



**NATIONAL  
TREASURY**

**REPUBLIC OF SOUTH AFRICA**

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**EXPLANATORY MEMORANDUM**

**ON THE**

**TAXATION LAWS AMENDMENT BILL, 2011**

**27 January 2012**

[W.P. — '11]

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# 1. INCOME TAX: RATES AND THRESHOLDS (Appendix I)

*Table I: Current rates for individuals and special trusts:*

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

*Table II: Proposed rates for individuals and special trusts:*

Taxable income	Rate of tax
Not exceeding R150 000	18 per cent of taxable income
Exceeding R150 000 but not exceeding R235 000	R27 000 plus 25 per cent of amount by which taxable income exceeds R150 000
Exceeding R235 000 but not exceeding R325 000	R48 250 plus 30 per cent of amount by which taxable income exceeds R235 000
Exceeding R325 000 but not exceeding R455 000	R75 250 plus 35 per cent of amount by which taxable income exceeds R325 000
Exceeding R455 000 but not exceeding R580 000	R120 750 plus 38 per cent of amount by which taxable income exceeds R455 000
Exceeds R580 000	R168 250 plus 40 per cent of amount by which taxable income exceeds R580 000

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

Taxable Income	Rate of Tax
All taxable income	40 per cent of the taxable income

*Table IV: Current rate for companies (no change proposed):*

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

*Table V: Current rates for small business corporations:*

Taxable Income	Rate of Tax
Not exceeding R54 200	0 per cent of taxable income
Exceeding R54 200 but not exceeding R300 000	10 per cent of the amount by which the taxable income exceeds R54 200
Exceeding R300 000	R24 580 plus 28 per cent of the amount by which the taxable income exceeds R300 000

*Table VI: Proposed rates for small business corporations*

Taxable income	Rate of tax
Not exceeding R59 750	0 per cent of taxable income
Exceeding R59 750 but not exceeding R300 000	10 per cent of amount by which taxable income exceeds R59 750
Exceeding R300 000	R24 025 plus 28 per cent of amount by which taxable income exceeds R300 000

*Table VII: Current rates for registered micro businesses:*

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

*Table VIII: Proposed rates for registered micro businesses*

Taxable turnover	Rate of tax
Not exceeding R150 000	0 per cent of taxable turnover
Exceeding R150 000 but not exceeding R300 000	1 per cent of amount by which taxable turnover exceeds R150 000
Exceeding R300 000 but not exceeding R500 000	R1 500 plus 2 per cent of amount by which taxable turnover exceeds R300 000
Exceeding R500 000 but not exceeding R750 000	R5 500 plus 4 per cent of amount by which taxable turnover exceeds R500 000
Exceeding R750 000	R15 500 plus 6 per cent of amount by which taxable turnover exceeds R750 000

*Table IX: Current rates for gold mining companies (no change proposed):*

Taxable Income	Rate of Tax
On gold mining taxable income	See formula in paragraph 4(b) of Appendix I
On non gold mining taxable income	28 per cent of the taxable income
On non gold mining taxable income if exempt from STC	35 per cent of the taxable income
On recovery of capital expenditure	Greater of average rate or 28 per cent of the taxable income

*Table X: Current rate for PBO's, companies and trusts (no change proposed):*

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

*Table XI: Current rate for company personal service providers (no change proposed):*

Taxable Income	Rate of Tax
All taxable income	33 per cent of taxable income

*Table XII: Current rates for long-term insurance companies (no change proposed):*

Taxable Income	Rate of Tax
Taxable income of individual policyholder fund	30 per cent of taxable income
Taxable income of company policyholder fund	28 per cent of taxable income
Taxable income of corporate fund	28 per cent of taxable income

*Table XIII: Current rate for non-resident companies (no change proposed):*

Taxable Income	Rate of Tax
All taxable income from South African source	33 per cent of taxable income

*Table XIV: Current rates for retirement lump sum withdrawal benefits:*

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

*Table XV: Proposed retirement fund lump sum withdrawal benefits:*

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

*Table XVI: Current rates for retirement lump sum benefits:*

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

Table XVII: Proposed retirement lump sum benefits

<b>Taxable income from lump sum benefits</b>	<b>Rate of tax</b>
Not exceeding R315 000	0 per cent of taxable income
Exceeding R315 000 but not exceeding R630 000	R0 plus 18 per cent of taxable income exceeding R315 000
Exceeding R630 000 but not exceeding R945 000	R56 700 plus 27 per cent of taxable income exceeding R630 000
Exceeding R945 000	R141 750 plus 36 per cent of taxable income exceeding R945 000

Table XVIII: Current rebates

Description	Amount
Primary rebate	R10 260
Secondary rebate	R5 675

Table XIX: Proposed rebates

<b>Description</b>	<b>Reference to Income Tax Act, 1962</b>	<b>Amount</b>
Primary rebate	Section 6(2)(a)	R10 755
Secondary rebate	Section 6(2)(b)	R6 012
Tertiary rebate	Section 6(2)(c)	R2 000

