NATIONAL
TREASURY

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAXATION LAWS AMENDMENT BILL, 2015
(FIRST BATCH)

05 June 2015

[W.P. – '15]

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EXPLANATION OF MAIN AMENDMENTS

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

1.1. HEDGE FUNDS

[Applicable provision: Section 25BA]

Objective: To minimize inadvertent tax consequences that may arise as a result of the announcement by the Minister of Finance that the business of a hedge fund is declared to be a collective investment scheme with effect from 1 April 2015.

I. Background

In the 2015 Budget Review, the Minister of Finance made an announcement and on the same day declared the business of hedge funds to be Collective Investment Schemes (CIS) with effect from 1 April 2015. In terms of Government Gazette No 38503 of 25 February 2015, the managers of all hedge funds must within 6 months from 1 April 2015, lodge with the Registrar of Collective Investment Schemes (who is the Executive Officer of the Financial Services Board (FSB)) an application to register as a manager to operate a hedge fund in accordance with the Collective Investment Schemes Control Act.

The FSB will not require a hedge fund to dispose of undesirable assets and reinvest the proceeds in assets of another class prior to its approval by the FSB as a CIS. Undesirable assets may be disposed of after the structure of the hedge fund has been accepted by the FSB and the hedge fund is regulated as a CIS.

II. Reasons for change

The regulation of some declared CISs has an unintended transitional tax consequence. The tax consequence results from tax arising on the disposal by a hedge fund of assets to a trading vehicle which is acceptable to and approved by the FSB.

Since undesirable assets will only be disposed of after the FSB has approved the hedge fund as a CIS, no changes are required in this regard. The provisions of section 25BA and paragraph 61(3) of The Eighth Schedule will automatically apply to the disposal of undesirable assets.

III. Proposal

In order to allow for effective regulation of a CIS that is approved by the FSB, the transitional tax amendments listed below are proposed:

A. Disposal of assets

The current hedge fund may dispose of all of its assets to the vehicle that will be regulated as an approved CIS for no consideration other than the right to receive a participatory interest in the approved CIS.

No capital gains tax or normal tax will arise on the transfer of the assets from the current hedge fund since the current hedge fund will be deemed to transfer the assets at its current base cost, if the assets are capital assets or at its cost if the assets are trading stock.

The approved CIS will be deemed to acquire the assets:

- at the base cost for the transferring hedge fund, if the assets are capital assets, and;
- at the amount equal to the cost of the assets for the transferring hedge fund, if the assets are trading stock.

The current hedge fund and the approved CIS is deemed to be one and the same person in respect of the date of acquisition of the asset and the date of incurral of expenses.

B. Structural changes

Currently, most hedge funds operate as en commandite partnerships. The proposed change from the business of a hedge fund to an approved CIS will result in a partnership having to dispose of its assets to an approved CIS. The partnership will for income tax purposes automatically cease to exist when the assets are disposed of to an approved CIS and the partners will receive the right to receive a participatory interest in the approved CIS.

C. Sunset provision

The amendments to section 25BA(3) are transitional provisions intended to ensure the tax neutral restructuring of the business of hedge funds to approved CISs. These provisions will be repealed when the FSB determines that unregulated hedge funds may no longer apply for a “conversion” to approved CISs.

IV. Effective date

The proposed amendments will be deemed to have come into effect on 1 April 2015 and will apply in respect of hedge funds becoming regulated and approved CISs on or after that date.

1.2. OUTRIGHT TRANSFER OF COLLATERAL

[Applicable provisions: Section 1, 9C(4), 22(4B) and (9), and paragraph 11(2)(n) of the Eighth Schedule to the Income Tax Act, Section 1 and 8(1)(u) of the Securities Transfer Tax Act]

Objective: To change the tax treatment of the transfer of beneficial ownership in collateral to reduce any negative effects on business practices that encourage liquidity in the financial market and limit the use of collateral in possible tax avoidance arrangements.

I. Background

Most debt agreements involve the usage of collateral, more specifically the use of equity going forward as the demand for liquid assets is increasing due to higher capital and liquidity requirements. The provision of collateral can take two forms, namely, (i) pledge (no transfer of beneficial ownership with no tax implications) and (ii) outright transfer (out and out cession of beneficial ownership with tax implications).

