within the first prong of the hybrid equity instrument definition if either: (i) the issuer of the share is obligated to redeem the share within three years of the share issue; (ii) the holder of the share has a right to redeem the share within three years of the share issue; or (iii) the issuer of the share will be terminated (or is likely to be terminated) within a three year period.

    - Equity shares fall within the second prong of the hybrid equity instrument definition if either: (i) the dividends in respect of the equity shares do not rank *pari passu* with other classes, or (ii) the dividends are calculated directly or indirectly with reference to a specified rate of interest, an amount of capital subscribed for the share, or a loan or advance made to the issuer by a connected person.

In addition to the above, dividends in respect of any share (regardless of whether the share qualifies as an equity share) will trigger interest treatment if the dividend yield is tied to a financial instrument with an interest-bearing yield (see note in respect of section 8E and 8EA; third party backed shares).

II. Reasons for change

A. Shortcomings of the equity share definition

The current "equity share" definition is problematic. Firstly, the definition no longer links to the company law definition on which the "equity share" definition was initially based because the company law definition does not exist in the new Companies Act. The "equity share" definition also does not cleanly link to commercial practices that separate commonly issued ordinary shares from commonly issued preference shares.

B. Shortcomings of the hybrid equity instrument definition

The basic aspects of the "hybrid equity instrument" definition are unwieldy and confusing. Many of the differences between equity and non-equity shares in terms of a hybrid equity instrument also make little sense in light of the revised definitions of "share" and "equity share". These differences may allow for continued avoidance and create potential traps for the unwary.

III. Proposal

A. Revised equity share definition

It is proposed that the definition of "equity share" be realigned in accordance with common commercial practice. The main attributes of an ordinary share are dividends based on company profits and the perpetual existence of those shares. In short, an "equity share" will be defined as a "share" (under section 1) unless the share has fixed dividend rights or is subject to a right of redemption:

- Fixed dividend rights: A fixed dividend right exists if the dividend is calculated wholly or partly with reference time value of money principles (e.g. specified rates of interest based on the issue price of the shares issued).

- Redemption rights: A redemption right exists if: (i) the issuer of the share is obligated to redeem or otherwise acquire the share in whole or in part, or (ii) the holder has a right to have the issuer redeem or otherwise acquire the share in whole or in part. Alternatively, a redemption right exists if a comparable acquisition obligation/right exists in respect of a company that is a member of the same group of companies as the issuer (i.e. an obligation/right that forces a company within the same group of companies as the issuer to acquire the issuer's shares).

B. Revised hybrid equity instrument definition

With the introduction of the new "equity share" definition as outlined above, the basic hybrid equity instrument definition can be simplified. Under the revised definition, any share will qualify as a hybrid equity instrument (i.e. give rise to dividends treated as interest in the hands of the recipient) if either:

(i) the issuer of the share is obligated to redeem the share within three years of the share issue;

(ii) the holder of the share has a right to redeem the share within three years of the share issue; or

(iii) the issuer of the share will be terminated (or is likely to be terminated) within a three year period.

In addition to the above, dividends in respect of any share (regardless of whether the share qualifies as an equity share) will generate interest treatment if the dividend yield is tied to a financial interest with an interest-bearing yield (see note in respect of section 8E and 8EA; third party backed shares).

IV. Effective date

The proposed amendment in respect of the "equity share" definition will be effective from 1 January 2013. The proposed amendment in respect of the "hybrid equity instrument" definition will be effective for dividends and foreign dividends received on or after 1 January 2013.

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

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

I. Background

A. *Debt versus shares*

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

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

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

B. *Legislative background*

1. Pre-2011 legislation

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

2. Legislation in 2011

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

II. Reasons for change

A. *Hybrid Equity Instruments*

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

B. *Third-party-backed shares*

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

III. Proposal

A. Overview

The proposed regime is again two-fold with both legs essentially aiming at the same concern – holders of debt-like shares that rely on third party balance sheet wholly unrelated to the issuer. In the case of security arrangements, the holder of the debt-like share (typically labeled as a preference share) is looking to debt-bearing financial instrument issued by a third party to indirectly support the preference dividend yield of the issuer. In the case of third-party backed shares, the holder of a debt-like share (again typically labeled as a preference share) is looking to the credit of a third party guarantee (or obligation) to indirectly support the preference dividend yield of the issuer.

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

B. Hybrid shares secured by interest-bearing instruments

1. Basic anti-avoidance rule

The anti-avoidance rule for hybrid shares secured by interest-bearing instruments has a two-pronged trigger. Under the first prong, the dividend yield in respect of the share must be calculated directly or indirectly with reference to a specified rate or interest or the time value of money. Under the second prong, the share must be secured by a financial instrument (i.e. an interest-bearing instrument or one determined with reference to time-value of money principles). Alternatively, the second prong will be satisfied by a negative pledge that achieves the same effect as a direct security (i.e. an arrangement preventing disposal of the financial instrument other than the mere restriction on distributions of the financial instrument by the issuing company).

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

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

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

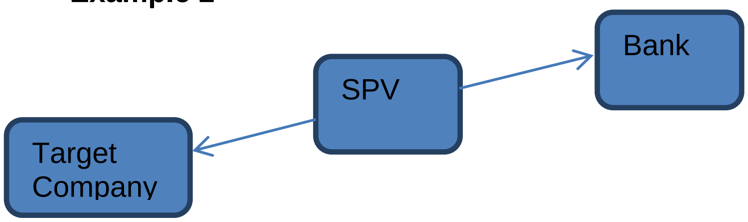
2. Exceptions

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

At its core, the exceptions to the anti-avoidance rule require that the consideration for the share issue somehow relate to the acquisition of equity shares (e.g. ordinary shares) in an active operating company. Under the first exception, the consideration for the hybrid shares issued must be directly or indirectly applied to acquire equity shares in an operating company. Under the second exception, the consideration must be for retiring bridging loans initially used for the same purpose. Under the third exception, the consideration must be for refinancing hybrid shares if the initial hybrid shares were used directly or indirectly to finance the acquisition of equity shares in an operating company. In the case of refinancing arrangement, the consideration for the newly issued hybrid shares cannot exceed the balance outstanding in respect of the original shares (as well as the accrued interest thereon).

Note: No relief from the anti-avoidance rule exists if the preference share consideration is used to acquire ordinary shares in an operating company that is part of the same group of companies as the issuer. This limitation is meant to avoid possible artificial cash injections to a process related member of the group.

Example 2



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

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

Example 3

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

Company plus the bank account that collects the ordinary share dividend proceeds (plus the interest thereon).

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

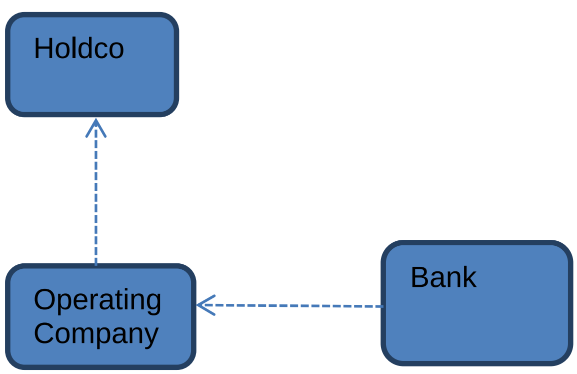
A. Shares backed by third-party guarantees

1. Basic anti-avoidance rule

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

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

Example 1



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

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

2. Exceptions

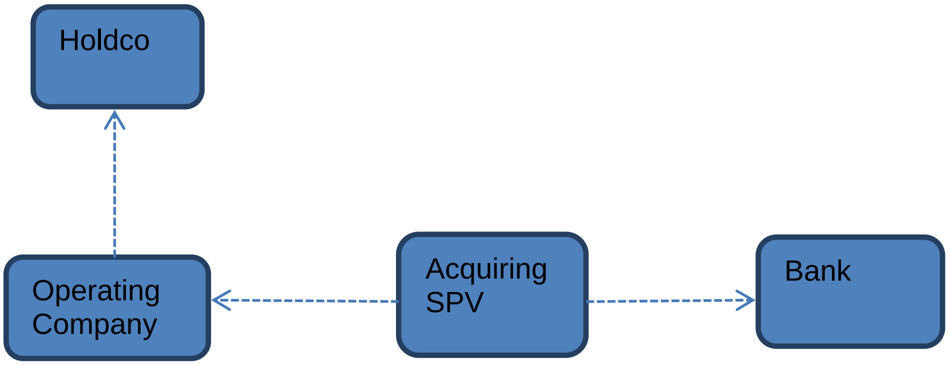
As stated above, shares guaranteed by third parties may avoid the anti-avoidance rule if the consideration for the issue of the shares is applied directly or indirectly for the purpose of acquiring equity shares of an operating company. This exception recognises the need for (preference) share financing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

At its core, the exceptions to the anti-avoidance rule require that the consideration for the (guaranteed) share somehow relate to the acquisition of equity shares (e.g. ordinary shares) in an active operating company. Under the first exception, the consideration for the (guaranteed) shares issued in exchange therefore must be directly or indirectly applied to acquire equity shares in an operating company. Under the second exception, the consideration must be dedicated to retiring bridging loans used for the same purpose of acquiring equity shares in an operating company. Under the third exception, the consideration must be dedicated to refinancing (guaranteed) shares initially used to finance the acquisition of equity shares in an operating company (or to retire bridging finance used for the same initial purpose). In the case of a refinancing arrangement, the consideration for newly issued hybrid shares cannot exceed the balance outstanding in respect of the initial (guaranteed) share interest (and the accrued interest thereon).

If the exceptions apply, the exceptions allow for a variety of third party guarantees/obligations. The guarantees/obligations can initially come from a qualifying holder of the issuer or a controlled subsidiary of the issuer. The guarantees/obligations can also come from the acquired operating company (that is the object of the financing), a qualifying holder of the operating company or a controlled subsidiary of the operating company. Lastly, the guarantees can come from an intermediary of a share issuer where the consideration is applied to acquire the same operating company shares as the initial issuer (and to qualifying holders of the intermediary issuer or a controlled subsidiary of the intermediary issuer). For purposes of these rules, a qualifying holder must own at least 20 per cent of the company at issue; a controlled subsidiary must be 70 per cent owned by the company at issue (and the parent controlling company of the controlled subsidiary must be subject to the same or a higher level of guarantees/obligations than the controlled subsidiary).

Note: No relief from the anti-avoidance rule exists if the preference share consideration is used to acquire ordinary shares in an operating company that is part of the same group of companies as the issuer. This limitation is meant to avoid possible artificial cash injections to a related member of the group.

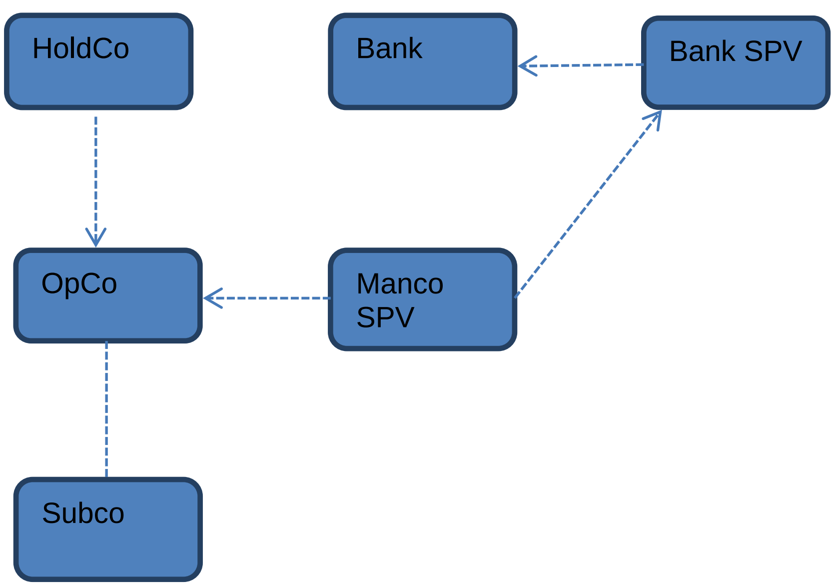
Example 2:



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

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

Example 3



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

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

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

Results: At the outside, the preference shares issued by Bank SPV may be adversely impacted by the anti-avoidance rule because of the multiplicity of third party guarantees (by Bank, Manco SPV, Holdco, Opco and Subco). However, because the consideration was ultimately used for the share acquisition of a certain percentage of Opco's ordinary shares, the exceptions apply. This relief allows the parties to disregard Manco SPV's guarantee (the other issuer) and the Opco (the operating company). Holdco (holder of Opco) and Bank (holder of issuer) are qualifying holders so these entities can also be disregarded. Lastly, Subco can be disregarded because Subco is a controlled company for OPco and does not face greater restrictions than Holdco.

IV. Effective date

The proposed amendments apply to dividends received or accrued on or after 1 October 2012 in respect of years of assessment commencing on or after 1 October 2012.

2.4. INTRODUCTION OF THE "DEBT" DEFINITION

[Applicable provisions: Section 1 ("debt definition"]

I. Background

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

II. Reasons for change

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

III. Proposal

It is proposed that all the various concepts which seek to define debt and related concepts (e.g. debt instruments, loans etc…) be unified within a single definition. Under the revised formulation, a debt will simply be defined as "any amount owing to or by a person."

IV. Effective date

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

2.5. ANTI-HYBRID DEBT INSTRUMENT RECHARACTERISATION RULES

[Applicable provision: Sections 8F]

I. Background

A. Overview

In the area of corporate financing, there are three basic sources of finance – equity, debt and retained profits. For commercial purposes, debt and equity are the key sources of external finance. As a general matter, debt is redeemable with a yield based on the time value-of-money (e.g. interest); payment obligations have no regard to the performance of the debtor company (i.e. are required without regard to profits or cash available). On the other hand, equity is typically non-redeemable with the yield (i.e. dividends) depending on the performance of the company (i.e. profits); payment obligations are discretionary or can be deferred.

For tax purposes, interest on debt is generally deductible in the hands of the payor (e.g. if incurred in the production of income) and included in the hands of the recipient. On the other hand, dividends are not deductible by the payor nor are they includible in the hands of the shareholder. However, dividends may be subject to the Dividends Tax.

B. Hybrid Instruments

Current law contains anti-avoidance rules that deal with hybrid debt instruments (i.e. debt instruments with equity features) as well as hybrid equity instruments (equity instruments with debt features). In the case of hybrid debt instruments), the anti-avoidance rules seek to re-characterise interest as dividends in the hands of the payer. However, the instrument otherwise remains a debt instrument for all other purposes of the Income Tax Act (including interest treatment for amounts received by the payee).

This recharacterisation potentially occurs when: (i) the debtor is obliged to convert the instrument to shares, (ii) the issuer has an option to convert the debt instrument to shares, (iii) the issuer can force the holder to reinvest in shares, or (iv) the holder has a deep-in-the money right of conversion. However, for this recharacterisation to apply, the conversion obligation or right must be exercisable within a three-year period from date of issue.

II. Reasons for change

When determining the debt versus equity character of an instrument, it is widely believed that most of the tax law follows form. This focus on form seemingly provides taxpayers with the freedom to choose a label for an instrument with consequential tax benefits without regard to (economic) substance. This freedom poses a risk to the fiscus because certain taxpayers consistently choose a combination of features that bring about unintended tax benefits. The key driver for this form of tax planning is for the issuer to obtain an interest deduction for payment.

When making payments to exempt persons, taxpayers have even a greater tendency to classify share-type instruments as debt in order to obtain an interest deduction, knowing the recipient is exempt. In this instance, the debt label is commercially neutral for the taxpayer, but the result is negative for the fiscus because there is no matching of deductions with inclusions.

While anti-avoidance rules exist as outlined above for debt conversions, taxpayer artificial classifications go beyond the use of mere conversion features. For instance, an instrument lacking a maturity date for repayment is a strongly questionable form of debt. Moreover, even the conversion focus presently existing within the hybrid debt rules is too narrow, being limited to a three-year period.

III. Proposal

A. Overview

In order to reduce the scope for the creation of equity that is artificially disguised as debt, a two-fold regime is proposed. One set of rules focuses on features relating to the nature of the instrument itself (i.e. the corpus); the second set of rules focuses on the nature of the yield. In making these rules, it is understood that the features distinguishing debt from equity are varied. Nonetheless, the proposal takes aim at domestic companies that issue stated debt instruments so as to artificially generate interest deductions. The proposal will recharacterise debt as equity only if the instruments at issue have clear-cut equity features. In this respect, the proposal focuses on debt-labeled instruments that:

(i) have features indicating that redemption is unlikely within a reasonable period; or

(ii) have features requiring a conversion into shares.

In terms of decisive features focusing on yield, the focus is on the contingent nature of the yield involved. A debt yield is based on time value of money external to the company issuer with an equity yield being contingent on a variety of factors, such as company profitability, liquidity and solvency.

If the focus relates to the debt instrument itself, the debt instrument will be treated as a (non-equity) share for all purposes of the Income Tax Act. In this scenario, the full yield associated with the instrument will be treated as distributions (for purposes of the payor and payee) over the life of that instrument, and the disposal of the instrument will be treated as a disposal of shares. If the focus relates solely to the yield, only the yield at issue will be treated as a distribution.

Lastly, the proposed regime will contain some exceptions to the above recharacterisation. These exceptions include an exception for small business, certain banking capital and transitional relief for property companies.

B. Instrument recharacterisation

1. <u>Redemption features</u>

A key feature of debt is the holder's ability to redeem the capital amount loaned within a reasonable period. If the holder of the instrument lacks this ability to redeem the capital amount within a reasonable period, the instrument will be treated as a non-equity share for all purposes of the Income Tax Act. In order to breach this standard, the debt instrument issued by a company (taking into account all related agreements) must have one of the following features:

(i) The instrument (i.e. the corpus) is not fully redeemable or is fully redeemable only at the option of the issuer;

(ii) The instrument (i.e. the corpus) is fully redeemable only after a period that exceeds 30 years from the date of issue; or

(iii) On a balance of probabilities, the instrument (i.e. the corpus) will not be fully redeemed within a period of 30 years; or

(iv) Repayment of any portion of the instrument (i.e. the corpus) is subject to the solvency or liquidity of the issuer.