Table XX: General savings thresholds

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amount
Broad-based employee share schemes		
Maximum exemption for shares received by an employee in terms of a broad-based employee share plan	Definition of "qualifying equity share" in section 8B(3)	R50 000
Maximum deduction for shares issued by an employer in terms of a broad-based employee share plan	The proviso to section 11(IA)	R10 000
Exemption for interest and certain dividends		
Exemption for foreign dividends and interest from a source outside the Republic which are not otherwise exempt	Section 10(1)(i)(xv)(aa)	R3 700
In respect of persons 65 years or older, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt	Section 10(1)(i)(xv)(bb)(A)	R33 000
In respect of persons younger than 65	Section 10(1)(i)(xv)(bb)(B)	R22 800

years, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt		
Annual donations tax exemption		
Exemption for donations made by entities	Section 56(2)(a) and the proviso thereto	R10 000
Exemption for donations made by individuals	Section 56(2)(b)	R100 000
Capital gains exclusions		
Annual exclusion for individuals and special trusts	Paragraph 5(1) of Eighth Schedule	R20 000
Exclusion on death	Paragraph 5(2) of Eighth Schedule	R200 000
Exclusion in respect of disposal of primary residence (based on amount of capital gain or loss on disposal)	Paragraph 45(1)(a) of Eighth Schedule	R1,5 million
Exclusion in respect of disposal of primary residence (based on amount of proceeds on disposal)	Paragraph 45(1)(b) of Eighth Schedule	R2 million
Maximum market value of all assets allowed within definition of small business on disposal when person over 55	Definition of "small business" in paragraph 57(1) of Eighth Schedule	R5 million
Exclusion amount on disposal of small business when person over 55	Paragraph 57(3) of Eighth Schedule	R900 000

*Table XXI: Retirement savings thresholds*

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



Pension fund monetary amount for permissible lump sum withdrawals	Paragraph (ii)(dd) of proviso to paragraph (c) of definition of "pension fund" in section 1	R50 000
Retirement annuity fund monetary amount for permissible lump sum withdrawals	Paragraph (b)(ii) of proviso to definition of "retirement annuity fund" in section 1	R50 000

*Table XXII: Deductible business expenses for individuals*

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Car allowance		
Ceiling on vehicle cost	Section 8(1)(b)(iiiA)(bb)(A)	R480 000
Ceiling on debt relating to vehicle cost	Section 8(1)(b)(iiiA)(bb)(B)	R480 000

*Table XXIII: Employment-related fringe benefits*

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Exempt scholarships and bursaries		
Annual ceiling for employees	Paragraph (ii)(aa) of proviso to section 10(1)(q)	R100 000
Annual ceiling for employee relatives	Paragraph (ii)(bb) of proviso to section 10(1)(q)	R10 000
Medical scheme contributions		
Monthly ceiling for schemes with one beneficiary	Section 18(2)(c)(i)(aa) and paragraph 12A(1)(a) of Seventh Schedule	R670
Monthly ceiling for schemes with two beneficiaries	Section 18(2)(c)(i)(bb) and paragraph 12A(1)(b) of Seventh Schedule	R1 340
Additional monthly ceiling for each additional beneficiary	Section 18(2)(c)(i)(cc) and paragraph 12A(1)(c) of Seventh Schedule	R410
Awards for bravery and long service	Paragraphs (a) and (b) of further proviso to paragraph 5(2) of Seventh Schedule	R5 000
Employee accommodation	Paragraph 9(3)(a)(ii) of Seventh Schedule	R59 750
Accommodation for expatriate employees	Paragraph 9(7B)(ii) of Seventh Schedule	R25 000
Exemption for de minimis employee loans	Paragraph 11(4)(a) of Seventh Schedule	R3 000

Additional employer deductions for learnerships		
Monetary ceiling of additional deduction for the employer when utilising a learnership agreement with an employee	Section 12H(2)	R30 000
Monetary ceiling of additional deduction for the employer in the case of an employee completing a learnership agreement	Section 12H(3) and (4)	R30 000
Monetary ceiling of additional deduction for the employer involving a learnership agreement with an employee with a disability	Section 12H(5)	R20 000

*Table XXIV: Depreciation*

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Small-scale intellectual property	Paragraph (aa) of proviso to section 11(gC)	R5 000
Urban Development Zone incentive	Section 13quat(10A)	R5 million

*Table XXV: Miscellaneous*

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Low-cost housing		
Maximum cost of residential unit where that residential unit is an apartment in a building	Paragraph (a) of definition of "low-cost residential unit" in section 1	R250 000
Maximum cost of residential unit where that residential unit is a building	Paragraph (b) of definition of "low-cost residential unit" in section 1	R200 000
Industrial policy projects		
Maximum additional investment allowance in the case of greenfield projects with preferred status	Section 12I(3)(a)	R900 million
Maximum additional investment allowance in the case of other greenfield projects	Section 12I(3)(a)	R550 million
Maximum additional investment allowance in the case of brownfield projects with preferred status	Section 12I(3)(b)	R550 million
Maximum additional investment allowance in the case of other brownfield projects	Section 12I(3)(b)	R350 million