II. Reasons for Change

In 1996, a specific tax dispensation for Securities Lending Arrangements (as currently defined in the Income Tax Act) was made in the Income Tax Act and the Stamp Duties Act (subsequently incorporated in the Securities Transfer Tax Act). As a result, the event of granting collateral by way of a pledge for securities lending is currently not subject to income tax and securities transfer tax because it does not involve the actual transfer of beneficial ownership. The specific tax dispensation for Securities Lending Arrangements is limited and effectively allows for the deferral of securities transfer tax for a limited period of 12 months.

On the other hand, when an outright transfer of collateral is executed during a securities lending transaction, equity securities are subject to both income tax and securities transfer tax, due to the fact that the outright transfer of collateral involves the actual transfer of beneficial ownership.

Regulatory changes applying to the financial sector have necessitated the urgent review of the tax treatment of collateral. Effectively the regulatory changes will result in financial sector participants especially the banking and pension fund industries having to:

- meet more stringent capital requirements e.g. Liquidity Coverage Ratio under Basel III for the banking sector, and;
- hold collateral posted to the pension fund in the name of the said pension fund under Regulation 28.

The benefits of an outright transfer of collateral have been identified by the financial sector industry as:

- assistance to the financial sector industry in meeting regulatory changes and demands;
- increase in availability of high quality liquid assets which directly increases market liquidity;
- reduction of transaction costs and market pricing because of the ability to rehypothecate collateral and reduce tax costs; and
- making South Africa more attractive as an investment destination.

III. Proposal

In order to minimize the negative effects on business practices and market liquidity, the following amendments are proposed:

A. Securities Transfer Tax Exemption for 12 months and Capital Gains Tax exemption if shares are returned within 12 months

It is proposed that a similar tax dispensation as applies to Securities Lending Arrangements be introduced for the outright transfer of collateral and that no income tax and securities transfer tax implications arise for collateral arrangements for a duration of up to 12 months. Similar to securities lending arrangements listed securities will not be allowed to be provided as collateral for longer than 12 months. This implies that the concept of “rolling collateral” will not be allowed. The 12-month limit will assist to avoid scenarios of sales disguised as collateral transactions or transactions where the collateral is used against rolling debt positions that are designed to keep a collateral position open for longer than 12 months.

B. Listed securities

The proposed exemption for the outright transfer of collateral will only apply to listed securities as defined in the Securities Transfer Tax Act.

C. Identical Assets

To ensure that the wording of the Income Tax Act and Securities Transfer Tax Act correctly reflects the policy intent with the return of collateral of the same kind and of the same or equivalent quantity and quality as originally envisaged, it is proposed that the definition of ‘identical assets’, as currently defined in paragraph 32 of the Eighth Schedule to the Income Tax Act, be inserted and incorporated into section 1(1) of the Income Tax Act.

IV. Effective Date

It is proposed that the amendments apply to any collateral arrangement entered into on or after 1 January 2016.

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2. INCOME TAX: INTERNATIONAL

2.1. COUNTER MEASURES FOR TAX-FREE CORPORATE MIGRATIONS

[Applicable provisions: Section 9H, paragraphs 11(2)(b) and 64B(1)(b) of the Eighth Schedule to the Income Tax Act]

Objective: To reverse the unintended consequences of the 2013 amendments to paragraph 11(2)(b) of the Eighth Schedule and to make changes aimed at countering tax free corporate migrations**.**

I. Background

A. Prior to 2013

Prior to 2013, the issue of shares by a company was not considered to be a disposal for capital gains tax purposes. It was envisaged that this would be tax neutral for company formations and would increase foreign investment in and capitalisation of South African resident companies.

However, it came to Government's attention that certain types of investments by non-residents could have resulted in the tax-free exit of resident companies. Ultimately, the transactions of concern initially involved a strategy to gain foreign control of a resident company through the tax-free issue of shares by the resident company to a non-resident in exchange for shares in a non-resident company.

Secondary to this step, the resident company would be stripped of its foreign operations free of tax by relying on the participation exemption (under paragraph 64B of the Eighth Schedule) on the disposal by a resident of its shares in its foreign operations (including shares acquired through the preceding tax-free cross-issue of shares). Added to this, the dividends participation exemption (under section 10B(2)(a)) would exempt any foreign dividends being channelled through the resident company in the intervening period from income tax.

Finally, the tax residence of the resident company would in some instances be shifted offshore through a shift in the place of effective management which, in any case, results in a much lower exit charge arising at this stage given the preceding asset realisation and low level of unrealised gains in the assets at the time of ceasing to be a South African tax resident.