2. <u>Conversion features</u>

For commercial reasons, convertible debt instruments may be preferred by investors as opposed to straight debt. Investors in this scenario effectively sacrifice some of the interest yield in exchange for an upside stake in potential growth. . This conversion feature for shares effectively achieves these aims and should not be viewed as an anti-avoidance technique or as a non-commercial transaction.

On the other hand, an obligatory conversion feature or a conversion feature in the hands of the issuer is problematic. A genuine debtor does not have a choice of switching to equity if unable or unwilling to pay. In that vein, the basic aspects of the current anti-hybrid rules will be retained without the three year rule. More specifically, to trigger the anti-hybrid rules, a debt instrument issued by a company (taking into account all related agreements) must have one of the following features:

(i) The instrument (or part thereof) is automatically convertible (or convertible at the option of the issuer) into the shares of the issuer (or another company within the same group of companies as the issuer);

(ii) The issuer is obligated (or has the option) to repay the instrument (or part thereof) with shares of the issuer (or another company within the same group of companies as the issuer); or

(iii) The holder has an obligation to exchange the instrument for shares, or to re-invest any portion of the instrument repayment proceeds into shares, of the issuer (or another company within the same group of companies as the issuer).

3. Impact of recharacterisation

If an instrument is recharacterised by virtue of the lack of redemption features, the existence of conversion features or by virtue of the shareholder nature of the instrument, the instrument will be fully reclassified as (non-equity) shares. As a result, stated interest in relation to the instrument will be treated as a distribution in the hands of the payor as well as the payee. The net result is no deduction for the payor and no inclusion in the hands of the payee with the payment often becoming subject to the Dividends Tax if the distribution is akin to a dividend. Repayments or disposals in respect of these instruments will be treated as repayments or disposals in respect of shares.

C. Yield recharacterisation

In some circumstances, the debt/equity recharacterisation will focus on the yield without converting the instrument in total. The net result will be to treat the particular yield at issue as a distribution without converting the instrument as a whole (or even without converting other yields that lack equity features). In order to breach this standard, the yield at issue (taking into account all related agreements) must have one of the following features:

(i) The yield is not determined with reference to time-value-of-money principles (e.g. instead being based on company profits);

(ii) The timing of payment is subject to the liquidity or solvency of the issuer of the instrument; or

(iii) The yield is payable in shares.

If a particular yield is recharacterised, that yield will be deemed to be a dividend. As a result, the payor may not deduct the yield, and the dividend is exempt from normal tax in the hands of the recipient (but the dividend is generally subject to the Dividends Tax). The instrument itself will retain its debt characterisation (unless otherwise tainted) and other payments will have to be tested separately for debt/equity recharacterisation.

D. Exemption from the re-characterisation rules

The anti-hybrid rules will be subject to certain exemptions as a matter of policy. In particular, exemptions will exist for small businesses and banks.

1. Small business relief

Small businesses will not be subject to the hybrid recharacterisation rules. In most cases, the differences between debt and equity have little overall impact on the fiscus, and it is understood that very small businesses utilise shareholder levels so as to exploit the de minimis exemption for interest. In recognition of these concerns, a company is not subject to the hybrid instrument rules if either: (i) the total gross asset value of the company does not exceed R10 million, or (ii) the company does not general more than R14 million of gross income in respect of the relevant year of assessment.

2. Bank capital relief

Banks often issue various forms of capital, including Tier I (straight equity) and Tier II (debt with equity features) capital. Increased pressure is being placed on the banks to increase these forms of capital via the international banking Basel standards. While it is understood that certain forms of Tier II capital will probably be in violation of the hybrid recharacterisation rules, these rules will be waived for Tier I and Tier II capital so as not to place further pressure on the cost of banking capital given the global regulatory uncertainties in this regard. This area will be subject to review but care will be taken to ensure that unnecessary pressure is not added to banks so as to undermine liquidity needed for local financing.

IV. Effective dates

The proposed hybrid instrument recharacterisation rules will come into effective in the case of amounts received, accrued, paid or incurred on or after 1 January 2014. The regime is being delayed for one year so as to provide taxpayers with time to re-arrange their affairs.

V. Special considerations involving immovable property companies and hedge fund companies

A number of listed property companies (known as property loan stock companies) offer linked units containing a debenture and a share. The debenture element represents almost all of the value of the unit so as to allow for alleged deductible interest payments by the company. The debenture typically requires payment of this alleged interest based on net rental income.

It is also understood that a number of unlisted immovable property companies have undertaken the same structure.

The above dual linked structure is a clear example of equity disguised as debentures. While this structure must be recharacterised as a general matter, it is understood that immovable property companies used as investment vehicles often operate as a conduit internationally, and the debenture mechanism effectively accomplishes this result. With these concerns in mind, a Real Estate Investment Trust (REIT) regime is being proposed to conform to international standards (see notes on REAL ESTATE INVESTMENT TRUSTS). This REIT regime should be in place by 2014 when the hybrid recharacterisation rules come into effect. The proposed REIT regime will cover listed REITs and controlled subsidiaries of listed REITs. Other forms of immovable property entities still must be considered after further consultation.

Similar issues also exist in the case of certain hedge funds. Certain hedge funds that operate as a company provide units in the form of debt to investors. The yield from this debt mimics the allocable profits of the hedge fund offered to investors. The debt label for this form of investment is designed so as to mimic conduit flow-through treatment (i.e. by creating deductible interest for the hedge fund and corresponding income for the investor). Like the REIT, this regime needs to be replaced with a more formalised arrangement, which will depend on the creation of a more regulated environment. All of these issues will require consultation before the 2014 effective date of the newly proposed anti-hybrid debt rules.

2.6. SUSPENDED DEDUCTIONS FOR INTEREST/ROYALTIES PAID TO EXEMPT PERSONS

[Key provision: Section 23L]

I. Background

The tax system largely operates on a receipt or accrual basis, meaning that expenditures are deductible when those expenditures are paid or incurred. On the deduction side, if expenditures relate to a benefit to be received over a period of more than one year, the expenditure is spread over the period of the benefit. Royalties fall squarely within this paradigm. Interest deductions arising from debt instruments is spread on a similar basis, but this spreading takes the impact of compounding into account (i.e. involves a yield-to-maturity calculation).

II. Reasons for change

The receipt/accrual and payment/incurral paradigm is largely symmetrical, thereby ensuring overall neutrality for the tax system. However, the payment/incurral paradigm can become problematic if payment/incurral is made by a taxpayer for the benefit of an exempt person. In the case of royalties and interest, cross-border payments are also problematic because (under the system as revised) foreign payees will be subject to withholding only when the amount at issue is paid or becomes payable.

This potential room for mismatch provides certain taxpayers with the opportunity to accelerate deductions without actually being forced to make payment until a much later date. In the area of interest, this potential for mismatch encourages the use of pay-when-you-can or payment-in-kind loans. In either case, an accelerated deduction may be possible before payment is made or required. Even assuming the underlying instrument qualifies as genuine debt, this accelerated deduction places the tax system at risk due.

III. Proposal

In view of the above, it is proposed that deductions incurred in respect of a loan or the use of intellectual property will be suspended until the amount of interest is paid or becomes payable. This proposal will apply to all payments or amounts owing to parties who are exempt from normal tax, even if these persons are subject to (e.g. interest and royalty) withholding tax.

> **Example 1:**
> ***Facts:*** Pension Fund advances a three-year R10 million loan to Financial Institution. Interest is charged at JIBOR + 2% per annum. Interest is cumulative and is only payable at the end of the loan term of three years (together with the capital amount).
>
> ***Result:*** Under section 24J, interest is normally deductible during the each of the three years as the interest is compounding. However, the deductions arising from the interest incurred by Financial Institution are suspended until payable in the third year because the payee (i.e. Pension Fund) is exempt from normal tax.
>
> **Example 2:**
> ***Facts:*** Foreign Parent owns all the shares of South African Subsidiary. Both companies have entered into a five-year licensing agreement. Under the agreement, South African subsidiary owes R10 million per annum in exchange for the use of a franchise for local South African operations. However, payment is required only at the sooner of the date when the franchise is profitable (at a rate not exceeding 20 per cent of the profits) but no later than the close of the five-year period.
>
> ***Result:*** Although South African Subsidiary would normally be allowed to deduct the licensing fee over the five-year period (i.e, at R10 million per annum), the deductions are suspended because the payee (i.e. Foreign Parent) is not subject to normal tax. This suspension lasts until the amount is paid (or becomes payable).

IV. Effective Date

The proposed amendment will be effective for amounts incurred on or after 1 January 2013.

2.7. QUALIFYING INTERESTS IN ASSET-FOR-SHARE REORGANISATIONS

[Key provision: Section 42 (1) (“qualifying interest definition)]

I. Background

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

II. Reasons for change

The 2011 Taxation Laws Amendment Act amended the threshold in respect of the participation exemption (which provides tax exemptions for qualifying resident companies in respect dividends and capital gains derived from foreign company shares held by those resident companies). More specifically, the minimum threshold was reduced from 20 per cent down to 10 per cent. This amendment aligns the threshold with international norms and for related cross-border issues (e.g. the test for deemed inclusions in respect of controlled foreign companies and in respect of Exchange Control). The initial 20 per cent threshold for the participation exemption was aligned with the 20 per cent threshold for asset-for-share rollovers.

III. Proposal

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

As a side matter, unbundling transactions are not permitted if disqualified persons (and their connected persons) hold 20 per cent or more of the unbundled company shares immediately after the distribution. Disqualified persons include certain foreign and exempt persons. This 20 per cent threshold was tied to the asset-for-share threshold so this threshold should also be reduced to 10 per cent.

IV. Effective date

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

2.8. SHARE-FOR-SHARE RECAPITALISATIONS

[Key provision: Section 43 and paragraph 78 of the Eighth schedule]

I. Background

Company restructurings come in a variety of forms. Company reorganisations typically involve two or more companies seeking to acquire, liquidate, merge or unbundle with the main consideration entailing the issue or redemption of shares. Reorganisation transactions of this nature are often eligible for rollover relief (i.e. deferral or gains and losses) under Part III (i.e. section 41 through 47) of the Income Tax Act.

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

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

II. Reasons for change

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

III. Proposal

A. Share recapitalisations

It is proposed that the capital gain rules applicable to share-for-share recapitalisations be replaced in favour of a new regime. Under the revised regime, rollover treatment will apply to shares held as capital assets as well as shares held as trading stock. However, this rule will not apply in respect of share-to-debt conversions and in respect of share-for-share transactions that involve non-equity shares (shares with certain preference features).

In this regard, roll-over relief will be provided for share-for-share transactions. However, to the extent that any party to the share-for-share transaction receives other consideration in addition to shares (e.g. cash and debt), this other consideration will be taxable. In the main, the new recapitalisation rules will otherwise fall within the same paradigm as the pre-existing reorganisation rules (e.g. being subject to the same restraints as the proposed share mismatch rules and the general anti-avoidance rules).

B. Note on conversions

The revised recapitalisation rules will incorporate share-for-share transactions associated with the conversion of a close corporation to a company and the conversion of a co-operative to a company (as did the prior recapitalisation rules). These transactions technically give rise to disposals at a shareholder level. These transactions do not appear to trigger gain or loss of assets at the company-level for a variety of reasons (note: if a conversion does trigger asset disposals at a company-level, section 44 would still be available as the basis for taxpayer relief.

IV. Effective date

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

2.9. VALUE MISMATCHES INVOLVING SHARE AND DEBT ISSUES

Applicable provisions: Section 24B , 24BA, 24BB, 40CA and 41(2); paragraph 1 (“value shifting arrangement” definition), paragraph 11(1)(g), paragraph 13(1)(f) of the Eighth Schedule, and paragraph 23(b)(ii) of the Eighth Schedule.

I. Background

A. The issue of shares for assets

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

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

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

B. Value shifting anti-avoidance rules

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

C. The issue of debt for assets

In addition to share financing, companies can finance the acquisition of assets through the issue of their own debt. This issue is tax-free from the perspective of the company issuer, and this use of debt has always been viewed as expenditure incurred (thereby providing the asset with a full tax cost when acquired by the company). On the other hand, taxpayers disposing of assets to a company in exchange for a debt issue generally realise capital gain or loss in respect of capital assets (and ordinary revenue or loss in the case of trading stock assets).

II. Reasons for change

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

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

III. Proposal

C. Share issue mismatches

1. Tax charge stemming from share issue mismatches

It is proposed that the value-for-value principle applicable in respect of all asset-for-share exchanges should be clarified by legislation. In this regard, value mismatches involving shares will explicitly give rise to tax in the hands of the party receiving a benefit regardless of whether or not connected persons are involved. History has shown that the avoidance of concern can be achieved without regard to whether formal "connected persons" are involved.

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

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

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

If a company issues shares to acquire assets, the assets will generally have a tax cost (i.e. are viewed as having an expenditure incurred) equal to the value of the shares issued. On the other hand, if the share issue is part of a Part III rollover transaction, the assets will generally have a tax cost in the hands of the company equal to the tax cost previously held by the asset transferor.

- The tax cost of assets received by the company stemming from either transaction is "increased" to the extent that the company has any gain due to the excess value of the assets contributed for the share issue.

- The tax costs of the assets received by a company from either transaction is "decreased" to the extent that a deemed dividend arises due to the excess value of the shares issued.

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

- The tax cost of the shares received by the transferor stemming from either transaction is “decreased” to the extent that the company issuer has any gain due to the excess value contributed.

- The tax cost of the shares received by the transferor from either transaction is “increased” to the extent that a deemed dividend arises due to the excess value of the shares issued by the company issuer.

Example 1
Facts: X transfers capital assets with a market value of R1 million to Company ABC. As consideration for these assets, Company ABC issues 10 000 shares (with a market value of R40 per share (i.e. shares with a total value of R400000)) to X. These assets will be held as capital assets in the hands of Company ABC.

Result:
Tax charge: The market value of the assets disposed of by X exceeds the market value of the shares issued by Company ABC. Company ABC will realise capital gain of R600 000 (i.e. difference between the R1 million market value of assets transferred and the R400 000 share value received).

Tax costs: Company ABC will be deemed to have a tax cost equal to the value of the shares issued plus the gain realised by Company ABC. Hence, the total tax cost is R1 million (R400 000 expenditure deemed incurred plus R600 000 of gain realised). On the other hand, X will be deemed to have a tax cost equal to the market value of the assets transferred (i.e. the expenditure incurred), decreased by the gain realised by Company ABC (R1 million less R600 000). In the end, X will have a tax cost of R400 000 in the shares.

Example 2
Facts: Y transfers capital assets with a market value of R1 million to Company DEF. As consideration for these assets, DEF issues 10 000 shares (with a market value of R120 per share (i.e. shares with a total value of R1.2 million)) to Y. The assets will be held as capital assets in the hands of Company DEF.

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

Tax costs: Company DEF will be deemed to have a tax cost in the assets received equal to R1 million (the R1.2 million shares issued (i.e. the expenditure incurred), reduced by the R200 000 deemed dividends). Y will be deemed to have a tax cost of R1.2 million (the R1 million value of assets transferred plus the R200 000 deemed dividend).

D. Debt issue mismatches

Like the rules for share issue mismatches, it is proposed that the value-for-value principle applicable in respect of all asset-for-debt exchanges should be clarified by legislation. In this regard, value mismatches involving the issue of debt will give rise to tax in the hands of the party receiving a benefit regardless of whether or not connected persons are involved.

- If the market value of the asset disposed of by the transferor exceeds the market value of the debt issued, the company issuer will be subject to an additional level of ordinary or capital gain. The character of this additional gain will be treated as ordinary revenue.

- If the company issues debt that have a market value that exceeds the assets received in exchange, this excess amount will be deemed to give rise to ordinary revenue (i.e. gross income) in the hands of the transferor.

The tax cost adjustment rules are the same as those for share issue mismatches. Adjustments will be required for both the debts issued and for the assets transferred.

E. Continuation of the value shifting anti-avoidance rules

In light of the new anti-avoidance rules to prevent share and debt value mismatches, the current value shifting anti-avoidance rules can be narrowed. The value shifting rules will no longer apply in respect of companies but will continue in respect of trusts and partnerships.

IV. Effective date

The new section 24B to come into effect on 1 January 2013 and will be applicable in respect of disposals on or after that date.

2.10. DEBT-FINANCED ACQUISITIONS OF CONTROLLING SHARE INTERESTS

[Key provisions: Sections 23K and 24O]

I. Background

A. General deduction formula

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

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

B. Indirect share acquisitions

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

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

II. Reasons for change

Under the current paradigm, a practical dichotomy exists. Interest deductions associated with debt-financing of direct share acquisitions are not deductible while indirect debt-financing via section 45 are allowed. These indirect share acquisitions have been formally accepted in the tax system as an acceptable mode of tax deductible financing as long as this financing is contained (see section 23K). Therefore, no reason exists to deny interest-deductions associated with direct share acquisitions occurring under similar circumstances. To force an indirect share acquisition in all instances is to effectively add unnecessary transaction costs.

III. Proposal

A. Overview

A special deduction will be added for interest incurred if that interest is associated with debt used to acquire controlling share interests and the acquisition is comparable to those indirectly allowed for indirect share acquisitions. In essence, these interest deductions will be allowed against acquiring company income when the underlying debt is used to acquire controlling share interests (i.e. equity shares) in a target company. Control will be defined within the context of the “controlled group of companies” definition. These deductions will be allowed as long as the target company remains within the same group of companies as the acquiring company.

The net impact of this regime will leave taxpayers with two options when acquiring controlling share interests in a target company. The parties can continue to utilise the indirect share acquisition technique for debt-financing or the newly added regime for direct debt-financing.

The indirect option continues to allow for interest to be deducted against target company income. The direct option will now allow for interest to be alternatively deducted against acquiring company income.