Maximum additional training allowance (per employee)	Section 12I(5)(a)	R36 000
Maximum additional training allowance in the case of industrial policy projects with preferred status	Section 12I(5)(b)(i)	R30 million
Maximum additional training allowance in the case of other industrial policy projects	Section 12I(5)(b)(ii)	R20 million
Minimum cost of manufacturing assets for greenfield projects	Section 12I(7)(a)(i)(aa)	R200 million
Amounts to be taken into account in determining whether an industrial project constitutes a brownfield project	Section 12I(7)(a)(i)(bb)(A)	R30 million
	Section 12I(7)(a)(i)(bb)(B)	R200 million
Venture capital companies		
After 36 months, at least 80 per cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a junior mining company, with assets of which the book value does not exceed the amount indicated immediately after the issue	Section 12J(6A)(b)(i)	R300 million
After 36 months, at least 80 per cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a company, other than a junior mining company, with assets of which the book value does not exceed the amount indicated	Section 12J(6A)(b)(ii)	R20 million
Presumptive turnover tax		
A person qualifies as a micro business for a year of assessment where the qualifying turnover of that person for that year does not exceed the amount indicated	Paragraph 2(1) of Sixth Schedule	R1 million
Maximum of total receipts from disposal of immovable property and assets of a capital nature by micro business	Paragraph 3(e) of Sixth Schedule	R1,5 million
Minimum value of individual assets and liabilities in respect of which a micro business is required to retain records	Paragraphs 14(c) and (d) of Sixth Schedule	R10 000
Public benefit organisations		
PBO trading income exemption	Section 10(1)(cN)(ii)(dd)(ii)	R200 000
Deduction of donations to transfrontier parks	Section 18A(1C)(a)(ii)	R1 million
Housing provided by a PBO: maximum monthly income of beneficiary household	Paragraph 3(a) of Part I of Ninth Schedule and paragraph 5(a) of Part II of Ninth Schedule	R7 500
Recreational clubs		
Club trading income exemption	Section 10(1)(cO)(iv)(bb)	R120 000

Prepaid expenses		
Maximum amount of deferral	Paragraph (bb) of proviso to section 23H(1)	R80 000
Small business corporations		
Maximum gross income	Section 12E(4)(a)(i)	R14 million
Housing associations		
Investment income exemption	Section 10(1)(e)	R50 000

*Table XXVI: Administration (Taxation Laws Second Amendment Bill)*

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

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

Description (The contents of this column are solely for convenience and are of no force or effect)	Reference to Value-Added Tax Act, 1991	Monetary amount
Registration		
-Compulsory	Section 23(1)(a)	R1 million
-Voluntary	Section 23(3)(b), (c) and (d)	R50 000
-Commercial accommodation	Paragraph (a) of definition of 'commercial accommodation' in section 1	R60 000
-Payments basis of VAT registration	Section 15(2)(b)(i)	R2,5 million
-Exception to payments basis : in respect of supplies of goods or services made by a vendor	Section 15(2A)	R100 000

Tax invoices		
-Abridged tax invoice	Section 20(5)	R3 000
-No tax invoice required	Section 20(6)	R50
Tax periods		
- Category C (monthly) submission of VAT 201 return	Section 27(3)(a)(i)	R30 million
-Category D (6-monthly) submission of VAT 201 return	Section 27(4)(c)(i)	R1,5 million
-Category F (4-monthly) submission of VAT 201 return	Section 27(4B)(a)(i)	R1,5 million

*Table XXVIII: Transfer Duty: Imposition*

Value	Rate of Tax
Does not exceed R600 000	0%
Exceeding R600 000 but not exceeding R1 million	3% on such value
Between R1.0 million and R1.5 million	5% of such value plus R12 000
Exceeds R1.5 million	8% on such value plus R37 000

*Table XXIX: Diamond Export Levy: Rate and Exemptions*

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

*Table XXX: Royalty Act: Rate and Exemption*

Royalty formulae	Rate
-Refined: $0.5 + \left[ \frac{\text{EBIT}}{\text{gross sales} \times 12.5} \right] \times 100$	Cannot exceed 5%
-Unrefined: $0.5 + \left[ \frac{\text{EBIT}}{\text{gross sales} \times 9} \right] \times 100$	Cannot exceed 7%
Exemption for small business	
-Gross sales of extractor does not exceed R20 million	

*Table XXXI: Estate Duty: Rates, thresholds and abatement*

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

## **2. INCOME TAX: EMPLOYMENT, INDIVIDUALS AND SAVINGS**

### **2.1. RETIREMENT: THIRD REBATE FOR OLDER PERSONS**

[Clause 9(1)(b)(b-d), Applicable provision: Section 6]

#### **I. Background**

The tax system contains two rebates applicable to natural persons – a primary rebate and a secondary rebate. The primary rebate is available to all natural persons; whereas, the secondary rebate is available solely to persons of age 65 or more.

#### **II. Reasons for change**

The purpose of the rebates is to provide relief for subsistence living. The secondary rebate recognises that subsistence living may be higher at old age due to ill-health and loss of job opportunities. The net effect of this rebate is to shelter passive income, regardless of source (e.g. annuities and interest).

At issue is the depth of the relief. Many elderly persons, especially those of more advanced age, are under pressure with risk-free yields dropping nationally as well as globally. This decline on risk-free yields has a unique impact on the elderly who are seeking stable income in their final years. Given this impact, many elderly persons are seeking some form of tax relief to maintain sufficient funding without direct subsidies from Government.

#### **III. Proposal**

In order to provide further relief for persons of advanced age, a third rebate is proposed. Persons of age 75 or more will now be entitled to a third rebate (in addition to the previous two rebates). This third rebate will equal R2 000.