B. 2013 Amendments

In an attempt to counter the abovementioned concerns, in 2013 paragraph 11(2)(b) of the Eighth Schedule to the Income Tax Act was amended. As a result, the issue of shares by a resident company is currently not exempt from Capital Gains Tax where shares are issued to any person in exchange, directly or indirectly, for shares in a foreign company. The introduction of this exception was aimed at dealing with the initial step of these transactions that involved the issue of shares in exchange for shares in a foreign company.

II. Reasons for change

As stated previously, the introduction of the exception under paragraph 11(2)(b) of the Eighth Schedule to the Income Tax Act was aimed at preventing the potential tax free corporate migrations that took advantage of the tax free transfer of the control of a resident company and the participation exemptions. However, it has come to the attention of government that the 2013 amendments to paragraph 11(2)(b) of the Eighth Schedule are too broad and impact on transactions that broaden the South African economy and by implication the tax base through the acquisition of foreign entities in exchange for the issue of shares and undermines the expansion of South African multinationals.

As the current wording of paragraph 11(2)(b) of the Eighth Schedule refers to the direct or indirect acquisition of shares in a foreign company, the application of the provisions of paragraph 11(2)(b) of the Eighth Schedule has unintended consequences on the asset for share transactions covered by section 42. This may result in the company issuing the shares (transferee company) under a section 42 asset-for-share transaction not being able to benefit from the intended capital gains tax relief envisaged under the roll-over provisions.

Finally, it has been identified that the current ambit of the participation exemption in respect of the disposal of shares in a non-resident company by residents is open to abuse. Whilst it was intended that the disposal of foreign shares should not be subject to tax, it is of concern that non-resident controlled groups use this exemption to strip resident companies of their holdings in foreign operations and may oftentimes keep the resident company tax resident in South Africa while embarking on this base erosion strategy.

III. Proposal

In order to reverse the unintended consequences of the 2013 amendments to paragraph 11(2)(b) of the Eighth Schedule, without losing sight of the initial policy intent to counter untaxed corporate migrations out of South Africa, the following changes are proposed:

A. Reversal of the 2013 amendment

It is proposed that the 2013 amendments to paragraph 11(2)(b) of the Eighth Schedule be reversed. The issue of shares by a South African resident company as consideration for the acquisition of shares in a foreign company will no longer be subject to Capital Gains Tax. For purposes of reversing the unintended consequences of the 2013 amendment, it is proposed that this amendment should be reversed retrospectively from the date of its introduction, i.e. in respect of shares issued on or after 1 April 2014.

B. Counter measures for tax free corporate migrations out of South Africa

A two-pronged approach will be adopted to counter the identified base erosion strategies that use the participation exemption to strip resident companies of unrealised gains in shareholdings in foreign operations. This approach will include:

1. The denial of participation exemption on disposals to connected persons

In the first instance, as a mechanism to counter tax-free disposals of foreign operations of resident companies, it is proposed that disposals of foreign shares by South African residents to connected persons should not benefit from the participation exemption. As a result, it is proposed that an amendment be effected to paragraph 64B of the Eighth Schedule and that any disposal of shares in a foreign company by a resident to a connected person will be subject to capital gains tax.

2. The claw-back of participation exemption benefits on a change of tax residence

In addition to the above, it is proposed that upon a change of tax residence as envisaged in section 9H, any participation exemption benefits (both under section 10B(2)(a) and paragraph 64B of the Eighth Schedule) enjoyed by a South African resident during the three year period before ceasing to be a South African tax resident will be subjected to tax.

It is proposed that the abovementioned proposed two pronged approach aimed at countering tax free corporate migrations should be applied retrospectively from the date of the release for public comment of the first batch of the draft Taxation Laws Amendment Bill of 2015.

IV. Effective date

A. Amendments to paragraph 11(2)(b) of the Eighth Schedule

The amendments to paragraph 11(2)(b) will be deemed to come into effect on 1 April 2014 and will apply in respect of shares issued on or after that date.

B. Amendments to section 9H and paragraph 64B(1)(b) of the Eighth Schedule

The amendments to section 9H and paragraph 64B(1)(b) will be deemed to come into effect on the date of the release for public comment of the first batch of the draft Taxation Laws Amendment Bill of 2015 and will apply respectively in respect of any person that ceases to be a resident or a resident that becomes a headquarter company on or after that date, and to shares disposed of on or after that date.