The proposed regime will mainly apply to wholly domestic acquisitions because the current indirect route is allowed only within the domestic context.

B. Anti-avoidance limits

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

IV. Effective date

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

2.11. DEBT REDUCTIONS FOR LESS THAN FULL CONSIDERATION

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

I. Background

A. General

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

B. Ordinary revenue

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

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

2. As a secondary matter (i.e. if the debt relief does not trigger a reduction in losses), the Income Tax Act provides for a recoupment or a recovery equal to an amount by which an obligation to make payment is wholly or partially relieved. As with the rule for loss

reductions, this result applies only if the obligation gave rise to an expenditure or allowance that was previously allowed as a deduction.

C. Capital Gains Tax

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

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

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

II. Reasons for change

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

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

III. Proposal

A. Dual system overview

A uniform system is proposed that will address debt relief (i.e. debt reductions or cancellations for less than full value consideration) resulting from the debtor's inability to pay. This uniform system will cover both the rules relating to ordinary revenue and the rules relating to capital gains.

B. Ordering rules

1. <u>Current paradigm</u>

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

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

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

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

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

2. <u>Proposed ordering rules</u>

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

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

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

- If the debt reduction or cancellation falls outside of all of the above paradigms (i.e. is not a donation, a bequest or a taxable employer-employee fringe benefit or within the ordinary paradigm), the debt reduction or cancellation will be taken into account in terms of the capital gain rules.

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

3. Debt previously incurred in respect of depreciable assets

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

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

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

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

Example 2
Facts: Company Y borrows R3.5 million. Company Y applies all of the borrowed funds to acquire a plant. Company Y depreciates the plant by R3 million, leaving R500 000 of base cost (R3.5 million less the R3 million of depreciation). The lender subsequently cancels R3 million of the debt.

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

C. "Capital" debt relief

1. Two-tier system

As discussed above, proposed "capital" treatment for debt reductions and cancellations will apply as long as the initial debt was not used to finance deductible expenditure or allowances (and as long as the debt is not viewed as a donation, a bequest or a fringe benefit). Capital treatment will have the following two-tier impact:

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

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

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

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

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

2. Special relief for cancelled tax debts

Reduced or cancelled tax debts can only impact the base cost of assets so held. For instance, the tax at issue may be an indirect tax that was taken into account upon acquisition of an asset. The proposed capital loss reduction rule, however, will not apply in respect of tax debts reduced or cancelled by SARS in respect of taxes otherwise due. Reduced or cancelled tax debts of the latter nature are too remote to justify any further tracing. The net effect is to eliminate the reduction or cancellation of tax debts associated with income tax and other taxes that bear no direct connection with asset acquisitions.

3. Pre-existing rules

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

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

Example 1
Facts: Taxpayer purchases intellectual property for R5 million and pays the seller in cash (borrowed from the bank). Due to unforeseen circumstances, the intellectual property is worth less than the purchase price so the seller refunds R600 000 to the purchaser pursuant to the initial sales contract.

Result: The R600 000 refund results in a base cost reduction of R600 000 under the general rule. If Taxpayer sells the intellectual property before the purchaser provides the refund, the R600 000 refund results in capital gain.

Example 1
Facts: The facts are the same as EXAMPLE 1, except that the bank reduces the debt by R600 000 as part of a debt work out.

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

D. "Ordinary" debt relief

1. Three-tier system

As discussed above, proposed "ordinary" treatment for debt reductions and cancellations will apply as long as the initial debt was used to finance deductible expenditure or allowances (but only as long as the debt is not viewed as a donation or a bequest). Ordinary treatment will have the following three-tier impact:

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

- Reduction of assessed losses: If the debt reduction or cancellation is viewed as falling within an ordinary paradigm and the amount cannot be traced to trading stock so held (or the cost price in the trading stock is fully depleted to zero), the excess reduction or cancellation will be applied against the balance of any assessed losses that the debtor may have.

- Ordinary revenue or recoupment: Lastly, if the debt reduction or cancellation is viewed as falling within an ordinary paradigm and the amount falls outside the cost price and balance of assessed loss reduction rules, any residual will be viewed as giving rise to ordinary revenue.

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

Example 1
Facts: Company X owes debt of R1 million. The trading stock held by Company X has a cost price of R400 000, and Company X has assessed losses of R350 000. Company X's creditors discharge all R1 million of the debt owed due to Company X's inability to pay. Of the debt owing, R400 000 stems from trading stock currently held and R150 000 stems from previously held trading stock.

Result: The amount of the discharged debt (R1 million) will first be applied to reduce the cost price of the trading stock (R400 000) to zero. The remaining amount (R600 000) will be applied to eliminate the balance of assessed losses (R350 000). The residual (R250 000) will be included in the income of Company X as ordinary revenue.

Example 2
Facts: Company Y owes debt of R1 million. Company Y owns an industrial lot with a warehouse. The lot cost R220 000 and the warehouse structure cost R350 000 with both amounts funded from current debt. To date, Company Y has claimed R280 000 of depreciation in respect of the warehouse, leaving a base cost of R70 000. Company Y has ordinary assessed losses of R600 000.

Company Y's creditors cancel R750 000 of the debt owed as part of an informal debt workout.

Result: In respect of the total debt cancelled, the base cost of both the lot and the warehouse (i.e. remaining base cost R290 000) will be reduced to zero, leaving R410 000 of debt reduction to be accounted for (R700 000 less R290 000). Assuming the remaining debt reduction of R410 000 was previously applied to fund deductible operating expenses, Company's balance of assessed losses will be reduced from R600 000 down to R190 000.

2. <u>Pre-existing rules</u>

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

IV. Effective date

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

2.12. REPEAL OF ANTI-AVOIDANCE FOR THE TRANSFER OF DEPRECIABLE ASSETS BETWEEN CONNECTED PERSONS

(Section 23J of the Income Tax Act)

I. Background

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

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

II. Reasons for change

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

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

III. Proposal

It is proposed that the anti-avoidance provisions under section 23J be wholly deleted based on the reasons provided above. It is also noted that the issues raised by section 23J are part of larger problem of inflating untaxed gains (or gains offset by assessed losses) so as to generate future deductions (via inflated depreciation deductions or otherwise). These concerns are probably best addressed through the adoption of domestic transfer pricing principles (an item under consideration for the 2013 legislative cycle).

A. Drafter's instructions

Delete all of section 23J of the Income Tax Act.

IV. Effective date

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

2.13. PASSIVE HOLDING COMPANIES

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

I. Background

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

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

II. Reasons for change

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

III. Proposal

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

IV. Effective date

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

2.14. CONVERSION OF SHARE BLOCK INTERESTS TO FULL TITLE

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

I. Background

A. Role of share block companies

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

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

B. Termination of share block companies

1. <u>Conversion to sectional title scheme</u>

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

2. Other forms of conversion

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

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

C. Special tax rule for conversions to sectional title

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

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

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

II. Reasons for change

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

III. Proposal

It is proposed that rollover relief for sectional title conversion be effectively extended to cover share block company distributions that allow for full title ownership. The only condition is that the right in full title must relate to the same underlying immovable property as the exclusive use right in property previously held by the shareholder. The nature of the rollover relief within the capital gains tax provisions will operate the same as conversions to sectional title. Relief from transfer duty and value-added tax will similarly be extended.

IV. Effective date

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

---

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

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

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

I. Background

A. Income taxation of financial instruments

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

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

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

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

B. Accounting treatment of financial instruments

Recent International Financial Reporting Standards (IFRS) address the full array of financial instruments (e.g. shares, debt and derivatives) (see IAS 39 and IAS 32, which will soon be transformed to IFRS 9). IFRS classifies financial instruments into four broad categories as described below. The main purpose of this classification is to facilitate a more accurate set of calculations for shareholders.
In achieving this result, IFRS divides financial instruments into four broad categories. These categories are important in determining whether the instruments should be accounted for on a realisation basis or on an annual notional market-to-market basis through profit and loss. These four categories are as follows:

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

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

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

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

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

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

II. Reasons for change

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

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

III. Proposal

A. Overview

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

B. Covered persons

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

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

3. A hedge fund as defined in Board Notice 89 of 2007 (Gazette No. 30228 (29 August 2007), issued pursuant to section 15 of the Financial Advisory and Intermediary Services Act of 2002 (Act No. 37 of 2002).

C. Annual fair value taxation

Covered persons (i.e. banks, brokers and funds) will be required to directly include in taxable income or loss most of the fair value measurements of IFRS that arise during the same year of assessment. More specifically, covered persons must include in taxable income the aggregate amount of all changes in value that are recognised through profit and loss in respect of financial assets and liabilities as measured by IFRS. However, this inclusion is limited to the extent that:

1. The financial assets and financial liabilities are classified as held for trading under IFRS; or

2. The financial assets and liabilities are designated upon initial recognition as fair value through profit and loss on the basis that the designation eliminates or reduces a measurement or recognition inconsistency.

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

The net effect of this proposal is to shift a large segment of financial assets and liabilities into annual mark-to-market taxation, including certain assets and liabilities viewed as derivatives. On the other hand, it should be noted that many financial assets and liabilities remain outside the IFRS fair value system.

- For instance, certain financial instruments are specifically excluded under IFRS, such as group investments, employee share schemes and financial leases.

- Derivatives constituting designated and effective cash-flow hedges are also excluded.

Moreover, the proposed tax regime implicitly excludes designated financial assets and liabilities if designated for reasons other than the reduction or elimination of recognition or measurement inconsistencies. Examples of this exclusion are designated financial assets and liabilities based on management and performance evaluated on a fair value basis. These designations typically arise when an entity seeks to measure a strategic interest through profit and loss (e.g. private equity investments or a strategic interest in certain companies).

D. Instruments between consolidated group members

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

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

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

Note: For this purpose, the term hedge is broader than the designated hedge rules of IFRS (because parties often indirectly hedge for IFRS purposes by accounting for both the derivative and the other financial instrument at fair value for profit and loss). Instead, a hedge exists if the bank, broker or hedge fund is counter-party to another financial instrument that protects against adverse price movements or significantly limits exposures to other risks of the derivative at issue.

Example 1:
Facts: Company X is a domestic bank. Company X is part of consolidated financial group of companies that includes Company Y, the latter of which is a long-term insurer. Company X enters into a derivative with Company Y. Neither Company X nor Company Y hedges the derivative.

Result: Mark-to-market treatment does not apply to the derivative held by Company X despite Company X's bank status. Both counter-parties Company X and Company Y are part of the same consolidated group, and Company Y falls outside of the proposed mark-to-market regime. Lastly, Company X did not hedge the derivative.

Note: If the derivative is an equity derivative, the close-out or disposal of the derivative will trigger ordinary revenue (see notes on UNHEDGED EQUITY DERIVATIVES). If the derivative is a currency derivative, the basic mark-to-market rules (of section 24I) apply.

Example 2:
Facts: A stock brokerage company is part of a banking group with the bank as the holding company. As part of its operations, the brokerage company holds listed company shares (+). The brokerage company hedges (-) its exposure through a contract for difference (i.e. derivative) whose value is determined with reference to the listed shares, and the counter-party to this contract is the bank (+). The bank also enters into (-) a comparable derivative with an independent client (+).

Result: The derivative between the brokerage company and the bank do not fall within the anti-avoidance rule. Even though both the brokerage company and the bank are part of the same consolidated, both companies fall within the same proposed mark-to-market regime. The second derivative entered into by the bank remains within the mark-to-market regime because the client is not part of the same consolidated group.

Example 3:
Facts: The facts are the same as Example 2, except that the bank issues a comparable derivative to another company in the same consolidated group. The other company is a long-term insurer.

Result: The derivative between the bank and the long-term insurer creates an issue. Both the bank and the insurer are part of the same consolidated group, and the counter-party to the derivative with the bank (i.e. the insurer) falls outside the proposed mark-to-market regime. However, the bank is hedged in respect of the derivative so the mark-to-market regime continues to apply.

E. Transitional year

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

In order to accomplish this shift with minimal disruption, it is proposed that covered persons perform a transitional calculation at the end of the year of assessment immediately before the new system goes into effect. Under this transitional calculation, taxpayers entering the new system will have to determine the net value of all financial assets and liabilities subject to fair value reporting as determined above. This aggregate amount will then be compared against the tax cost of all trading stock or capital assets within the financial assets category, reduced by the face value of all financial liabilities.
The above difference between the net IFRS balance sheet calculation and the net tax balance sheet calculation will then be added in, or subtracted from, taxable income. Because these amounts may be large enough so as to create cash-flow problems, the net difference will be added to, or subtracted from, taxable income over a four year period.

IV. Effective date

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

3.2. MARK-TO-MARKET TAXATION OF LONG-TERM POLICYHOLDER FUNDS

[Key applicable provisions: Sections 29S and 29B]

I. Background

A. Tax rates for four fund insurers

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

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

B. Allocable deductions for taxable policyholder funds

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

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

II. Reasons for change

A. Realised versus unrealised insurer tax allocations

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

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

B. Recent capital gains tax increase

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

Example

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

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

In essence, because the effective capital gains tax rate is increasing from 7.5 per cent to 10 per cent by the date of disposal, an additional 2.5 per cent charge is due in respect of the R100 prior notional capital gain allocated to individual Policyholder A as shown in the Example. However, this amount cannot be properly charged against Individual

Policyholder A as the actual disposal of Share X occurred after Individual Policyholder A ceased to be a policyholder. Therefore, the additional 2.5 per cent charge will ultimately have to be borne by Individual Policyholder B because Individual Policyholder B is the only remaining policyholder that is notionally connected to Share X at the time of disposal.

III. Proposal

A. Policyholder fund mark-to-market taxation

1. Overview

While the realisation principle for the taxation of disposals remains the most viable approach for most taxpayers, this principle is becoming outmoded for financial institutions, including insurers. The realisation principle is notably out of sync with the mark-to-market allocation of income tax associated with individual and company policyholder funds. It is accordingly proposed that a deemed disposal and re-acquisition approach be applied to all policyholder fund assets that mimics mark-to-market taxation. Imposition of this approach will apply on an annual basis when allocating income tax among policyholders. The impact is a deemed sale and repurchase of all policyholder interests at the close of each policyholder fund's year of assessment.

2. Item-by-item considerations

Policyholder funds generally contain assets that fall into four broad categories: (i) domestic shares/units, (ii) foreign shares/units, (ii) debts, and (iv) immovable property. Policyholder funds also frequently utilise derivatives mainly to offset certain risks associated with underlying assets.

- *Domestic shares/collective scheme units:* The deemed sale/repurchase calculation is intended to trigger gain or loss for financial assets as if market value sales occurred between independent parties. This deemed sale/repurchase accordingly is not intended to trigger certain anti-avoidance rules (e.g. section 9C as well as paragraphs 39 and 42 of the Eighth Schedule).

- *Foreign shares/collective scheme units:* The deemed sale/repurchase calculation for foreign shares and foreign collective scheme units will mirror the rules for domestic instruments of the same nature. The only unique issue involves policyholder funds holding substantial units in foreign collective investment schemes that potentially qualify as controlled foreign companies (CFCs). Under current law, these investments do not give rise to CFC inclusions under section 9D, and this exclusion will remain. The participation exemption for the disposal of foreign collective scheme units will also not apply (because, as a policy matter, these interests are notionally owned by an independent collection of policyholders).

- *Debt instruments:* Gains or losses from the deemed disposal of debt instruments will be treated as transfers under section 24J. These transfers will automatically impact the yield to maturity calculation for interest so no special rules are necessary.

- *Real estate:* The deemed sale/repurchase rule will generally apply to real estate. However, policyholder funds will no longer be viewed as directly holding underlying interests in real estate. As a result, assets allocable to a policyholder fund (or the portions thereof) will no longer be eligible for (depreciation allowances). On a similar vein, deemed and actual disposals will no longer give rise to ordinary recoupments.

- *Derivatives:* Derivatives will separately trigger gain or losses based on changes of fair values. Policyholder will recognise gains to the extent that the fair value of their interests increase and will recognise losses to the extent that the fair value of their interests decrease. Oftentimes, these gains or losses will act as offsets to the extent the derivatives at issue operate as hedges to underlying assets within policyholder funds.

To the extent the above financial instrument assets are of a capital nature, these capital assets must henceforth be accounted for on the basis of weighted averages (as opposed to specific identification). The weighted average method is more in sync with financial accounting and more properly neutralises gain or loss associated with specific notional interests held by specific policyholders.

3. Transitional pre-1 March 2012 gains and losses

While the proposed system of mark-to-market taxation of policyholder funds will greatly simplify the administration associated with policyholder fund collections, the transition from realisation principles to a mark-to-market system of taxation undoubtedly creates complications. More specifically, this shift essentially means that long-term insurers will be required to immediately recognise all unrealised gains and losses arising before the 1 March 2012 effective date in respect of policyholder funds. This recognition will be deemed to have occurred at the close of 29 February 2012.

This deemed recognition of pre-1 March 2012 gains and losses is important from a policyholder point of view because this deemed recognition ensures that pre-1 March 2012 capital appreciation will only be taxed at the historic 7.5 per cent. The new higher inclusion capital gain tax rate of 10 per cent will apply only in respect of post-effective date value changes arising from 1 March 2012.

4. Liquidity relief

The new mark-to-market system of taxation for policyholder funds will undoubtedly create liquidity pressures on long-term insurers.

- In the short-term, the deemed recognition of pre-1 March 2012 gains and losses creates immediate liquidity pressures on long-term insurers who will now be forced to pay tax on gains that represent many years of prior appreciation. This liquidity pressure will be greatest in respect of illiquid real estate investments.

- Going forward, liquidity pressure may arise due to extreme volatility. More specifically, if significant gain arises within a single year, a liquidity problem may arise in the following year if that following year entails significant losses. This problem arises because the losses will reduce the pool of assets available for the cash-conversion required to pay the tax associated with the prior year.