#### **IV. Effective date**

The proposed amendment will be effective from 1 March 2011.

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### **2.2. MEDICAL SCHEME CREDITS**

[Clauses 43(1)(a-b)(g), 94(a-b), 95 and 105; Applicable provisions: Insertion of section 6A; amendment of section 18; deletion of paragraph 2(e) of the Fourth Schedule, addition of subparagraph (6) to paragraph 9 of the Fourth Schedule and amendment of paragraph 12A of the Seventh Schedule]

#### **I. Background**

Even though the income tax system does not generally allow for deductions in respect of personal consumption, medical expenses remain a notable deviation. An incentive exists for

taxpayers to make contributions to medical schemes. Taxpayers making these contributions receive a set level of monthly deductions depending on the number of persons utilising the scheme. These deductions are premised on contributions associated with average minimum benefits associated with all domestic medical schemes. Over the years, the level of permissible deductions for these contributions has been adjusted upward on an annual basis.

## **II. Reasons for change**

Several years ago, deductions for medical scheme contributions were switched from a 2/3rds approach to a set formula because the 2/3rds formula awarded taxpayers with more expensive plans. This 2/3rds formula was viewed as providing unfair benefits for upper-income families that could afford more expensive plans. The revised system of set monthly numerical deductions was designed to level the playing field.

Currently at issue is the use of deductions. It is now contended that the current deduction system still operates to the unfair benefit of wealthier taxpayers. The net effect of a deduction in respect of low-taxed workers is an effective savings of 18 per cent of the contributions; whereas, wealthier individuals achieve an effective savings of 40 per cent.

A need has also been identified to accommodate situations where a taxpayer is incurring medical expenditure in respect of the taxpayer's immediate family for whom he or she is liable for family care and support. This accommodation is often required where a member of the taxpayer's immediate family is disabled or elderly.

## **III. Proposal**

### *A. Annual adjustment for the current tax year*

In terms of the current tax year, deductions for monthly medical contributions will again be raised. Taxpayer contributions are set at R720 for the benefit of the taxpayer and at R720 for the benefit of the first dependant (normally the taxpayer's spouse). Deductible contributions for coverage relating to other dependents are set at R440 per dependant.

### *B. Conversion to a credit system*

In the longer term, it is proposed that the deduction system for medical scheme contributions be converted into a credit system in respect of all taxpayers. (However, the full deduction for medical scheme contributions currently in place in the case of taxpayers 65 years of age and older will remain at least temporarily). Under the credit system, all taxpayers under 65 years of age will receive a tax credit for monthly medical contributions that will equally benefit all taxpayers in nominal terms. In particular, taxpayers will receive a monthly tax credit of R216 per person, per month for themselves and their spouses. In terms of other dependants, these credits will be set at R144 per person. The credit will be non-refundable and will operate in the same way as the first, second and third rebates.

### *C. Broadening of "dependant" definition*

Taxpayers that incur medical expenditure in respect immediate family for whom they are liable for family care and support should be recognised by the tax system. To this end, the definition of dependant will be broadened so as to allow a taxpayer to claim the related



expenditure in line with the taxpayer's regime where the expenditure is either allowed in full, or subject to the 7,5% of taxable income rule.

**Example:**

**Facts:** A single taxpayer under 65 years of age, and not disabled, incurs medical expenses on behalf of his or her mother. This taxpayer is liable for family care and support in respect of his or her mother.

**Result:** The taxpayer will be able to add the expenditure incurred in respect of his or her mother to his own medical expenditure. The taxpayer will accordingly be able to claim a deduction to the extent that this total amount exceeds 7, 5 per cent of his taxable income.

*D. Discussion document*

A discussion document has been issued that further clarifies the policy associated with the conversion from deductions to credits in respect of medical scheme contributions. The discussion document also investigates the use of a tax credit system in respect of out-of-pocket medical expenses.

**IV. Effective date**

The increased annual deductions associated with medical scheme contributions will be effective for all contributions occurring on or after 1 March 2011. The pending credit system for medical scheme contributions and the broadened dependant definition will be effective from 1 March 2012.

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**2.3. DIVIDENDS FROM EMPLOYEE SHARE-BASED TRUSTS**

[Clause 28(1)(n); Applicable provision: Section 10(1)(k)(i)(dd)]

**I. Background**

*A. Disposal or vesting of restricted share incentive schemes*

Anti-avoidance rules exist to prevent taxpayers from disguising high-taxed salary through the use of restricted share (or share-based) incentive schemes that would otherwise trigger low-taxed (or even no-taxed) income or capital gains. These anti-avoidance rules essentially trigger ordinary revenue when these instruments are disposed of by employees (or fully vest for their benefit). The triggering events are designed to be delayed so that the appreciation associated with these schemes is fully taxed.

The anti-avoidance rules at issue technically apply to "restricted equity instruments." The term "equity instrument" is fairly expansive, including shares and share-based rights associated with shares. These share-based rights even include contractual rights or obligations, the value of which is determined directly or indirectly with reference to a share. In order for an equity instrument to be viewed as a restricted equity instrument, these equity instruments must contain one or more restrictions that mainly relate to the disposal or ownership of those instruments.