In order to alleviate these liquidity pressures, all mark-to-market capital gains and losses will be spread equally over four years of assessment (at the pre-1 March 2012 capital gain rate). This spreading means that pre-1 March 2012 capital gain or loss stemming from the initial shift to the mark-to-market approach will be spread equally over a four year period beginning in the year of assessment ending in 2012 (and ending in 2015). Future annual mark-to-market capital gains and losses will be spread over a four year period (starting with the first annual charge arising at the close of the 2012 year of assessment).

In order to provide further liquidity relief in respect of pre-1 March 2012 gains (and 2012 deemed year-end closings), long-term insurers do not have to account for the impact of the market-to-market system for first and second provisional tax purposes in respect of years of assessment ending on or before the close of 2012 (only for purposes of the third top-up payment). This form of provisional tax relief will not apply for future annual mark-to-market gains.

B. Revised policyholder deduction formula

With the advent of mark-to-market taxation for policyholder funds, a wholly revised deduction formula can be proposed for selling, administration and indirect expenses. Mark-to-market taxation allows for this simplification because all unrealised gains and losses will be taken into account on an annual basis, especially capital gains and losses. This change means that all taxable and untaxed profits can be calculated on an annual basis for formula purposes.

More specifically, both the company and individual policyholder funds allow for the deduction of selling, administration and indirect expenses on the basis of the following formula:

$$\frac{\text{taxable investment income}}{\text{investment income}}$$

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

IV. Effective dates

The new rates for capital gains will apply in respect of disposals/reacquisitions occurring on or after 1 March 2012. The first deemed disposal/reacquisition rules will apply from 29 February 2012 with annual deemed disposals/reacquisitions occurring from the close of every year of assessment, starting at the close of any year of assessment ending in 2012.

On the other hand, the weighted average rules will apply in respect of years of assessment commencing from 1 January 2013. The revised four fund formulae will similarly apply in respect of years of assessment commencing from 1 January 2013.

3.3. CREATION OF A UNIFIED SYSTEM OF TAXING REAL ESTATE INVESTMENT TRUSTS FOR PROPERTY INVESTMENT SCHEMES

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

I. Background

A. Role of property investment schemes

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

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

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

- A second feature of the REIT is the long-term nature of the property investments. Because the REIT holds property for rental income and capital growth, the REIT typically funds expansion through further borrowings (as opposed to cash sales).

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

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

B. Regulation and taxation of PUTs

1. <u>FSB regulation</u>

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

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

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

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

2. <u>Income taxation</u>

The PUT (like a collective investment scheme in securities) falls within a unique tax regime that allows for the PUT to be effectively treated a tax conduit. More specifically, ordinary revenue (e.g. rental) received or accrued by a PUT is taxed at standard income tax rate unless distributed to holders according within a 12 month period. PUT distributions are treated as ordinary revenue in the hands of investors. Unlike companies, the net effect is to tax the rental income at one one level.

PUTs also have the advantage of being free from any capital gains tax. Capital gains tax applies only when investors dispose of their units. One disadvantage of this regime, however, is that the PUT is unable to benefit from the reorganisation rollover rules.

C. Property Loan Stock (PLS)

1. <u>Contractual terms</u>

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

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

2. <u>Income taxation</u>

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

II. Reasons for change

A. Uneven regulation

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

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

B. Tax legitimacy for the PLS

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

III. Proposal

A. Regulatory

1. Overview

In view of the above, a unified approach for property investment schemes will be adopted for financial regulatory and tax purposes. The new entity will be called a Real Estate Investment Trusts (REIT) in line with the international norms (encompassing both the PUT and PLS regimes). The objective of the REIT is to provide investors with a steady rental stream that acts as substitute for interest income while also providing capital growth stemming from the underlying property. Both the financial regulation and tax rules proposed will accordingly be considered with this objective in mind.

2. Financial Regulations

In order for an entity to qualify as a Real Estate Investment Trusts (REIT), the entity must be listed with the JSE as a REIT. To obtain this REIT listing:

(i) The REIT entity must have a minimum amount of gross property assets (direct interests in immovable property (such as land and buildings), interests in a lease relating to immovable property, interests in a property subsidiary or holdings in another REIT);

(ii) The REIT entity must solely invest in immovable property assets and collateral debt instruments and hedges used to reduce the risk associated with property-related loans);

(iii) The REIT entity must distribute most of its profits on yearly basis; and

(iv) The REIT entity must not have excessive borrowings (i.e. gearing) in relation to the total gross asset value of all immovable property held by that entity.

The above requirements must be contained within the trust deed in the case of a PUT and in the memorandum of incorporation in the case of a PLS. In the case of a PUT, the trustee will be responsible for submitting a certificate of compliance to the JSE. In the case of a PLS. the directors will be responsible for the certificate of compliance.

B. Unified tax regime for REITS

1. Qualifying entry criteria

A unified regime for the PUT and the PLS is proposed. In order to fall within this regime, the company or collective investment scheme in property must be a listed entity that is classified as a REIT under the JSE rules. In addition, a domestic property subsidiary of a REIT (as defined by the JSE) will also qualify for the new regime.

2. Entity-level relief

A REIT will be exempt from capital gains taxation. Only the holders of shares or participatory interests in a REIT are subject to tax (i.e. typically capital gain). Receipts and accruals in respect of a financial instrument (e.g. dividends, the disposal of shares and bonds, derivatives income) will be treated taxable as ordinary revenue. These receipts and accruals will be subject to tax without regard to exemptions (e.g. the exemption for dividends) that would otherwise apply. Taxable ordinary treatment exists in respect of these other forms of income to prevent potential mismatches arising from the deductible distributions of income by the REIT, as outlined below.

3. Deductible distributions

REIT distributions will be fully deductible from the ordinary revenue of a REIT if that distribution satisfies both timing and a gross income requirement. Under the timing requirement, the distribution must stem from income and receipts earned by the REIT within the current or the immediately prior year of assessment. Under the gross income requirement, the distribution must relate to a year in which the total gross rentals received or accrued by the REIT at least equal 75 per cent of total gross receipts or accruals. If both tests are satisfied, all distributions are fully deductible. If either test is not satisfied, the distribution is treated as an ordinary dividend.

IV. Effective date

The proposed amendment comes into effect in respect of years of assessment commencing on or after a date set by the Minister.

3.4. ENHANCED REGULATORY AND TAX CO-ORDINATION OF SHORT-TERM INSURANCE RESERVES

[Applicable provision: Sections 1 “gross income”, 28(2), (5), (6) and (9)]

I. Background

A. Required regulatory reserves

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

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

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

   In addition to the above reserving system, adjustments are required for actual payments by the insured and received by the insured. Amounts received include salvages of damaged property, recoveries from unrelated third parties associated with the insured event and amounts reimbursed by reinsurer.

2. <u>Unearned premium provision (UPP):</u> These reserves relate to the matching of premiums accrued that relate to claim protection beyond the financial year. More specifically, the amounts involve estimated future payments arising from future events under existing policies where the future extends beyond the financial year. For instance, if a short-term insurer receives premiums upfront for a one-year contract, the premiums relating to any portion of the year beyond the short-term insurer's financial year must be placed within the UPP. The UPP is reduced for deferred acquisition costs (the DAC) with the DAC effectively acting as a negative liability (i.e. an asset). The DAC represents commissions and other administrative costs associated with providing the insurance product at issue.

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

4. <u>Reinsurance</u>: If an insurer reinsures certain risks, this reinsurance must be taken into account if the reinsurer is approved (i.e. is a South African insurer or has South African funds available dedicated to cover insurance risk). Unapproved reinsurance

is not taken into account (i.e. reinsurance of a foreign insurer wholly outside South African jurisdiction). To the extent an approved reinsurer is involved, the OCR and UPP will reduced for anticipated claim reimbursements to be received (as well as premiums to be paid).

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

B. Tax Implications

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

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

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

II. Reasons for change

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

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

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

III. Proposal

A. Overview

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

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

B. Basic tax computations

1. <u>Written premiums</u>

Short-term insurers will include premiums within gross income solely on the basis as those premiums are included as (written) premiums for regulatory purposes. Under this revised approach, advanced premium receipts will be ignored (as a form of book entry debt). Advanced (written) premiums typically arise when funds are received by an insurer before the applicable insurance contract begins. Regulatory (written) premiums will serve as the starting point because these premiums are the basis in which regulatory reserves are calculated. Refunds of premiums (including insurance contract cancellations) will either require the reversal of premium income or will be viewed as paid expenditures under the general deduction formula.

2. <u>Deductions for claims (e.g. OCR)</u>

Short-term insurers will deduct claims actually paid under the general deduction formula. All claims incurred but not actually paid will be deductible as part of the OCR. These OCR reserves encompass reserves for claims incurred but not yet paid, and claims incurred but not yet reported. As an ancillary matter, amounts obtained by an insurer via rights of subrogation will be deductible to the extent not taken into account as reserves (i.e. salvage of damaged property and recovery from third parties involved in the claims event will be added to gross income on the basis of actual receipts). Accruals for these items are implicitly accounted for within the OCR.

3. Unearned premium provision (UPP)

Short-term insurers can fully offset the UPP against written premiums that are included within gross income. As stated above, the UPP is a regulatory reserve for written premiums relating to a future year. The UPP must be adjusted taking into account deferred acquisition costs (the DAC). Stated differently, commissions and associated acquisitions costs outside the UPP will deductible during the current financial year under the general deduction formula (i.e. those actually paid during the current financial year). Deferred acquisition costs incurred but not yet paid will be taken into account solely as part of the UPP.

4. Reinsurers

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

Premiums actually paid should be addressed as part of the general deduction formula. Pursuant to the system of regulatory reserving, premiums incurred will be taken into account within the UPP (as an offset). Reimbursements currently received will be directly added to gross income. Future reimbursements (i.e. reimbursements accrued) will be taken into account as part of the OCR.

5. Annual add-backs

All amounts set aside under the OCR and UPP for regulatory purposes during a current year will be added back as inclusions for the following year (eventually reduced for cash payments and receipts associated with these reserves). This add-back mechanic will fully apply to the tax system. As with the regulatory system, add-backs are performed annually.

C. Deviations from regulation

As stated above, the tax system will continue to contain deviations from the regulatory regime. However, these deviations will be limited and explicitly stated (i.e. the overall system will no longer be subject to a SARS discretionary adjustment). At this stage, the following deviations have been identified: (i) the unexpired risk reserve, (ii) cash-back bonuses, (iii) unapproved reinsurance, and (iv) investment contracts.

1. Unexpired risk reserve

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

2. Cash-back bonuses

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

As stated below, the issue of insurance disguised as investment contracts can be addressed more directly than strictly prohibiting cash-backs. In terms of accurate reserving, the SAM process will require best estimates as opposed to a formula approach because accuracy has become more important for regulatory purposes than excessive prudence.

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

3. Unapproved reinsurers

As stated above, short-term insurers cannot rely upon unapproved reinsurers as part of their reserves. Therefore, the UPP (and OCR) of a short-term insurer utilising an unapproved reinsurer is calculated as if the unapproved reinsurance did not exist. The current tax system, on the other hand, appears to be allowing an offset for both unapproved reinsurance paid or incurred as well as the UPP (and OCR). The net result is an elevated level of deductions. It is accordingly proposed that short-term insurers take into account unapproved reinsurance under the UPP (and the OCR) as if the reinsurer were approved.

4. Insurance as disguised investment

As discussed in the explanation of INVESTMENT CONTRACTS DISGUISED AS SHORT-TERM INSURANCE, certain insurance products essentially act as disguised investment plans. The payment or incurral of these products will no longer be viewed as an ordinary expense but instead as an expenditure of a (non-deductible) capital nature. In addition, investment contracts will be excluded from permissible tax reserves.

IV. Effective date

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

3.5. INVESTMENT CONTRACTS DISGUISED AS SHORT-TERM INSURANCE

[Applicable provision: New section 28A]

I. Background

A. Payment of insurance premiums

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

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

B. Required regulatory reserves by short-term insurers

Short-term insurance comes in many forms, including motor, property, guarantees and construction risk cover. Short term insurers assume risk from the insured in return for premiums. Premiums received or accrued by the insurer are included in the insurer's gross income.

In the course of business, short-term insurers are required by the regulator (specifically the Financial Services Board (FSB)) to reserve specified amounts of capital to meet potential claims. Reserves are not deductible for most taxpayers. However, in view of the strictly regulated nature of these reserves (as well as the policy rationale for these reserves as a means to protect the public), short-term insurers can deduct certain forms of regulatory rules despite the general denial just described.

II. Reasons for change

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

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

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

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

III. Proposal

A. IFRS limitation

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

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

Hence, an insurance contract will be viewed as an investment contract if the short-term insurer fails to accept significant risk from the policyholder. Because the mislabeling of investment contracts is greatest among related parties, the proposed recharacterisation will apply only if the policyholder and the insurer are part of the same consolidated group for IFRS purposes. It should also be noted that this proposal will apply to wholly domestic transactions and to cross-border transactions (because the concerns in both sets of transactions are the same).

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

Going forward, investment contracts must be viewed as independent from the short-term insurance reserve system. Premiums from these contracts will be fully includible without offset for reserves. Investment contract fund growth will also be fully taxable. Repayments of contract will deductible to the extent of previously includible premiums.

> **Example:**
> ***Facts:*** Parent owns all the shares of Subsidiary, a captive short-term insurer. Parent enters into a short-term insurance policy with Subsidiary that qualifies as an investment contract. In 2013, Parent pays R5 million in premiums under the contract to Subsidiary. In 2013 and 2014, the funds held by Subsidiary generate R400 000 and R550 000 of ordinary

revenue during each year respectively. In late 2014, Subsidiary repays the funds to Parent.

Result: Subsidiary has R5.4 million of income in 2013 (i.e. the R5 million in premiums plus R400 000 of ordinary revenue). In 2014, Subsidiary has a R4 450 000 of loss (R5 million of loss offset by R550 000 of income).

C. Impact on policyholders

Policyholders may not deduct premium payments in respect of short-term policy contracts viewed as investment contracts. On the other hand, the receipt of investment contract proceeds will be exempt from normal tax (i.e. exempt from ordinary revenue and capital gains). The net result is to treat these contracts as comparable to endowment policies from a policyholder perspective.

IV. Effective date

The proposal will apply in respect of all policies issued on or after 1 January 2013. All policies varied, amended or revised will be viewed as new policies for this purpose.

---

4. INCOME TAX: BUSINESS (INCENTIVES)

4.1. DEPRECIATION OF SUPPORTING STRUCTURES FOR ENERGY PROJECTS

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

I. Background

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

II. Reasons for change

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

III. Proposal

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

IV. Effective date

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

4.2. REVISION OF THE INDUSTRIAL POLICY PROJECT INCENTIVE

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

I. Background

A. General overview

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

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

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

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

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

B. Approval and information reporting

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

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

II. Reasons for change

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

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

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

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

III. Proposal

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

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

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

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

IV. Effective date

The effective date relating to the clarification associated with the aggregate ceiling for the additional investment allowance will commence from the date of the incentive's inception (insertion by section 26 of Act No. 60 of 2008). The effective date relating to deletion of the compliance certificate and the clarification of annual reporting periods will commence from 1 January 2013.

4.3. OIL AND GAS INCENTIVE AND STABILITY REVISIONS

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

I. Background

A. General overview

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

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

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

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

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

II. Reasons for change

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

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

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

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

III. Proposal

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

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

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

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

IV. Effective date

The effective dates will relate to the date of collateral change. The rate limitations to the Tenth Schedule will apply with effect for years of assessment commencing from 1 March [April?] 2012. The rate limitations will apply in respect of dividends paid on or after 1 April 2012. The transfer pricing limitations will apply in respect to years of assessment commencing on or after 1 April 2012.

4.4. TAXABILITY OF GOVERNMENT TRANSFERS AND SUBSIDIES

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

I. Background

A. Flow of funds

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

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

- Funding can be for anticipated purchases of goods and services by a private party (declining use);
- Funding can be made directly for goods and services purchased for the benefit of a private party;
- Funding can be reimbursive after the private party has purchased the goods and services; and
- Funding can be in the nature of a reward for achieving certain milestones (e.g. for creating so many jobs or providing a required level of value addition) (uncommon).

B. Tax impact of grants

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

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

II. Reasons for change

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

Most notably, the overall tendency to tax grants is questionable. As a practical matter, most grant recipients do not expect grants received to be taxed because taxation of the grant is viewed as a partial withdrawal of the grant promised. Government officials making the grant allocation often do not consider the tax implications of the grant when making the allocation, thereby leaving a potential short-fall in the intended objective once tax is taken into account.
Lastly, the current system of relief is limited solely to grants at the national level. Grants paid by a provincial authority pursuant to a provincial budget process are fully taxable and do not qualify for exemption, even if no tax was envisioned when the grant was made. Grants from a province are only potentially eligible for exemption if the payment is directly traceable from the national level.

III. Proposal

A. General Overview

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

B. Revised list approach for exemptions

Under the revised approach, a comprehensive legislative list of exempt grants will be published and updated annually (see list under the Eleventh Schedule below). This legislative list will be developed in conjunction with expenditure-related legislation (e.g. the Appropriations Bill and the Division of Revenue Act). Furthermore, the Minister of Finance will retain the power to exempt grants by way of notice. The purpose of this Ministerial authority will be to provide exemption for certain grants devised between the annual budget periods.

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

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

C. Anti-double-dipping

1. Reduction of tax attributes

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

a. If an exempt grant is awarded to the taxpayer and the grant is used to fund the acquisition of trading stock or to reimburse expenses incurred to acquire trading stock, the cost price of that trading stock must be reduced by the amount of the grant. If an exempt grant exceeds the cost price of the trading stock, the excess will reduce the taxpayer's allowable deductions (to the extent these are available) (see point 4. below)

b. If an exempt grant is awarded to the taxpayer and the grant is used to fund the acquisition of an allowance asset or to reimburse the prior acquisition of an allowance asset, the base cost of that allowance asset must be reduced by the amount of the grant. If the grant exceeds the base cost and the asset is an allowance (i.e. depreciable) asset, the base cost of that asset will be deemed to be zero and the excess grant funding will reduce the taxpayer's allowable deductions (to the extent these are available) (see point 4. below).

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

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

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

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

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

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

2. Limitations on future (depreciation) allowances

A new set of rules will apply where taxpayers claim allowances for assets acquired with exempt grant funds. If an exempt grant is awarded to the taxpayer and the grant is used to fund the acquisition of an allowance asset, the total allowances claimed by the taxpayer on the asset must not exceed the base cost of the asset reduced by the amount of the grant.

In addition, if an exempt grant is awarded to the taxpayer to reimburse the prior acquisition of an allowance asset, the total allowances claimed by the taxpayer on the asset must not exceed the base cost of that allowance asset reduced by the amount of the grant and any prior allowances claimed by the taxpayer.

Example 1
Facts: Company A acquires business assets in 2013 for R2 million. Company A may claim a depreciation deduction of R400 000 on the business assets over 5 years. Company A receives an exempt government grant of R500 000 in 2013.

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

Example 2
Facts: Company F acquires a bottling plant in 2013 for R8 million. Company F may claim a depreciation deduction of R3.2 million in 2013 when it acquires the plant, and R1.6 million in each of the three succeeding years. Company F depreciates the plant by R3.2 million in 2013, leaving R4.8 million of base cost (R8 million less the R3.2 million of depreciation). Company F then receives an exempt government grant of R2 million in 2014 as a reimbursement for its expenses to acquire the bottling plant.

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

D. In-kind benefits

If a government grant is awarded in-kind for the benefit of a taxpayer, questions may arise as to whether the grant is an expenditure or cost actually incurred by the taxpayer. If the amount is not so incurred, the reduction of attributes resulting from a grant will actually leave the taxpayer in a worse position than if no grant existed. In order to remedy this confusion, all includible in-kind amounts will be deemed directly incurred by the taxpayer.

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

Result: Taxpayer will be deemed to incur the expenses of R50 000 and R75 000 directly since the grant was an in-kind award by government for the benefit of the Taxpayer. Therefore the expenses for the training services are deemed to be directly incurred by the Taxpayer, initially generating deductions under the formula of R50 000 and the taxpayer must reduce its allowable deductions under section 11(a) by R50 000.

The computer equipment will be deemed acquired by the taxpayer for a cost of R75 000, initially generating an asset acquisition cost of R75 000 thereby reducing the taxpayer's base cost to nil.

IV. Effective date

The effective date for the proposed amendments will apply retrospectively to all grants received or accrued on or after 1 January 2012.

Eleventh Schedule: Legislative List of Exempt Grants		
Name of grant	*Department paying grant*	*Administrator of grant*
Integrated National Electrification Programme: Off- Grid	Department of Energy	Same
Food Fortification Grant	Department of Health	Same
Capital Restructuring Grant	Department of Housing	Same
Youth Technology Innovation Fund	Department of Science and Technology	Technology Innovation Agency
Idea Development Fund	Department of Science and Technology	Technology Innovation Agency
Technology Development Fund	Department of Science and Technology	Technology Innovation Agency
Equity Fund	Department of Science and Technology	Technology Innovation Agency
Industry Matching Fund	Department of Science and Technology	Technology Innovation Agency
South African Research Chairs Initiative	Department of Science and Technology	National Research Foundation
Automotive Production and Development Programme	Department of Trade and Industry	Same
Small, Medium Enterprise Development Programme	Department of Trade and Industry	Same
Small/Medium Manufacturing Development Programme	Department of Trade and Industry	Same
Automotive Incentive Scheme	Department of Trade and Industry	Same
Business Process Services	Department of Trade and Industry	Same
Black Business Supplier Development Programme	Department of Trade and Industry	Same
Capital Projects Feasibility Programme	Department of Trade and Industry	Same
Critical Infrastructure Programme	Department of Trade and Industry	Same
Co-operative Incentive Scheme	Department of Trade and Industry	Same
Enterprise Investment	Department of Trade and	Same

Programme	Industry	
Export Marketing and Investment Assistance	Department of Trade and Industry	Same
Sector Specific Assistance Scheme	Department of Trade and Industry	Same
Film Production Incentive	Department of Trade and Industry	Same
Industrial Development Zone Programme	Department of Trade and Industry	Same
Clothing and Textiles Competitiveness Programme	Department of Trade and Industry	Industrial Development Corporation
Technology and Human Resources for Industry Programme	Department of Trade and Industry	Same
Support Programme for Industrial Innovation	Department of Trade and Industry	Same
Manufacturing Competitiveness Enhancement Programme	Department of Trade and Industry	Same
Transfer to Non-profit Institutions: South African National Taxi Council	Department of Transport	Same
Transfer to Universities and Technikons: University of Pretoria, KwaZulu-Natal and Stellenbosch	Department of Transport	Same
Taxi Recapitalisation Programme	Department of Transport	Taxi Scrapping Administrator
Jobs Fund	National Treasury	Development Bank of South Africa
Eastern Cape Jobs Stimulus Fund	Department of Economic Development Environmental Affairs and Tourism of the Eastern Cape	Eastern Cape Development Corporation

5. INCOME TAX: INTERNATIONAL

5.1. RE-EXAMINATION OF THE 33 PER CENT RATE FOR FOREIGN COMPANIES

[Applicable provision: Appendix 1 of the Income Tax Act]

I. Background

South Africa levies income tax on South African tax resident companies at a rate of 28 per cent. However, non-resident companies are subject to income tax on their South African sourced income at a rate of 33 per cent. An additional 10 per cent tax, known as the secondary tax on companies ("STC"), applies when a South African resident company distributes profits to shareholders. This has the effect of raising the effective tax rate of the South African resident companies to 34.5 per cent. Non-resident companies, on the other hand, are not subject to STC and therefore their effective rate remains 33 per cent. Non-resident companies are also not subject to any tax on the remittance of their South African branch profits offshore.

Following the introduction of STC in 1993, resulting in a higher effective rate for resident companies, a higher rate of corporate tax on non-resident companies was introduced in 1996. The rationale for the introduction of higher corporate tax rate was to place no-resident companies par with resident companies. In other words, the additional 5 per cent acted as a proxy for the lack of any tax on distributed local profits. The provision for the extra 5 per cent tax was included in most of South Africa's tax treaties.

II. Reasons for change

The phasing out of the STC and the introduction of the dividends tax will result in the South African resident companies paying tax at a lower rate than nonresident companies. At issue is the viability of retaining the higher rate of income tax on non-resident companies. There are arguments that retaining the additional 5 per cent rate will be in contravention of tax treaty non-discrimination provisions. It is argued that the 5 per cent uplift clause in South Africa's tax treaties was predicated on the existence of the STC. Thus, the retention of the additional 5 per cent, in the absence of STC will be a violation of the bone fide undertakings made to South Africa treaty partners during tax treaty negotiations.

III. Proposal

In view of the above, it is proposed that paragraph (1) (f) of Appendix I of the Income Tax Act be deleted.

IV. Effective Date

The proposed amendment will be effective for years of assessment beginning on or after 1 April 2012 (this being the same effective date for the overall new Dividends Tax).

5.2. REVISED ROLLOVER REGIME FOR CROSS-BORDER REORGANISATIONS

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

I. Background

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

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

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

II. Reasons for change

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

III. Proposal

A. Overview

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

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

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

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

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

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

- The transferred foreign company (or assets moving to a foreign company) must be squarely within indirect South African taxing jurisdiction. More specifically, at least 50 per cent of the equity shares of the transferred foreign company (or the foreign acquiring company that acquires the transferred assets) must be directly or indirectly held by a resident (alone or together with any other resident that forms part of the same section 41 group) after the transaction.

B. Cross-border asset-for-share transactions

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

In the main, the qualifying criterion for foreign share-for-share reorganisation rollover involving the exchange of foreign equity shares is limited to capital gain assets and to transactions that takes place purely within a South African controlled group. More specifically, the revised qualifying criterion is as follows:

- The foreign equity shares transferred must be held as capital assets before the transaction. The current anti-loss asset rule in respect of capital assets will be maintained. Therefore, the market value of the foreign equity shares transferred must exceed or equal to the base cost of the transferred shares in order to qualify for rollover relief. Rollover relief will not be granted for the transfer of foreign equity shares held as trading stock.

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

- Post-transaction requirement:

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

    - Alternatively, immediately after the transaction, all of the equity shares of the transferee company must be directly or indirectly held by a resident. This post-transaction holding requirement is determined by taking into account any resident company that forms part of the same (section 41) group of companies. This post-transaction holding requirement for the transferee company must additionally be maintained for an 18-month period.

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

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

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. Both South African Company and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign). After the transfer, FC1 is indirectly more than 50 per cent held by South African Company (90 per cent multiplied by 60 per cent equals a 54 per cent indirect holding by South African Company).

Example 2
Facts: The facts are the same as EXAMPLE 1, except that South African Company owns only 70 per cent of the shares of FC2 before the transaction and 70 per cent of the shares of FC2 after the transaction.

Result: The transaction fails to qualify for rollover relief under the foreign share-for-share rules. At the outset, both companies satisfy the "immediately before" criteria. Both South African Company and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign). However, the transaction fails the post-transaction criteria. After the transfer, FC1 is only 49 per cent indirectly held by South African Company (70 per cent multiplied by 70 per cent equals a 49 per cent indirect holding by South African Company).

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

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

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

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. Both FC1 and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign). After the transfer, FC1 is indirectly more than 50 per cent held by South African Company (a 90 per cent multiplied by 80 per cent equals a 72 per cent indirect holding by South African Company plus 10 per cent multiplied by 80 per cent multiplied by 80 percent indirect holding by South African Company through FC1 equals a 6.4 per cent indirect holding through FC1 for a 78.4 per cent total).

Example 4

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

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

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. Both South African Company and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 50 per cent shareholding without regard to whether the companies are domestic or foreign). After the transfer, FC1 is not "more than 50 per cent" indirectly held by South African Company (25 per cent multiplied by 100 per cent equals a 25 per cent indirect holding by South African Company). However, this lack of a "more than 50 per cent" interest can be disregarded because the transferee company is 100 per cent owned by a South African resident.

C. Cross-border amalgamation transactions

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

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

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

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

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

As an ancillary matter, an amalgamation of the target company could potentially trigger an exit charge if the target company technically ceases to be a CFC. This exit charge would apply the day before the cessation. This result should not arise as a policy matter, however, because the exiting assets will either end under ownership of a South African company or another CFC. The exit charge will accordingly be switched off in the case of a qualifying amalgamation rollover.

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

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

Result: The transaction fails to qualify for rollover relief under the foreign share-for-share rules. At the outset, both companies fail to satisfy the "immediately before" criteria, even though FC2 qualifies as a CFC before the transaction (being 100 per cent owned by South African resident). Both South African Company and FC2 are not part of the same group of company of companies before the transfer (i.e. are not connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign) nor is FC2 a CFC in relation to that group.

Example 2:
Facts: The facts are the same as EXAMPLE 1, except that FC2 is effectively managed within South Africa (i.e. qualifies as a South African resident).

Result: The amalgamation transaction qualifies for rollover relief because the amalgamation is an inbound transaction (i.e. the percentage ownership and CFC requirements are irrelevant). In respect of FC1 assets, rollover relief applies to the trading stock (with value exceeding cost price) but not to the capital assets (with the value falling below base cost).

D. Unbundling transactions

The proposed revised unbundling transaction rules apply to both inbound and foreign-to-foreign unbundlings. An inbound unbundling involves the distribution of foreign unbundled company shares to a resident group company shareholder. A foreign-to-foreign amalgamation involves the transfer of foreign unbundling company shares to a group CFC. In the case of both inbound and foreign-to-foreign unbundlings, the unbundled company must be more than 50 per cent owned by the unbundling company immediately before the distribution, and the distribution must be to a shareholder of the unbundling company that forms part of the same (section 1) group as the unbundling company. In addition, both forms of unbundlings require that the distributed shares in the unbundled company must be held as a capital asset immediately before the unbundling. It should be noted that the relief for inbound and foreign-to-foreign unbundlings applies regardless of whether the unbundling company is a resident or a foreign company.

In addition to the above requirements, foreign-to-foreign unbundling transactions (i.e. distributions to a foreign company group shareholder) contain the following additional requirements:

- The unbundling company and the foreign group shareholder of the unbundling company must be a CFC in relation to the same (section 1) group. This requirement will be measured immediately before the transaction.

- Immediately after the transaction, more than 50 per cent of the equity shares in the unbundled company must be directly or indirectly held by a resident. This more than

50 per cent threshold is determined taking into account any resident company that forms part of the same (section 41) group of companies.

As under prior law, large holdings in the unbundled company by disqualified shareholders immediately after the unbundling will prevent this form of rollover relief from applying. Disqualified persons are largely foreign shareholders (other than a CFC) or exempt persons (such as a pension fund). These rules prevent unbundling rollovers from being used as a means of moving shares from a taxable position to a tax-free position. Under prior law, disqualified holdings may not amount to 20 per cent or more, but this threshold will be reduced to 10 per cent (see qualifying interest Drafters Note).

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

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

Example 2
Facts: The facts are the same as EXAMPLE 1, except that the 30 per cent minority shareholder is an unconnected foreign person.

Result: The transaction fails to qualify as an unbundling rollover. The minority foreign shareholder is a disqualified person, and that shareholder is above the 10 per cent threshold.

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

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

E. Liquidation distributions

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

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

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

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

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

As an ancillary matter, the liquidation of company could potentially trigger an exit charge if the liquidating company technically ceases to be a CFC. This exit charge would apply the day before the cessation. This result should not arise as a policy matter, however, because the exiting assets will either end under ownership of a South African company or another CFC. The exit charge will accordingly be switched off in the case of a qualifying liquidation rollover.

Example 1

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

Result: The liquidation qualifies for rollover relief. Immediately before the liquidation, FS1 and FS2 are members of the same (section 1) group of companies and FS2 is a CFC in relation to that group. Immediately after the liquidation, FS2 is a CFC that is more than 50 per cent owned by South African Holding Company.

Example 2
Facts: South African Holding Company holds 100 per cent shares in Foreign Subsidiary 1 (FS1), which in turn owns 70 per cent of Foreign Subsidiary 2 (FS2). FS2 owns 70 per cent of Foreign Subsidiary 3 (FS3), which in turn owns 90 per cent of Foreign Subsidiary 4 (FS4). The minority interest in FS2, FS3 and FS4 are held by unconnected foreign persons. FS4 liquidates, transferring 90 per cent of its assets to FS3 and 10 per cent to an unconnected foreign person.

Result: The liquidation fails to qualify for rollover relief. Immediately before the liquidation, FS4 and FS3 are members of the same (section 1) group of companies but FS3 is not a CFC in relation to that group.

F. Terminating amalgamating and liquidating companies

As discussed above, amalgamating and liquidating rollovers require termination of the amalgamating and liquidating companies (i.e. the companies that will be transferring assets). Termination is equally required for in-bound and foreign-to-foreign transactions, but the nature of these terminations will be required to cover the various forms of foreign termination (which differ from local terminations).

IV. Effective date

All of the above transactions apply in respect of transactions entered into on or after 1 January 2013.

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

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

I. Background

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

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

II. Reasons for change

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

III. Proposal

A. Overview

The domestic intra-group rollover rules will be extended to include the restructuring of offshore companies (i.e. CFCs). The revised rule will mainly follow the paradigm associated with other foreign restructuring rules, especially the rollover rules relating to foreign share-for-share transactions. In foreign share-for-share transactions, rollover relief applies to the transfer of foreign equity shares for the issue of equity shares by the CFC transferee. In the case of an offshore intra-group regime now proposed, rollover relief will apply to the transfer of foreign equity shares for cash, the issue of debt or issue of non-equity shares by the CFC transferee.

B. Qualifying entry criteria

In the main, the qualifying criterion for foreign intra-group reorganisation rollover relief is limited to the transfer of capital assets consisting of foreign equity shares and to transactions that occur purely within a within a South African controlled group. More specifically, offshore intra-group rollover relief will be subject to the pre- and post-transactions requirements.

In terms of the pre-transaction requirements (i.e. requirements measured immediately before the transaction):

- The foreign intra-group relief will only apply to the transfer of equity shares held as capital assets. The capital asset restriction limits the relief to long term investments. In addition, the market value of the foreign equity shares transferred must exceed or equal to the base cost of the transferred shares.

- In line with domestic intra-group rules, the consideration provided by the transferee company for these equity shares can be of any nature other than the issue of equity shares.

- The transferee and transferor must be members of the same (section 1) group of companies. In addition, both the transferor and transferee must be CFCs in relation to the same group.

In terms of the post-transaction requirements (i.e. requirements measured immediately upon the close of the day of the transaction):

- The transferee and transferor must be members of the same (section 1) group of companies. Both the transferor and transferee must also be CFCs in relation to the same group.

Example:
Facts: South Africa Company owns 80 per cent of the shares of Foreign Company 1 (FC1) and 80 per cent of the shares of Foreign Company 2 (FC2). The other 20 per cent in FC1 and in FC2 are owned by unrelated foreign parties. FC1 owns 40 per cent the shares of FC3. The shares in each foreign company are of equal value, and the percentage shareholding also represents the actual number of shares issued and outstanding. All shares involved are equity shares and are held as capital assets.

In the transaction, FC1 transfers all of its equity shares in FC3 to FC2 in exchange for a note. Upon completion of the transaction, South African Company's proportionate share interests in all three companies remain the same.

Result: The transaction qualifies for rollover relief under the foreign share-for-share rules. Both South African Company and FC2 are part of the same group of company of companies before the transfer (i.e. are connected via a minimum 70 per cent shareholding without regard to whether the companies are domestic or foreign). After the transfer, FC1 is indirectly more than 50 per cent held by South African Company (90 per cent multiplied by 60 per cent equals a 54 per cent indirect holding by South African Company).

C. Potential de-grouping charges

As with domestic intra-group rules, foreign intra-group relief will be subject to two potential de-grouping charges. The main de-grouping charge again applies for the first 6 after the transaction, and the secondary charge for impermissible distributions applies for the first two years after the transaction.