## *B. Dividends from share incentive schemes*

In 2010, further amendments were added to prevent avoidance schemes stemming from the dividend aspect of restricted share (or share-based) incentive schemes. More specifically, dividends in respect of equity instruments are treated as ordinary revenue unless the instruments constitute an equity share or the dividend itself constitutes an equity instrument. The purpose of these dividend rules is to prevent taxpayers from converting high-taxed salary into low (or no) taxed dividends. The schemes of concern relate to special shares whose sole value relates to dividend rights held by employees.

## **II. Reasons for change**

The newly added anti-avoidance rule of 2010 appears to be an effective mechanism for preventing the use of dividends from restricted shares (or share-based) incentive schemes as a mechanism to disguise salary. However, the new rule is seemingly overly broad, covering transactions never intended. Of particular concern is the holding of shares through employee trusts.

While employee trusts are a common source of mischief, many employee trusts exist simply as a matter of administrative convenience in order to simplify administration of widely-targeted employee shares. Some of these trusts contain restrictions so that the employees retain some interest in the employer for a meaningful duration. This form of restriction is common in the case of black economic empowerment. Hence, the 2010 legislation in inadvertently imposes ordinary revenue treatment in respect of dividends arising from almost all employee share trusts.

## **III. Proposal**

The proposed legislation retains ordinary treatment for restricted equity share schemes as a general rule, but the revised legislation contains a carve-back. The purpose of the carve-back is to limit the new anti-avoidance rule without re-opening pre-existing avoidance. More specifically, if the only shares held by a trust are unrestricted equity shares, those dividends will be excluded from the anti-avoidance rule.

### ***Example:***

***Facts:*** Company X creates an employee share scheme trust. Company X lends R10 million to the trust, which acquires a specified number of ordinary shares in Company X. The shares in the trust will vest in the employees after a period of five years. The dividends received by the trust on the shares are used to pay off the Company X loan, with the balance paid to employees.

***Result:*** The dividends received by the Company X as repayment for loan amount as well as dividends received by employees are not subject to the anti-avoidance rules. These dividends will accordingly retain their exemption from normal tax despite the holding of the shares in a restricted equity trust.

#### **IV. Effective date**

The proposed amendment will be effective as of 1 January 2011 in respect of dividends received or accrued on or after that date.

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#### **2.4. EMPLOYER-OWNED INSURANCE POLICIES: EMPLOYER CONTRIBUTIONS AS A TAXABLE FRINGE BENEFIT**

[Clauses 30(1)(d), 47(1)(a-b), 94(1)(a), 102(1)(b-c), 106 and 161; Applicable provisions: Substitution of section 11(w)(i); Amendment of section 23(p); addition of item (cA) to paragraph 2(4) of the Fourth Schedule; amendment to paragraph 2(e) of the Seventh Schedule; addition of subparagraph (k) to paragraph 2 of the Seventh Schedule; addition of paragraph 12C to the Seventh Schedule;]

##### **I. Background**

###### *A. Policy types*

Employers generally enter into four different types of policies for the benefit of their employees or directors, or for their dependants and nominees (for the purposes of employer-owned insurance policies discussed in this document, reference will hereinafter only be made to “employees”). These four types of policies are as follows:

- Employer-funded death or permanent disability risk policies conducted through an ‘approved’ plan (i.e. group long-term insurance with the pension or provident fund being the policyholder);
- Employer-owned death or permanent disability risk policies through an ‘unapproved’ plan (i.e. an insurance policy where the employer is the policyholder);
- Employer-owned income protection risk policies; and
- Employer-owned compensation policies.

Each of these policies makes payment upon the death, disability, or severe illness of an employee of the taxpayer.

In the case of unapproved plans, the parties to whom the proceeds must be paid may vary. The policy can be structured so that the proceeds can be paid directly to the employees or to the employer. If the payout is made to the employer, a side arrangement usually exists so that the employer is obligated to turn over the insurance proceeds (or their equivalent) to the employees.

It must be noted in the case of employer-funded death or permanent disability risk policies that are conducted through an approved pension or provident fund, that the tax treatment follows the same paradigm as employer contributions to employer-retirement funds. As a

result, no fringe benefit will be generated in the case of employer-funded death or permanent disability risk policies conducted through an 'approved' plan.

#### *B. Long- and short-term insurance policies*

Employer-owned insurance policies relating to the death, disability or severe illness of an employee can be structured as a long-term or short-term insurance policy. In the case of a long-term insurance policy, there is often a direct link between the employees that are the subject of the policy and the premiums payable. For instance, the premium may be based on the value of the employee's income that must be replaced. However, in the case of short-term insurance there is often no direct link between individual employees and the value of the premium payable; the value of the premium is instead determined based on the total risk profile of the employee group. This form of short-term insurance typically provides incidental insurance relating to employees (e.g. in the case of work-related casualties).

#### *C. "For the benefit of the employee"*

As stated previously, an insurance policy can be intended directly or indirectly for the benefit of an employee. The employee can be the named beneficiary of the insurance policy. Alternatively, the employer can have an obligation in terms of the employment contract to pay the proceeds over to the employee. It is also possible that, in the absence of a formal obligation to pay over the proceeds, the established practice of the employer might indicate that the employer has the intention to benefit the employee. In each of these cases, the view is that the employer paid the premiums under the insurance policy directly or indirectly for the benefit of the employee.

### **II. Reasons for change**

If an employer incurs premiums in respect of a policy of insurance that relates to the death, disability or severe illness of employees for the direct or indirect benefit of those employees, the employees may deduct the premiums incurred in respect of that policy. However, the payment of the insurance premiums shall give rise to a simultaneous fringe benefit inclusion for the employees. The net effect should be a deduction for the employer and a matching inclusion for the employee so that the fiscus is in a neutral position with regard to time-value-of-money principles.

Alternatively, if an employer is the named beneficiary but has a side arrangement with the employee (or a mere intention or practice to pay over the policy proceeds to its employees), the tax impact should be the same as for payments made directly by the insurer to the employee. The employer is effectively incurring the expense of a "service" for the benefit of the employee. Nonetheless, the lack of explicit language has given rise to unnecessary disputes with some taxpayers taking the position that many of these indirect arrangements are beyond the reach of the fringe benefit regime.

### **III. Proposal**

#### *A. Employer insurance contributions as a fringe benefit*

In view of the need for clarity, explicit fringe benefit rules will be added for employer-owned insurance policies for the direct or indirect benefit of employees. Fringe benefit inclusions for

these benefits will equal employer premium contributions (i.e. will be deemed to be the value of the taxable fringe benefit). These fringe benefit inclusions will be taken into account for Pay-As-You-Earn purposes.

It must be noted that even in cases where an employer-owned insurance premium falls outside of the ambit of the explicit fringe benefit rules discussed above, pre-existing paragraph 2(k) of the Seventh Schedule may apply to treat other forms of employer-provided insurance as a taxable employer-provided service.

#### *B. Employer-owned income protection risk policies*

Employer-provided disability policies will largely follow the same paradigm as unapproved group plans that protect against death. However, a long-held distinction exists between two forms of disability plans – income capacity versus income protection.

More specifically:

- *Income capacity plans*: Individual income capacity plans operate just like individual life plans (no deduction for the individual, but a tax-free payout of proceeds). Furthermore, employer-owned income capacity plans operate just like employer-owned life plans (deductible employer premiums matched by employee fringe benefit inclusions, and a tax-free payout). These fringe benefit inclusions for premiums will be taken into account for Pay-As-You-Earn purposes.
- *Income protection plans*: On the other hand, in the case of an individual income protection plan, the individual is incurring an expense related to the production of income with the premium being deductible by the individual. The corollary is that the payment of the proceeds results in gross income (see the discussion under EMPLOYER-OWNED INSURANCE POLICIES: TAXATION OF PROCEEDS PAYOUT). Similarly in the case of an employer-owned income protection plan, employees should be entitled to a deduction to the extent of the fringe benefit incurred as a result of the employer paid insurance premium. To ensure that the deduction will be available to the employee, the premium paid by the employer will be deemed to have been paid by the employee to the extent of the fringe benefit incurred. The employer administration around Pay-As-You-Earn will comprise the inclusion of the fringe benefit and the deduction of the premium. The result will be a monthly set-off, and the employee will be in a tax neutral position.

#### *C. Employer-owned compensation policies*

In the past, the premiums paid by an employer in respect of hybrid investment/risk policies for the benefit of employees were generally not included as a fringe benefit, particularly in the case of deferred benefit schemes. Instead, these policies were treated as taxable upon payout of the proceeds. As part of the general rule in respect of employer-provided benefits (see above), this position will now be rectified. Going forward, the employer will have to include the premium as a fringe benefit in the income of the employee (under the explicit fringe benefit rules inserted).

Because these policies will now generate a fringe benefit for the employee, policyholders (employers) may seek to end the arrangement. (See the discussion under EMPLOYER-

OWNED INSURANCE POLICIES: CESSION OF COMPENSATION AND PURE RISK POLICIES).

#### **IV. Effective date**

These amendments will apply to all premiums incurred on or after 1 March 2012.

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### **2.5. EMPLOYER-OWNED INSURANCE POLICIES: KEYPERSON RISK PLANS**

[Clauses 48(1)(b), 161 and 163; Applicable provision: Substitution of section 11(w)(ii); Addition to section 23B; Amendment to section 19 of Act 7 of 2010; Repeal of section 42 of Act 7 of 2010]

#### **I. Background**

Some businesses take out keyperson insurance policies on the life of an employee (the keyperson) whose services contribute substantially to the success of the business, and whose death or disability will result in a loss for the business. The policy is owned and paid by the business (i.e. the business is the policyholder).

Upon the loss of a keyperson, the proceeds may assist the business by enabling the business to:

- Survive losses during the adjustment period (i.e. loss of clients due to the loss of the keyperson); and/or
- Meet the special expenses of recruiting and training a new employee.

Underlying business expenses are potentially deductible by the employing business, and the premiums in respect of insurance intended to meet such expenses should be similarly deductible.

Under income tax legislation, the tax impact of keyperson plans depends on whether the plan is conforming or non-conforming. Employers with conforming plans (i.e. those meeting certain statutory requirements) can deduct the premiums in respect of those plans; whereas, no deduction is allowed for non-conforming plans. As a practical matter, insurance pay-outs from conforming plans give rise to tax, whilst pay-outs from non-conforming plans are generally viewed as tax-free.