In respect of the main de-grouping charge, the transferee company will be subject to tax for built-in gains (i.e. the capital gain that would otherwise be rolled over by virtue of the intra group transfer) if the transferee ceases to satisfy the group and CFC requirements at any point within a six-year period (the section 1 group and CFC requirements for both transferor and transferee). Any gain resulting from the de-grouping charge is capped at the lesser of the gain at the time of the intra group transfer or the gain existing at the time of the de-grouping.

In respect of the secondary de-grouping charge, the transferee company will again be subject to tax for built-in gains if the consideration for the initial intra-group acquisition is distributed or otherwise removed from the group for less than full market value consideration within a two-year period. The definition of group for this purpose is slightly narrower than the section 1 definition. In this circumstance, a group does not include foreign companies that do not qualify as CFCs (i.e. the consideration cannot be shifted wholly outside South African taxing jurisdiction).

IV. Effective date

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

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

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

I. Background

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

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

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

- It should also be noted that restructuring of controlled foreign company assets can also qualify for tax relief in terms of the foreign business establishment exemption or for disposals occurring within a high-taxed countries.

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

II. Reasons for change

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

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

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

III. Proposal

A. Overview

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

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

B. General participation exemption

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

- The transferor (taking into account group members) must hold a participation interest of at least 10 per cent of the equity shares and voting rights of the transferred foreign company. (No special rules are required for hybrid shares given the fact that hybrid shares are no longer included in the section 1 “equity share” definition (see EQUITY SHARE AND HYBRID EQUITY INSTRUMENT DEFINITIONS).

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

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

- The disposal must occur for full value consideration. More specifically, the transferor must receive full consideration for the foreign equity shares transferred. Full consideration means consideration that has a market value that equals or exceeds the market value of the foreign equity shares transferred. For purposes of this requirement, the receipt of shares will not be taken into account as consideration.

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

The full value (cash or cash-equivalent) consideration requirement is new. This requirement ensures that the participation exemption will not be used as a migration or divestiture technique. Hence, unbundlings will no longer fall within the participation exemption (but can fall under the offshore reorganisation rollover rules). Share-for-share reorganisations will also fall outside the participation exemption (again being available only within the offshore reorganisation rollover rules). Share consideration is excluded because complex share-for-share schemes have been devised that utilise the participation exemption as a means of achieving an indirect form of migration or divestiture. Lastly, the anti-avoidance deferral charge will no longer be necessary for future disposals in light of the full value (cash or cash-equivalent) consideration requirement.

As a final note, the participation exemption will continue to override the residual exit charge for the loss of CFC status. In particular, the transfer of a CFC (and one or more subsidiary CFCs of the transferred foreign company) may trigger an exit charge due to the loss of CFC status stemming from the disposal. The participation exemption will override this exit charge for deemed disposals of foreign equity shares.

Example 1

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

Result: The sale of CFC 2 by CFC 1 qualifies for the participation exemption. The sale is to a foreign company that is not a CFC and the consideration received equals the value transferred (and none of the consideration provided by Foreign Company constitutes shares).

Example 2:

Facts: The facts are the same as EXAMPLE 1, except that CFC 1 is a pure shell company. Instead of the sale being made by CFC 1, South African Company sells all of the CFC 1 shares to Foreign Company on the same terms as Example 1.

Result: Similar to EXAMPLE 1 above, the sale of CFC 1 by South African Holding Company qualifies for the participation exemption. The sale is to a foreign company that is not a CFC and the consideration received equals the value transferred (and none of the consideration received constitutes shares). In addition, it should be noted that both CFC 1 and CFC 2 will lose their CFC status because South Africans will no longer have any direct or indirect ownership in these foreign entities. This loss of CFC status will trigger an exit charge. However, any deemed disposal of CFC 2 shares by CFC 1 stemming from this exit charge will be eligible for the participation exemption because the exit charge stems for an initial disposal that is eligible for the participation exemption.

Example 3

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

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

C. Headquarter company exemption

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

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

IV. Effective date

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

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

[Applicable provisions: Section1 (paragraph (b) of the "resident" definition; 9H; 12 (2) and 13(1)(g) of the Income tax Act]

I. Background

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

The cessation of residence could take place in the following forms:

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

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

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

II. Reasons for change

On 8 May 2012 the Supreme Court of Appeal ("SCA") in the matter between CSARS and Tradehold Limited ("Tradehold) delivered its decision. The respondent in this case, Tradehold, is an investment holding company incorporated in South Africa and listed on the

Johannesburg Stock Exchange whose main asset comprised of shares in Tradegro Holdings Limited (Tradegro), a company incorporated in Guernsey.

At a meeting held in Luxembourg on 2 July 2002, Tradehold's board of directors resolved to hold all further board meetings in Luxembourg. This had the effect that, as from 2 July 2002, Tradehold became effectively managed in Luxembourg thereby ceasing to be resident in South Africa.

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

It is clear from international precedent in this regard that an exit charge that is levied in respect of a deemed disposal before a person ceases to be a resident is not protected in terms of a double tax treaty provision similar to that considered in Tradehold.

III. Proposal

The proposed legislation revises the exit charge so that the exit charge more closely aligns with international norms. As a result, a person's year of assessment will be deemed to have ended the day before that person becomes a resident of another country. In addition:

1. persons other than companies will be deemed to have disposed of all their assets, immediately before the end of that year of assessment, at their market value; and

2. a company will be deemed to have been liquidated and all its assets distributed proportionately to its shareholders and to have re-incorporated, established or formed a new foreign company on the following day.

Foreign residency will only start in the new year of assessment. The proposed rules clarify that a double tax agreement does not exempt a person from capital gains tax the day before a person ceases to be a South African resident.

IV. Effective date

The proposed amendment will apply in respect of any year of assessment commencing on or after 8 May 2012.

5.6. RATIONALISATION OF WITHOLDING TAXES ON PAYMENTS TO FOREIGN PERSONS

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

I. Background

A. Overview

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

B. Dividends tax

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

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

C. Interest withholding tax

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

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

D. Withholding tax on royalties

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

II. Reasons for change

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

III. Proposal

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

A. Interest

1. Withholding tax rate and amount

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

2. Liability

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

3. Timing of tax payment to SARS

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

4. Refund mechanism and declaration

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

5. Currency translation rules

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

6. Clarification of Government paid interest

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

B. Royalties

1. Withholding tax rate

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

2. Liability

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

3. Timing of tax payments to SARS

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

4. Currency translation rules

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

5. Refund mechanism and declaration

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

IV. Effective Date

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

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

[Applicable provision: Sections 10(1)(h), 10(1)(l), 37J(1), 37K(3) and 37L(1)]

I. Background

A. Interest and royalty withholding exemptions for CFCs

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

B. Foreign person income tax exemptions for cross-border interest and royalties

Separate exemptions exist for foreign persons receiving or accruing interest and royalties. In the case of interest, foreign persons are exempt from income tax unless (i) that person is a natural person who is physically present within South Africa during the relevant year of assessment for more than 183 days, or (ii) that person has a permanent establishment within South Africa at any time during the relevant year of assessment. In the case of royalties, foreign persons are exempt if the royalties are subject to cross-border withholding. These exemptions for foreign persons fully apply to amounts received or accrued by CFCs.

C. Interest and royalties as CFC inclusions

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

II. Reasons for change

The current system of interest and royalties in respect of withholding tax, direct taxable income and CFC inclusions is not fully coordinated, thereby giving rise to uncertainty and potential gaps. The current system also appears to waive withholding in favour of potential CFC inclusions. This waiver has the effect of pushing interest and royalties received or accrued by CFCs outside direct South African taxing jurisdiction in favour of secondary taxing jurisdiction arising from CFC income. The latter form of income is notably harder to enforce and contains many more exemptions. The purpose of the CFC rules is largely to extend the South African tax base. Therefore, no reason exists to have CFC rules that effectively reduce direct South African taxing jurisdiction.

III. Proposal

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

Moreover, the exemption from normal tax in respect of interest and royalties will be fully aligned. Both interest and royalties received or accrued by foreign persons will be fully exempt from normal tax unless: (i) that person is a natural person who is physically present within South Africa during the relevant year of assessment for more than 183 days, or (ii) that person has a permanent establishment within South Africa at any time during the relevant year of assessment.

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

IV. Effective Date

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

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

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

I. Background

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

II. Reasons for change

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

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

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

III. Proposal

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

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

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

(b) the foreign company is subject to a high level of tax (an aggregate effective rate of 75 per cent of the South African rate that would otherwise be imposed) during the relevant year of assessment; and

(c) the foreign company has a foreign business establishment during the year of assessment.

IV. Effective date

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

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

[Applicable provision: Section 31 (6)]

I. Background

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

II. Reasons for change

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

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

III. Proposal

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

- The holder is a South African company;
- The obligor is a CFC in relation to the South African holder and 10 per cent directly owned by that holder;
- The CFC is highly taxed (an aggregate effective rate of 75 per cent of the South African rate that would otherwise be imposed); and
- The CFC has a foreign business establishment.

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

IV. Effective date

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

[Applicable provision: Section 6*quin* of the Income Tax Act]

I. Background

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

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

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

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

II. Reasons for change

In addition to the circumstances above, dual taxation commonly arises where South African taxpayers render services within a foreign treaty country, even though these South African taxpayers do not have a permanent establishment in these countries. In particular, some tax treaty partner countries impose withholding tax on management fees despite the absence of a technical services article dealing with fees in their tax treaties. These foreign countries are mistakenly of the view that the lack of a technical services article means that these foreign services can freely be taxed by the foreign country; when, in fact, the absence of technical services article means that no foreign tax can be imposed at all.

At the same time, South African foreign tax credits are not an option for relief in these circumstances. In order for foreign tax credits to be available, the taxes at issue must be "proved to be payable". However, taxes imposed in violation of treaty cannot by definition be "payable" because the existence of a tax treaty means that no foreign tax should be required.

III. Proposal

A. Foreign taxes improperly imposed within foreign sources

In view of the above, it is proposed that the scope of the limited foreign tax credit (enacted in 2011) be widened. In addition to the current coverage relating to South African source income, the limited credit will be extended to taxes actually paid in respect of services rendered in a foreign source even though the taxes are not "payable" due to a double tax treaty.

B. Timing mismatches

Differences in tax systems create timing differences. In particular, the South African tax system generally imposes tax on a receipt or accrual basis. On the other hand, foreign withholding taxes are often imposed on a cash basis. These timing mismatches raise questions as to when the limited foreign tax credits arise – the year of accrual in South Africa or the year of actual payment (i.e. the year of the actual withholding).

In these circumstances, it is proposed that the law be clarified so that the limited credit applies in the year of accrual. Under this approach, income recognised by the South African tax system is properly matched against the limited foreign tax credits. For instance, if the income at issue accrues in year one but is only received by the taxpayer in year two (when the withholding tax is imposed), the limited foreign tax credit will apply in respect of year one. This matching already exists for the basic foreign tax credit. This matching ensures that tax credits are available when net taxable income arises (so as to be available for the reduction of South African tax).

IV. Effective Date

The proposed amendment dealing with improperly imposed foreign withholding taxes in respect of foreign source income will be effective for years of assessment beginning on or after 1 January 2013 in respect of amounts of foreign tax withheld on or after that date. The proposed amendment clarifying the timing of credits will be effective back to the date of the initial amendment (i.e. year of assessment from 1 January 2012).

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

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

I. Background

A. Overview and qualifications

The Headquarter (HQ) company regime provides various tax rules that promote South Africa as a regional financial centre (in the case, a holding company jurisdiction). The premise of the HQ company regime is that investments originated and redeployed offshore should not attract South African tax merely because these investments are routed through South Africa. Additional tax charges in these circumstances create a serious price barrier for multinationals because little South African value addition occurs, thereby deterring multinationals from utilising South Africa as a viable location.

The basic requirements for an HQ company are mainly that:

(i) each shareholder of the HQ company must hold at least 10 per cent of the HQ's shares;
(ii) the HQ company's asset base must comprise at least 80 per cent participation interests in foreign subsidiaries (i.e. equity, loans and intellectual property); and
(iii) if the income of an HQ company exceeds R50 million per annum, at least 50 per cent of the HQ company's gross income must be derived from the aforementioned asset base.

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

B. Back-to-back flows

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

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

II. Reasons for change

A. Always qualification rule

As stated above, the 10 per cent shareholder test and the 80 per cent asset test must be satisfied not only for the relevant year of assessment but also for all prior years of assessment in which that company exists. This "always qualification" rule creates practical difficulties in the case of certain start-up operations. In particular, in order to accelerate the legal establishment of the entity, many businesses prefer to acquire "off-the-shelf" companies previously in existence. These "off-the-shelf" companies are dormant with nominal amounts of cash.

Nonetheless, despite their widespread commercial usage, these "off-the-shelf" companies are problematic from a HQ company perspective. These companies will often fail the "always qualification" due to the uncertainty surrounding the nominal history of the company during the dormancy period. No policy reason exists to curtail the use of "off-the-shelf" companies to accelerate the start-up of an HQ company.

B. Back-to-back royalties

Even though the HQ company regime eliminates tax as a barrier in the case of back-to-back dividends and loan interest, no comparable relief exists in the case of royalties. Like loans, back-to-back intellectual properties (e.g. licenses) are often routed through HQ companies.

Yet, under current law, royalties in respect of back-to-back intellectual property are often subject to withholding tax when paid to foreign residents and may be subject to transfer pricing adjustments. These additional levels of tax can create unnecessary barriers if a South African HQ company is to act as a central clearinghouse for intra-group intangibles.

III. Proposal

A. Dormant company relief

It is proposed that the "always qualification" rule be waived to the extent that the company at issue is dormant. This test has two prongs: (i) the company must not have engaged in a trade during any year of assessment, and (ii) the company must not have held assets in excess of R50 000 during any year of assessment. This relief will effectively ensure that dormancy periods do not prevent application of the HQ company relief.

B. Back-to-back intellectual property

In line with the intended policy premise of the HQ company regime, it is proposed that the current transfer pricing rules be relaxed in respect of back to back licensing of intellectual property via an HQ company. The proposed rules in this regard will mimic the existing rules in respect of back-to-back loan interest. More specifically, transfer pricing will not apply, but net losses in this regard must be ring-fenced. As an ancillary matter, the HQ company will also be exempt from withholding tax on royalties in respect of back-to-back royalties if the royalties are paid to a 10-per cent or greater foreign shareholder.

IV. Effective date

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

5.12. SOUTH AFRICAN FUND MANAGERS OF FOREIGN INVESTMENT FUNDS

[Applicable provision: Section 1 (further provisio to the "resident" definition]

I. Background

Foreign investors (especially pension funds and other institutional investors) utilise a variety of international funds as a vehicle for specified international investment mandates. Many of these investments are routed through low tax jurisdictions (e.g. Cayman Islands and Netherlands Antilles) in order to ensure that these investments are tax efficient so as to avoid multiple levels of cross-border taxation. A growing object of these investment funds is the African region (including Southern Africa). These funds involve traditional investment funds as well as hedge funds.

Given the African focus of certain funds, the use of local South African expertise represents a desirable option. More specifically, certain foreign investment funds seek to use active local managers for direction when investing in South African assets or in other African assets. The South African manager is usually given an investment fund mandate (or a sub-mandate for a certain portion of the fund). The fund typically pays the South African investment manager a management fee. This fee is commonly based on a percentage of the assets of the fund, plus a performance fee if the fund's net asset value increases during the year. The fund also typically requires administration and other incidental financial services (e.g. accounting and legal compliance services).

II. Reasons for change

South Africa's economy, its reputation for financial services and regional expertise make South Africa an ideal destination for international capital dedicated to African regional investment. However, investing in African assets using the fund structure described above has the unintended side-effect of creating significant tax risks if a South African investment manager is involved.

Mainly at issue is the income tax test relating to "effective management". Like most global income tax systems, a fundamental feature of the South African income tax is the test for effective management as a trigger for South African taxation on a worldwide basis (i.e. resident-based taxation). If use of a local South African manager triggers this test, the whole of the fund could potentially be subject to South African worldwide tax. This possibility makes South African local managers potentially unattractive for foreign funds, especially since all of the funds are derived from an offshore location that has other global options. One practical way to limit this tax concern is to limit the local South African manager's freedom to make decisions, but this limitation undermines the very purpose of utilising the local manager.

It should also be noted that the "effective management" test is an important but older doctrine that was never really designed to address investment fund situations of this nature. The "effective management" test is mainly designed with traditional direct corporate investment in mind (e.g. for manufacturing and mining). For instance, many foreign companies will have a choice of undertaking active business operations within a South African subsidiary or branch. The effective management test would deem a foreign company with a South African branch to be a South African company if the core management overseeing those management operations is located in South Africa. In the case of a foreign-owned investment fund, management merely consists of balancing or choosing passive portfolio investments with little value addition to the underlying investments.

III. Proposal

A. Overview

In view of the above, it is proposed that a carve-out be created from the effective management test for foreign investment funds (operating in the form of company or trust entities). The purpose of this carve-out is to remove the potential for South African worldwide taxation due to the full and free use of a local investment manager. The management fees and performance fees earned by the local investment manager will remain subject to tax in South Africa (i.e. local South African tax will be limited to local South African value-addition).

In order to receive the proposed carve-out from the "effective management" test, the fund at issue must satisfy the following tests:

- The fund must be incorporated, formed or otherwise established in a foreign country;
- The fund must operate comparable fashion to a local collective investment scheme;
- The sole assets of the fund must consist of cash or listed financial instruments (or financial instruments determined with reference to listed financial instruments, such as derivatives);
- The fund must have no employees and no full-time directors; and
- South African residents may not directly or indirectly own more than 10 per cent of the value of the shares, units or participatory interests in the fund.

If the above activities are satisfied, the "effective management" test in relation to the foreign investment fund will not take into account services provided by a company that qualifies as a licensed "financial services provider" under the Financial Advisory and Intermediary Services, Act 2002 (Act No. 37 of 2002). Disregarded activities involve financial product advice, intermediary service and incidental activities thereto. The net effect of this exclusion from the "effective management" test should allow local investment managers the freedom to compete for international investment fund business.

IV. Effective Date

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

5.13. REVISED CURRENCY RULES FOR INTRA-GROUP EXCHANGE ITEMS

[Applicable Provision: Section 24I(7A), (10), 10A]

I. Background

A. Overview

The system for taxing currency gains and losses arising among related companies is divided into two sets of rules that depend upon different effective dates. On set of rules deals with loans or advances obtained or granted during any year of assessment ending on or before 8 November 2005. The more recent set of rules deal with all exchange items between related companies to the extent the exchange items have been entered into after 8 November 2005.

B. Pre-close of 8 November 2005 dispensation

Under the dispensation relating to the period arising on or before 8 November 2005, deferral of currency gains and losses exists for: (1) loans and advances of a capital nature, (2) loans and advances between companies that are connected persons, and (3) loans and advances that are not hedged by a related or matching forward exchange contract. Under this deferral regime, currency gain or loss in respect of these exchange items is spread equally over a 10-year period with an early trigger date for actual realisation. Given the 8 November 2005 cut-off, the 10 per cent spreading of currency gain and loss for all pre-existing exchange items will terminate no later than 8 November 2015.

C. Post-08 November 2005

Under the post-08 November 2005 dispensation, all exchange differences (not just debt–related items) in respect of related-company loans are simply deferred until realised (without any spreading over a 10-year period). More specifically, this deferral applies to exchange items between (1) a resident and a connected person in relation to that resident, (2) a resident and a controlled foreign company in relation to that resident or a group company in relation to the resident, or (3) a controlled foreign company and another controlled foreign company in relation to the same resident or the same group of companies.

II. Reasons for change

As a general principle, the taxation of annual mark-to-market currency exchange gains and losses should closely follow the accounting principles of International Financial Reporting Statement (IFRS) unless there are strong reasons for deviation. This principle simplifies compliance and enforcement, which is highly important in the case of notional gain/loss calculations (and in light of the complexity of the financial instruments involved). This principle also eliminates all book/tax disparities that drive tax planning.

The initial pre-close of 8 November 2005 spreading of exchange differences stands in stark contrast to financial accounting practice. The 10-per cent spreading rule merely alleviates the cash-flow burden of notional currency taxation on the basis that the intra-group exchange item is likely to be illiquid. The post-08 November 2005 regime is slightly broader than the initial relief and also covers a slightly wider net. Most notably, the new regime defers currency gain or loss until realisation without any 10-year spreading. The new rules move closer to IFRS (see below) but are not strictly aligned.

III. Proposal

A. Overview

In view of the overall policy to align mark-to-market currency taxation with IFRS, currency gains and losses in respect of related-company transactions will be more closely aligned with IFRS. By way of background, IFRS requires gains and losses in respect of all monetary items (e.g. foreign currency cash, loans and derivatives) to be annually recognised in fair value profit and loss (based on notional and realised currency gains and losses) (IAS 21 of IFRS) at a separate company level. However, at a group level, currency gain or loss in respect of loans is removed from fair value profit and loss to be classified as equity when the monetary item is viewed as a net investment in a foreign operation (paragraphs 15 of IAS 21). For purposes of these accounting rules, a monetary item is viewed as a net investment in a foreign operation if "settlement is neither planned nor likely to occur in the foreseeable future". This classification as equity will last until the monetary item is realised. Derivatives operating as hedges will similarly be classified as equity if operating as an "effective" fair value hedge to net investments in a foreign subsidiary (paragraph 102 of IAS 39).

B. Revised taxation of related-company monetary items

As discussed above, the taxation of currency in the circumstance of related-party entities will be more closely aligned with modern IFRS concepts. In particular, the new regime will apply to:

- Entities (mainly companies) that form part of the same group of entities for IFRS purposes (regardless of whether the group presents consolidated financial statements); and
    - In respect of debt between group entities, the debt is a claim for which settlement is neither planned nor likely to occur in the foreseeable future as contemplated in IFRS (e.g. thereby excluding short-term and trade receivables/payables); or
    - In respect of a forward exchange contract or a foreign option currency contract, the contract is designated as effective hedge within IFRS.

If the new regime applies, currency gain or loss in respect of debt (and the effective hedge) will be deferred until realisation. It should be noted that an IFRS group is broader than a group as defined under the Income Tax Act. In particular, an IFRS group has a "more than

50 per cent" threshold as opposed to a "70 per cent" threshold. An IFRS group also takes into account practical control (including practical control over special purpose vehicles).

Example 1:
Facts: South African Parent owns all the shares of Foreign Subsidiary. South African Parent provides a 25-year loan out of South African Parent's capital reserves that will probably be refinanced by Parent at the end the 25-year period. The interest rate is JIBOR plus 2 per cent. Foreign Subsidiary enters into a one-year hedge in respect of the interest rate and currency risks associated with the loan. This hedge is entered into with an independent foreign bank.

Result: Foreign Subsidiary must potentially account for the loan because the Rand is not part of Foreign Subsidiary's functional currency. However, the loan is not likely to be settled in the reasonably foreseeable future. Therefore, any currency gain or loss in respect of the loan (plus the hedge if classified as an effective hedging instrument) falls outside the annual mark-to-market system of currency taxation. Gains and losses in respect of these exchange items will be deferred until realisation (if otherwise taken into account under the deemed controlled foreign company inclusion rules).

Example 2:
Facts: South African Parent owns all the shares of Foreign Subsidiary. South African Parent borrows £5 million of funds from an independent U.K. bank for a five-year term at an interest rate of JIBOR plus 4 per cent. South African Parent on-lends the funds (in the form of pounds) to Foreign Subsidiary to be repaid when Foreign Parent is required to repay the initial loan to the U.K. bank.

Result: Both loans are taxed on an annual mark-to-market basis. The loan by South African Parent from independent U.K. bank is not part of the group. While part of a single group, the loan from South African Parent to Foreign Subsidiary is not viewed as a net investment in a foreign subsidiary due to the five-year termination date.

C. Pre-close of 8 November exchange differences

As an ancillary matter, the spreading provision in relation to pre-close 8 November 2005 loans will be completely abandoned so as to make a fresh start. Any remaining suspended currency exchange gains and losses will be triggered when the new regime comes into effect.

IV. Effective date

The proposed amendments will apply in respect of any year of assessment commencing on or after 1 January 2013. Exchange items falling within the current post-08 November 2005 rules but outside the new rules will be deemed realised at the end of the year of assessment preceding the effective date. Similarly, pre-close of 8 November 2008 residual exchange differences will be deemed realised at the end of the year of assessment preceding the effective date.

5.14. REMOVAL OF MISPLACED NON-MONETARY AND MONETARY FOREIGN CURRENCY CALCULATIONS

[Applicable Provisions: Section 24I(11); paragraphs 43(1) and (4) of the Eighth Schedule]

I. Background

A. Non-monetary capital assets purchased and sold in a single foreign currency

As a general matter, the capital gains system ignores currency gains and losses when an asset is acquired and disposed of within the same foreign currency. In these circumstances, capital gain or loss is simply calculated utilising the foreign currency as the starting point with this gain or loss converted to Rands at the end (at an average exchange rate). However, currency gains and losses in respect of assets acquired and disposed of within a same foreign currency will trigger a disposal if the asset at issue consists of foreign equity or South African sourced assets.

B. Loans (and associated hedges) matched against non-monetary items

Section 24I generally recognises foreign exchange gains and losses on an annual basis irrespective of whether the gains or losses are realised. One exception to this rule is currency gains and losses in respect of loans used to acquire non-monetary assets. Under this exception, currency gain and loss in respect of these loans is generally ignored. A comparable rule exists for derivative hedges in respect of these loans.

II. Reasons for change

A. Inappropriate currency capital gain/loss calculations

The current capital gains tax rules that disregard currency gains and losses in respect of non-monetary assets is hard to justify. While a rule of simplicity is defensible for many natural persons and other non-business entities, calculation of currency gain or loss for the disposal of non-monetary assets is an accepted fact for multinationals and larger businesses operating in a cross-border paradigm. This currency gain or loss calculation is actually required for accounting systems. Hence, deviations from this calculation actually add to compliance costs because tax compliance systems need to deviate from the default system methods of financial accounting.

B. Inappropriate currency matching of monetary to non-monetary items

In terms of mark-to-market taxation of currency gains and losses, financial accounting does not generally match monetary items with non-monetary items. The current tax deviation creates unnecessary systems issues for larger companies and creates unnecessary book/tax disparities. Linking monetary items to non-monetary items also makes little policy sense since the change in value associated with the non-monetary item has no direct or immediate bearing on currency gain or loss.

III. Proposal

A. Mixed approach for capital gains tax in respect of assets acquired and disposed of within a single foreign currency

Currency gain or loss for non-monetary capital assets will be adjusted for different taxpayers. The current simplified method for calculating capital gain or loss in respect of asset acquired and disposed of within a single foreign currency will be retained for natural persons and non-trading trusts. Other persons (i.e. companies and trading trusts) will be subject to currency capital gain or loss in line with underlying economics. Hence, if these other persons acquire an asset in a foreign currency and dispose of that asset in the same foreign currency, the simplified method will no longer apply. Instead, the acquisition price will be translated into local currency (typically Rands) using the exchange rate upon acquisition, and the disposal price will be translated into local currency (typically Rands) using the exchange rate upon disposal. The currency exchange rate differences stemming from the different dates will give rise to currency capital gain or loss.

B. Removal of non-monetary matching for loans (and associated hedges)

While the link to monetary to non-monetary items could possibly be justified as a means for countering the distortion resulting from capital gain or loss currency taxation described above, this justification is now removed with the deletion of this distorted method for companies and trading trusts. It is accordingly proposed that the current matching of monetary items (i.e. loans and associated hedges) to non-monetary items be completely removed from the mark-to-market system of currency taxation applicable to companies and trading trusts.

IV. Effective date

The amendments to the capital gains tax in respect of currency will apply to the disposal of assets on or after 1 January 2013. The amendments to mark-to-market taxation of currency will apply in respect of exchange items entered into on or after 1 January 2013.

5.15. REMOVAL OF FOREIGN CURRENCY DEFERRAL FOR PRE-PRODUCTION ACTIVITIES

[Applicable Provisions: Section 24I(7)]

I. Background

Section 24I governs the recognition and measurement of foreign currency exchange differences for monetary items (i.e. cash, loans, foreign exchange contracts and foreign currency option contracts). Foreign currency exchange differences are generally recognised for tax purposes on an annual basis irrespective of realisation. The rules under section 24I are largely based on financial accounting as in existence in the mid-1990s.

However, annual currency recognition will be deferred if monetary items are linked to non-monetary depreciable or amortisable assets that will be brought into use for the purposes of trade at a later stage. More specifically, this deferral applies to exchange differences relating to foreign currency loans (and related hedges) that are used to: (i) acquire, install, erect or construct tangible property, (ii) or to devise, develop, create, produce, acquire or restore intangible property. This deferral largely ends once the associated assets are brought into productive use.

II. Reasons for change

As a general matter, the recognition of currency gains and losses should closely follow financial accounting. Unlike the tax dispensation, financial accounting does not link monetary items with non-monetary asset for the purposes of recognising exchange differences even if the financial asset is used to directly or indirectly fund the non-monetary asset. It should also be noted that deviations from financial accounting come at a steep cost in terms of enforcement and compliance, especially in the area of currency calculations. In most instances, taxpayers will maintain an automatic computer system for accounting to determine currency gain and loss with the tax issued separate as isolated deviations. These deviations are often overlooked or hard to maintain for verification.

III. Proposal

In view of the above, the current tax deferral rule for currency exchange items entered into in order to finance pre-production assets is without foundation. The linkage between foreign currency tax calculations and specified non-monetary items will accordingly be removed.

IV. Effective date

The proposed amendment will be effective for years of assessment commencing on or after 1 January 2013. All currency gains and losses subject to deferral under current law will be triggered at the close of the date before the effective date.

---

6. VALUE-ADDED TAX

6.1. INSTALMENT CREDIT AGREEMENT

[Applicable Value-Added Tax Act provision: Section 1 (paragraph (b) of the 'installment credit agreement' definition)]

I. Background

A. Conventional instalment credit agreements

1. Definitional requirements

For VAT purposes, an instalment credit agreement is an agreement whereby goods are supplied:

(i) under an outright sale, whereby instalment payments are made over an agreement period), or

(ii) by way of a financial lease with an option to buy the good at the end of the lease-term upon payment of a residual.

In order for a financial lease to qualify as an instalment credit agreement, the agreement must satisfy several requirements. For instance, the rental for the lease payment must include an element of finance charges that is stipulated within the lease. In addition, the lessee must accept full risk of destruction or loss of the good (i.e. the risk must lie with the lessee as opposed to the lessor).

2. <u>VAT implications</u>

Instalment credit agreements trigger an upfront VAT charge. In the case of a financial lease offered by a bank, the bank typically purchases the good for the benefit of the lessee and then resells the good/asset to the client. The upfront purchases results in a VAT charge and an input claim by the bank. The bank then leases the good to the client, triggering another VAT charge (with the client obtaining an upfront VAT input if the client is a VAT vendor). This upfront charge is for the upfront value of the good (without regard to subsequent implicit interest).

B. Shariah compliant (Ijarah) sales

1. <u>Ijarah qualifications</u>

Islamic (Shariah) law forbids the charging of interest. However, Shariah law allows for more indirect means of financing. These indirect forms of financing include the Ijarah, which is a form of finance lease. An Ijarah typically assumes the following structure:

- The bank/financier purchases the asset and is the owner;
- The bank leases the asset to the client;
- The client pays a monthly payment (based on the Bank purchase price with a mark-up calculated with reference to time value of money principles);
- The client has an option to purchase the asset at the end of the lease period; and
- The bank is responsible for the costs of insuring the goods but recovers this charge by way of a separate invoice to the client

2. <u>Current VAT impact</u>

Strictly speaking, Ijarah leases do not conform to the requirements of an instalment credit agreement as defined in the VAT Act. In particular, the Ijarah lacks a formal "finance charge" and places the risk of loss on the lessor (despite the invoice charge to the client). Consequently, Ijarah leases are treated as normal rental agreements.

Rental agreements are a more expensive way of financing for clients because the VAT is calculated differently than for an instalment credit agreement. For instalment credit agreements, VAT is levied upfront on the cash cost of the asset (without regard to the implicit subsequent interest). On the other hand, in the case of rental agreements, VAT is levied on the full rental amount, including the implicit interest component. In terms of compliance, banks must account for Ijara financing differently from conventional instalment credit agreements.

II. Reasons for change

As stated above, Shariah (Ijarah) compliant financing agreements typically do not follow the same formal structure as that of conventional banking products, even though the economic impact is roughly the same. The net result is an additional VAT charge falling upon implicit interest that leaves this form of financing at a disadvantage. Over the last several years, various tax changes have been made to eliminate the tax disadvantages of various forms of Shariah compliant products vis-à-vis conventional Western products.

III. Proposal

It is proposed that the definition of "instalment credit agreement" be expanded to cater for certain aspects of Ijarah finance leases. In particular, the finance charge requirement will be expanded to include mark-ups based on time-value of money principles. In addition, risk of loss will be deemed to fall on the lessee if the lessee fully reimburses the lessor for the insurance undertaken by the lessor to protect against risk of loss.

IV. Effective date

The proposed amendment will apply in respect of instalment credit agreements entered into on or after 1 October 2012.

6.2. CREDIT AND DEBIT NOTES

[Applicable Value-Added Tax Act provision: section 21(1)]

I. Background

Vendors that make taxable supplies must issue a tax invoice to recipients within 21 days of the date of the supply. The VAT Act generally does not allow for the issue of more than one tax invoice per supply. However, vendors may issue credit and debit notes for supplies under specified scenarios so as to adjust the initial tax invoice. These scenarios cover cancelled supplies, fundamental changes to a supply, adjustments to agreed consideration and the return of supplies.

II. Reasons for change

If a vendor issues a tax invoice for an incorrect amount, the vendor is prohibited from issuing a corrected tax invoice via a debit or credit note (for the reasons explained above). For instance, if a vendor wrongfully issues a tax invoice for the amount of R1114 instead of R114, the vendor is prohibited from issuing a credit note to the recipient of the supply so as to correct the mistake because this scenario falls outside the list of permissible scenarios.

Further, if a vendor issues a tax invoice that has information missing in terms of section 20(4) or (5) then the vendor cannot reissue the tax invoice for the reasons explained above. The vendor is also prevented from issuing a credit/debit note for that supply owing to this specified scenario not being catered for.

III. Proposal

It is proposed that the specified conditions for the issue of credit or debit notes be extended to allow for the correction of incorrect tax invoices. These corrections will cover credit notes (for incorrect overcharges) and debit notes (for incorrect undercharges) and in other circumstances (i.e. where there are any missing particulars on the tax invoice as required by section 20(4) and (5)).

IV. Effective date

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

6.3. POTENTIAL VAT DOUBLE CHARGE FOR GOODS REMOVED FROM CUSTOMS CONTROLLED AREAS

[Applicable Value-Added Tax Act provisions: sections 8(24) & 18(10)]

I. Background

A. Goods imported into a customs controlled area (CCA)

As a general rule, VAT applies when goods are imported into South Africa. However, an exemption exists for movable goods imported into a customs controlled area (CCA) of an industrial development zone (IDZ). In this latter instance, no VAT applies as long as the goods remain within the CCA. When the goods leave the CCA (i.e. entered for home consumption), a deemed importation occurs so as to trigger VAT once more.

B. Goods locally supplied to a vendor in a CCA

Goods locally supplied by a vendor to a vendor in a CCA are subject to a VAT rate of zero. This concession for supplies to a vender within the CCA generally remains as long as the goods remain within the CCA. VAT relief also exists for goods that are temporarily removed from a CCA for a period of 30 days. On the other hand, if:

(i) goods are temporarily removed from the CCA; and

(ii) those goods are not returned within 30 days from date of removal, a VAT supply is deemed to be made by the CCA enterprise vendor (as if the supply stemmed from a disposal). IDZ operators fall within the same paradigm.