#### **II. Reasons for change**

In 2010, the rules relating to keyperson plans were changed based on the fact that the vast majority of employers entering into genuine keyperson plans desire a tax-free payout of proceeds as opposed to receiving an upfront deduction in respect of premiums incurred. For most businesses, the tax-free nature of the proceeds is viewed as the top priority. Otherwise, employers must top-up these plans to additionally cover potential taxes arising from policy payouts.

Employers seeking false-keyperson plans, on the other hand, were the main drivers for the upfront deduction. The goal for this category of employers was an upfront deduction for the employer without a corresponding fringe benefit in respect of the premiums for the employee. The taxable nature of the payment proceeds, and the (often) non-deductibility of the proceeds payout by the employer was ultimately less of a concern for employers because these payment proceeds were largely intended for the benefit of the employees.

### **III. Proposal**

In view of the above, taxpayers seeking an upfront deduction for keyperson policy plans will now have to opt into the regime. Inaction will mean that the premiums in respect of the policy will remain non-deductible (despite satisfying the other objective requirements). Non-deductible treatment means that the policy will give rise to a tax-free payment of proceeds. It is assumed that most employers will opt for inaction to obtain the default (non-deductible premiums with non-includible payouts).

Taxpayers seeking to opt into the regime must express a choice in the policy agreement (or an addendum thereto) by adding to the agreement that section 11(w)(ii) is intended to apply to that policy agreement. This choice is to be expressed by making this statement in the policy agreement so that the choice is clearly visible for all parties involved (including SARS). The one-off choice cannot be changed once made.

Other than expressly exercising the choice in the policy agreement that section 11(w)(ii) applies to that agreement, the taxpayer must also meet other objective criteria (introduced in the 2010 legislation):

- The business must be insured against the loss of a keyperson by reason of death, disability or severe illness;
- The policy must solely be a risk policy (without any cash or surrender value associated with investment policies); and
- The taxpayer must be the sole owner of the policy (setting aside the holding of technical title by creditors as collateral security).

It should be noted that it is the view of National Treasury that the reference to “an employee or director” in section 11(w)(ii) also includes plural form.

### **IV. Effective dates**

In respect of policies in existence before 1 March 2012, the policyholder must express the choice in favour of a section 11(w)(ii) deduction within the policy agreement (by way of addendum) by 31 August 2012. In respect of policies entered into on or after 1 March 2012, the choice can be expressed in the policy agreement itself. In both cases, the proposed amendment is applicable in respect of premiums incurred on or after 1 March 2012 only.

## 2.6. EMPLOYER-OWNED INSURANCE POLICIES: TAXATION OF PROCEEDS PAYOUT

[Clauses 7(1)(p) and (v), 28(1)(h) and 114; Applicable provisions: Paragraphs (d) and (m) of the definition of “gross income” in section 1; subparagraphs (gG) and (gH) of section 10(1); paragraph 55 of the Eighth Schedule]

### I. Background

#### A. Objective of employer-owned insurance policies

In the basic paradigm, businesses take out insurance to guard against loss, and individuals acquire their own insurance for the benefit of themselves (or their dependants or designated nominees). However, under certain circumstances, employers take out insurance in the event of death, disability or severe illness of their employees.

More specifically, the insurance proceeds can be intended for the benefit of:

- The employer (for example, keyperson risk policies or a policy of insurance intended to fund a buyout of ownership in the event that one of the owners dies); or
- The employees or their dependants (for example, employer-owned death or permanent disability risk policies, employer-owned income protection risk policies; or employer-owned compensation policies).

In the case of risk policies, the policy payouts are either in the form of a lump sum paid out to the beneficiaries (such as in the case of a death benefit) or in an annuity format (such as in case of income protection policies). In the case of investment policies, the policy proceeds are typically paid out in the form of a lump sum.

#### B. Flow of policy proceeds

As stated previously, an employer can either take out an employer-owned insurance policy that relates to the death, disablement or severe illness of employees for the employer's benefit or for the benefit of the employees. In the case where the employer intends to benefit, the structure is simple. The employer pays the premiums, and the employer is the beneficiary under the policy entitled to the benefits.

However, in the case where the employer intends for the employee to benefit from the proceeds payout, there are two possible structures:

- The policy can be structured so that the employee is the direct beneficiary, resulting in the proceeds being paid directly by the insurer to the employee; or
- The policy can be structured so that the proceeds payout is made by the insurer to the employer as the beneficiary under the policy. In this case, there is a corresponding obligation on the employer (usually in terms of an agreement between the employer and the employee) to pay over the proceeds (or their equivalent) to the employee. This



structure effectively leaves the employer in a neutral position with the benefit being received by the employee.

### *C. Tax impact of policy proceeds*

The tax treatment associated with policy proceeds received in respect of insurance policies (risk and/or investment) is governed by a combination of common law, legislation and practice. Basic common law appears to generally view lump sum proceeds as capital in nature (thereby falling outside of ordinary revenue).

In respect of the income tax treatment, special legislative rules (which were amended in 2010) exist for employer-owned insurance policies. The 2010 amendments were an attempt to clarify the tax treatment of the different types of employer-owned insurance policies in respect of policy payouts, taking into account the deduction for premiums paid.