C. *Personal consumption of goods in a CCA*

If (i) goods are imported into a CCA (or (ii) goods are supplied to a vendor in a CCA at the VAT rate of zero, special rules apply to prevent loss of VAT due to personal consumption. More specifically, goods entering a CCA under either circumstance are subject to a VAT charge if not wholly consumed in the course of making taxable supplies (i.e. if personal consumed).

II. Reasons for change

The above three sets of rules pertaining to CCA goods are not properly coordinated: The removal of goods imported into a CCA conflicts with the removal of goods locally supplied to a CCA enterprise vendor. In addition, the removal of goods locally supplied to a CCA enterprise vendor conflicts with the personal consumption of goods within a CCA. This lack of coordination potentially leads to more than a single VAT charge for essentially the same event (i.e. for essentially for the same level of value-added).

III. Proposal

The proposal seeks to remove the above overlaps between the three sets of rules relating to the CCA. Firstly, it is proposed that the import rules be separated from local supplies to a CCA. More specifically, goods imported into a CCA will remain outside the VAT until entered for home consumption without regard to the 30-day legislative rule for temporary imports. Temporary imports from a CCA will be allowed only by customs officials who set the triggering event for home consumption (without the 30-day period set by legislation). Secondly, goods within the CCA that have been initially converted to private use and then removed from the CCA will not be subject to VAT a second time under the 30-day rule.

IV. Effective date

The proposed amendment will apply to all supplies or imports occurring on or after 1 January 2013.

6.4. IMPORTED GOODS SOLD BY FOREIGN PERSONS PRIOR TO ENTRY FOR HOME CONSUMPTION

[Applicable Value-Added Tax Act provision: section 12(k)]

I. Background

A. *Physical location of customs border posts vis-à-vis South African territory*

A foreign person that supplies goods that enter South African territorial land and waters may be required to register for VAT if this activity is continuous or regular. This registration will be required even if that foreign person has no permanent establishment/place within South Africa.

At a physical level, South African territorial land and sea is larger than the exact outer locations of customs clearing locations where goods are entered from home consumption. In terms of shipping, foreign persons first transport goods via ship into South African territorial waters but enter goods for South Africa home consumption only upon reaching South African ports. In terms of land, foreign persons first transport goods by road or rail into South African territorial land but enter goods for South African home consumption only upon reaching South African customs border posts. The imposition of VAT upon importation is only triggered at the customs locations where goods are entered for home consumption.

B. Customs control clearing areas

Like many countries, South Africa has special designated areas that are viewed as outside South African areas of home consumption, even though these areas are clearly within South African territory. In this vein, the VAT Act currently contains an exemption for goods imported into South Africa by a foreign person if entered into a storage warehouse but not entered for home consumption. However, the foreign person can waive the exemption upon SARS approval.

II. Reasons for change

A. Pre-entry coastal sales

The supply chain of South African companies often involves trading among foreign suppliers. Pre-entry sales among foreign persons often arise in South African territorial waters before coastal entry for home consumption. These pre-entry sales typically arise because foreign investor risk appetite does not extend into South African territorial waters (i.e., a foreign company is willing to carry the risk or loss of supplies until the supplies reach South African territorial waters, after which the risk transfers to the South African company/or other buyer).

Foreign companies engaged in this practice may find themselves liable for VAT registration if these sales are regular or continuous within South African territorial waters. If liable for VAT registration, the foreign company additionally becomes liable for VAT in respect of these pre-entry sales, followed by a second VAT charge when the goods are entered for home consumption.

At a practical level however, foreign companies that lack a permanent establishment/place within South Africa generally want to avoid the compliance burden of registering and accounting for VAT. VAT registration of these wholly foreign entities is to be avoided at a policy level because foreign companies may become reluctant to trade with South African if forced to undertake VAT registration without meaningful South African physical operations.

Another issue is the potential for dual VAT charges. The first charge occurs when the foreign company charges the South African buyer with VAT for the purchase. The second charge occurs when the South African buyer enters the goods for home consumption at the port.

Although both charges are refundable, this dual charge may place unnecessary cash-flow pressures on the parties involved.

The circumstances described above usually manifest itself in the tobacco industry.

B. Pre-entry land sales

The issue of pre-entry sales within South African territorial land could also arise (though far less often). Foreign taxpayers may sell goods among themselves within South African territory (via road or rail) before formal entry for home consumption. These pre-entry sales often occur between members of the same group of companies.

If these pre-entry sales occur, the same VAT issues arise as the issues that arise at sea. There pre-entry land sales could trigger the foreign compliance burden of VAT registration despite the lack of any permanent establishment within South Africa. These sales also trigger unwieldy dual VAT charges (one for the pre-entry sale and one for the formal importation).

III. Proposal

It is proposed that pre-entry sales by foreign persons be treated as exempt if these pre-entry sales occur before home consumption. This exemption would mirror the concession (i.e. the exemption) for the supplies of goods made by foreign persons where those goods are imported and stored within a customs and excise storage warehouse before entry for home consumption. Exemption in these circumstances would effectively prevent the need for foreign VAT registration (while also eliminating any VAT charge on the pre-entry sale because the initial sale is no longer undertaken by a VAT vendor).

Like the exemption for pre-entry sale for goods sold within a customs and excise storage warehouse, taxpayers may elect to waive the exemption. This waiver will similarly require SARS approval. It is expected that the main users of this exemption will be parties with significant local activities (i.e. parties that are already in the VAT net for other reasons).

IV. Effective date

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

6.5. RELIEF FOR BARGAINING COUNCILS

[Applicable Value-Added Tax Act provision: new section]

I. Background

Bargaining councils may be formed by trade unions and employer organisations. These organisations deal with a variety of issues involving employer-employee relationships, including collective agreements and resolution of labour disputes. All bargaining councils must be registered in terms of the Labour Relations Act, 1995 (Act No. 66 of 1995).

Bargaining councils levy an administration fee that is payable by employees that are members of that specific bargaining council.

II. Reasons for change

Employee organisations currently enjoy an exemption from VAT. More specifically, this exemption applies in respect of membership contributions. A bargaining council is formed when a trade union and employer organisation coalesces to regulate employee-employer relationships, as contrasted with an ‘employee organisation’, which (although covering a similar scope) is a stand-alone entity.

The activities of a bargaining council (although similar to that of employee organisations), seemingly falls outside the exemption; this creates uncertainty as to the VAT treatment of bargaining councils.

III. Proposal

The activities of a bargaining council are not materially different from that of an employee organisation. It is accordingly proposed that goods or services supplied by bargaining councils to any of their members should be exempt from VAT to the extent that membership contributions are received as consideration.

IV. Effective date

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

6.6. RELIEF FOR POLITICAL PARTIES

[Applicable Value-Added Tax Act provision: new section]

I. Background

In its simplest form, political parties seek to exert influence over Government policy by expressing their vision, ideas and goals. Political parties garner support for their vision, ideas and goals through their membership base. One way for members to express their support for political parties is through membership contributions (monetary or otherwise). Generally speaking, political parties do not provide legal reciprocity for these contributions.

II. Reasons for change

Unlike the Income Tax Act (which fully exempts political parties), the VAT Act does not contain any specific provision that deals with contributions received by political parties from their membership. This absence leads to uncertainty as to whether membership contributions by political parties could be subject to VAT. At issue is whether the contributions can be construed as “consideration” for taxable services “supplied.”

III. Proposal

It is proposed that the supply of goods or services by a political party be specifically exempted from VAT to the extent of any membership contributions or donations received in exchange.

IV. Effective date

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

6.7. SECURITIES TRANSFER TAX: CLARIFICATION OF THE BROKER/DEALER-MEMBER EXEMPTION

I. Background

A. Basic trading through the JSE

1. <u>JSE principal/agent distinction</u>

All shares on the JSE must be traded through members (i.e. technically referred to as an "authorised user"). Only brokers can be members of the JSE. Banks and other financial institutions cannot be members of the JSE because their capital is not solely dedicated to JSE exchanges.

Brokers can either trade shares as an "agent" or as a "principal." Although the agency and principal distinction is not strictly defined under the JSE rules, a principal trade is largely viewed as a share acquired and owned by the broker in terms of common law principles. Similarly, trading of shares as an agent will occur if the broker acts as an agent of a client in terms of common law principles. Brokers hold shares through one or more "stock accounts" when acquiring shares as principal. Brokers hold shares through one or more "client accounts" when acquiring shares as agents.

The agency/principal distinction is important for JSE stability. Members that trade shares as agents must maintain capital of about one-to-two per cent of the value of the shares. Members that trade shares as principal must maintain capital of about ten-to-fifteen per cent of the value of the shares after taking into account hedged positions. Amounts retained as capital must be held in liquid form (i.e. as cash or near cash equivalents). This liquidity requirement reduces the potential yield of the capital allocated.

2. <u>Securities Transfer Tax: Broker-dealer Exemption</u>

Securities Transfer Tax applies at a rate of 0.25 per cent. This tax generally applies when a person acquires beneficial ownership of share. The role of the broker in the acquisition is a critical feature in the tax determination. If the broker acquires the shares as an agent, Securities Transfer Tax is generally payable. On the other hand, an exemption exists if the broker acquires the shares as principal (under prior law, technically referred to as an acquisition for the broker's "account and benefit").

The purpose of the exemption (as established in 1995) was to facilitate the broker's role as a market-maker in shares, thereby promoting liquidity. In the typical market-making transaction, the broker stands ready to purchase (i.e. "buy") a share at a set price publicly announced (as a form of unilateral offer) or to sell (i.e. "bid") at a set price that is publicly announced (as a form of unilateral offer). This unilateral setting of prices by brokers creates or enhances share liquidity by making prices commonly available. Greater liquidity means enhanced Securities Transfer Tax payments because non-brokers will be involved in a greater number of share acquisitions.

3. Income tax: Ordinary revenue versus capital gain

No explicit correlation exists between how a share is held by a broker under the Securities Transfer Tax and how that share is held for purposes of Income Tax. However, as a practical matter, most (if not all) shares held by a broker as principal should be characterised as trading stock because, to be a market-maker, the shares must be continuously offered and ready for sale. These shares are also likely to be treated as held for trading in terms of financial accounting (see IFRS IAS 39).

B. Shares held to facilitate the issue of derivatives

1. Broker-dealers and banks as market-makers in derivatives

Brokers have become central role-players in the equity derivative market due to their relationship with underlying shares. More specifically, brokers typically hold a "long" or "short" position in shares that operate to offset the risk associated with derivatives. In some cases, these brokers issue the derivatives directly to the open market backed by shares. In other cases (i.e. indirect market-making), these brokers offer derivatives to other intermediaries backed by shares with these intermediaries offering another set of derivatives to the open market.

Local and foreign banks represent the largest set of intermediaries offering derivatives to the open market. Users of these derivatives tend to be hedge funds, pension funds, life insurers and asset managers (e.g. collective investment schemes). Local and foreign banks acting as intermediaries typically rely on a broker that is a member of the same group as the bank (and often a wholly-owned subsidiary). These banks often guarantee the subsidiary broker's risks associated with the transaction and may even fund the subsidiary via soft-loans.

2. Broker-dealer versus banking regulation and capital requirements

In order to fully control associated market and credit risks, the JSE does not allow banks, insurers and entities under other primary forms of regulation to be members of the JSE. In the case of bank intermediary and broker relationships, a dual form of regulation results. The JSE regulates the broker, including the capital requirements. The Reserve Bank regulates the bank with a different set of capital requirements via global Basel standards. The level of capital depends on the level of exposure with full proprietary positions requiring a higher level of capital (e.g. starting from 8 to 9.75 per cent) with the level of capital increasing as global Basel standards are tightening. Bank guarantees also require capital.

II. Reasons for change

The exemption for brokers under Securities Transfer Tax was not designed with the derivative market in mind. The exemption merely envisioned the simple paradigm where brokers held shares at their own risk (i.e. for their own account and benefit or as principal) versus an agency relationship. The exemption did not explicitly address the use of shares that act as a risk offset for the issue of derivatives. This omission is significant because the growth in the equity derivative market has become substantial due to a variety of reasons (e.g. increased ability to obtain market exposure at lower cost) and the use of shares to back the derivative market is central to that market's success.

The relationships between a financial institution (bank, long term insurers etc) and a broker, where the broker is the subsidiary of a financial institution, have become particularly challenging because these relationships undermine meaningful distinctions between principal and agency relationships. In the cases of concern, most of the broker's risk in directly-held shares is passed on to the financial institution via the derivative with the financial institutions either holding a proprietary position in the derivative or issuing another offsetting derivative to the open market.

Because financial institution funding is less expensive than funding for brokers, risk is further shifted to the financial institutions in respect of capital requirements. The financial institution will typically guarantee the broker's capital at less than an arm's length charge or provide financing in the form of soft loans.

Hence, as can be seen, while the broker in a financial institution /broker relationship may hold shares as principal (i.e. for the broker's own account) as a technical matter, it is questionable whether the broker is actually anything more than an agent as an economic matter. The "agency" nature of this relationship becomes even more obvious when the financial institution indirectly controls the broker's ability to dispose of shares without the financial institution's approval (via explicit agreements or internal-group management criteria).

In recent years, the financial institution/broker relationship has come under scrutiny precisely because of this blurred relationship. This scrutiny has given rise to concerns that the broker exemption for proprietary holdings may not apply, giving rise to a 0.25 per cent charge for each share acquired to back derivative trading. It is now contended that this charge would significantly disrupt the derivatives market because many of these derivative trades operate on narrow margins (e.g. between 0.1 and 0.2 per cent).

III. Proposal

A. New basis for exemption

The principal/agency distinction will be modernised in favour of the current electronic "stock account" categorisation pursuant to the rules and directives of the JSE. More specifically, under the revised approach, shares purchased by a broker and placed in qualifying stock accounts may be exempt from the Securities Transfer Tax as long as the shares remain in a qualifying stock account as described below. Principle/agency distinctions will be removed.

B. Stock account types

1. Overall categories

Under the proposed system, the "stock account" classification will be broken down into five types namely:

- unrestricted stock accounts (STT exempt);
- bank restricted stock accounts (STT exempt);
- security restricted cash loan stock accounts (STT exempt);
- security restricted share loan stock accounts (STT exempt); and
- restricted stock accounts (subject to STT).

It is envisioned that these stock account classifications will be formally added to the rules and directives of the JSE so that these classifications can serve as the basis for enforcing the Securities Transfer Tax via brokers.

2. Unrestricted stock accounts

In order for shares to be placed in an "unrestricted stock account" under the proposed JSE rules and directives as envisioned, the broker must own the shares and have the full ability to acquire and dispose of the shares without being subject to the direct or indirect approval of another person. The existence of hedged derivatives in respect of the shares will not be taken into account when making this determination. All shares held in the "unrestricted stock account" will be exempt from the Securities Transfer Tax.

3. Bank restricted stock accounts

Under the JSE rules as envisaged, shares will be placed in a "bank restricted stock account" if the broker lacks the freedom to dispose of the shares solely due to the fact that the approval from a domestic bank, which is within the same financial consolidated group of companies as the broker (see IAS 27) is required prior to disposal of the shares. This rule also applies to foreign bank imposed restrictions if the foreign bank is subject to the same regulatory standard.

The proposed relief for bank restricted accounts stems from the unique role that banks have as market-makers in the case of derivatives. Banks not only have the necessary balance sheets to support this market but are also highly regulated so as to protect local financial markets from systemic risk. Taxing these activities would effectively undermine the liquidity of the JSE.

4. Security restricted cash loan stock accounts

In the case of "security restricted cash loan stock accounts" the broker will also be allowed to lack the freedom to dispose of the shares under specified circumstances. If a broker borrows money from a money lender, the money lender will normally require security for the loan. The broker will either pledge shares (that form part of the broker's assets) to the money lender or the broker will cede these shares in securitatem debiti to the money lender as security for the loan. If shares have been pledged or ceded in securitatem debiti to a money lender, the broker may not dispose of the shares without the money lender's consent.

If the broker's freedom to dispose of shares is only restricted by the fact that the money lender's consent is required prior to the disposal, the shares will be placed in a "security restricted cash loan stock accounts." No Securities Transfer Tax will be payable on the acquisition of shares by the broker if the shares are acquired and held within a "security restricted cash loan stock account".

The reason for the exemption from Securities Transfer Tax is that the money lender does not become the owner of shares pledged or ceded. The risks and benefits in respect of the shares (decline or growth in value and dividends) remain with the broker. More specifically, to be within this stock account, the outstanding balance in respect of the loan must be repaid to the money lender without regard to the value of the share used as collateral (or pledged). The yield on the loan must also be based on time-value-for-money, not on the value of the collateralised share.

5. Security restricted share loan stock accounts

The principles which apply to "security restricted cash loan accounts" also apply to "security restricted share loan stock accounts". Instead of borrowing money from a lender, the broker borrows shares in terms of a share lending arrangement from the lender. The actual share lending is exempt under the pre-existing short sale provisions.

At issue is any other shares held as collateral for the share lending scheme because the owner of these collateralised shares may not have the freedom to dispose of the shares. This form of restriction is again permissible as long as the yield is based on time-value-of-money principles and the obligation to repay is not dependant on the value of the collateralised shares.

C. Non-exempt stock accounts

If a broker acquired and holds shares in a stock account not listed above, the shares will be acquired in a restricted stock account. In these instances Securities Transfer Tax will be payable by the broker on the acquisition of the shares.

IV. Re-allocation of shares between stock accounts

It should be noted that the exemptions proposed will last only as long as the shares remain in qualifying exempt stock accounts. Movement of shares outside those accounts (even if the shares remain fully owned by the broker-dealer) will trigger Securities Transfer Tax.

V. Effective date

The proposed amendment will apply in respect of transfers occurring and the re-allocation of shares on or after 1 January 2013. The proposed legislation also contains interim relief (dating back to 1 January 2099). This interim relief will exist for shares used as hedges for derivatives.