In the case of capital gains, an explicit set of capital gain rules exist for long-term insurance proceeds. Original holders and beneficiaries are often free from capital gains taxation with secondary holders being subject to capital gains tax. The capital gains tax treatment for secondary holders was designed to eliminate the secondary market in respect of endowment plans. The capital gains tax also contains a few additional exemptions with long-term insurance policy proceeds conceivably becoming subject to capital gains tax if the proceeds arise in circumstances that fall between the exemption gaps.

## **II. Reason for change**

In order to create certainty in the industry, it is necessary to:

- Create a unifying theoretical theme that recognises and caters for the various types of employer-owned insurance policies;
- Create a tax regime in which tax consequences designed for a certain type of policy can be isolated; and
- Clarify the ordinary revenue and capital gains tax treatment of proceeds derived from employer-owned insurance policies.

In particular, the 2010 amendments did not sufficiently separate the various types of insurance policies from a legislative point of view, resulting in unintended consequences, and uncertainty. Given these concerns, the 2010 legislation should be repealed and a new paradigm created to cater for existing and new employer-owned insurance policies.

## **III. Proposal**

### *A. Overview*

#### 1. Basic paradigm

In view of the above, a new comprehensive set of rules are proposed to address the tax treatment of proceed payouts from employer-owned insurance policies. Application of these rules will essentially fall into the following paradigm:

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

## 2. Basic rules

As a general rule, it is proposed that all amounts directly or indirectly received or accrued from an insurer in terms of an employer-owned insurance policy (risk and/or investment) be initially included as gross income. The effect of the general rule is that the policyholder and/or the employee may be taxed on the policy proceeds. The inclusion of policy proceeds in gross income will typically cover proceeds payable upon the contingency of death, disability, or severe illness. Loans or advances granted by an insurer based on the value of the policy will similarly be included in gross income.

The second rule is that gross income in respect of employer-owned insurance policies may be eligible for one of two overall exemptions:

- An exemption for policyholders (employers) receiving proceeds in terms of a policy where the benefit was intended for the policyholder; and
- An alternative exemption for the employee, in the case of the employee or his/her dependants or nominees receiving the proceeds.

As a side matter, the tax regime for policy proceeds (i.e. the inclusion and exclusions) does not apply if the proceeds of a policy are part of an 'approved' group life plan associated with pension or provident fund membership. In the case of an 'approved' group life plan, the policy proceeds will be received by the pension or provident fund involved. The pension or provident fund will in turn pay the proceeds received to the member, or his/her dependant. The amounts so paid will be taxed under the retirement tax regime (i.e. pursuant to the lump sum formula), or alternatively as an annuity, without regard to the new rules proposed.

### *B. Proceeds received by the employer (paragraph (m) of the "gross income" definition)*

In respect of a proceeds payout in the case of an employer-owned insurance policy where the policy proceeds are received by the policyholder (the employer), the policyholder will be taxed, subject to a particular exemption. The exemption relates to keyperson plans where the policyholder did not choose to be eligible for the deduction of the premiums as from 1 March 2012 onwards. Restated for clarification, if the employer policyholder receives the insurance proceeds in respect of an employer-owned insurance risk policy for the benefit of the employer on or after 1 March 2012, the proceeds will be tax-exempt unless the policyholder elected in the policy agreement to be eligible to claim the premiums as deductions.

It should be noted that no exemption is available for the employer in the case of proceeds received by the employer in respect of an employer-owned insurance policy that is intended

for the benefit of an employee. The employer will be taxed on the policy proceeds received (as an inclusion of the proceeds in gross income). However, the employer will be eligible for a deduction when paying over the proceeds to an employee (if there is an obligation to do so), leaving the employer in a tax neutral position.

*C. Proceeds received by the employee (paragraph (d) of the “gross income” definition)*

As is the case with policy proceeds received by an employer, an employee will be taxed on policy proceeds stemming from an employer-owned insurance policy. Furthermore, the employee will be taxed regardless of whether the policy proceeds are received by the employee, or the dependant or nominee of the employee. Lastly, the employee will be taxed irrespective of whether the policy proceeds are received directly (from the insurer) or indirectly (from the employer).

Similar to the case where policy proceeds are received by an employer, the employee will be entitled to an exemption in respect of the policy proceeds received if the premiums were funded with post-tax contributions. More specifically, insurance proceeds received by the employee (or his/her dependants or nominees) on or after 1 March 2012 will be exempt in the hands of the employee:

- In the case of pure risk policies, if the premiums on or after 1 March 2012 were taxable in the hands of the employee as a fringe benefit, unless a subsequent deduction was also available (for example in the case of employer-owned income protection risk policies).
- In the case of any other policy, if all the premiums payable in respect of the policy were indeed taxed as a fringe benefit in the hands of the employee.

In respect of the employer’s Pay-As-You-Earn obligation, if the exemption discussed above applies, the employer does not have an obligation to declare any income on the tax certificate of the employee. However, where the exemption does not apply, the employer will have an obligation to deduct employees’ tax from the proceeds payout regardless of whether:

- The policy proceeds are paid to the employee or the employee’s dependant or nominee; or
- The proceeds are paid by the employer (indirect receipt) or by the insurer (direct receipt).

*D. Capital gains tax*

As under current legislation, second-hand long-term insurance policies will remain subject to capital gains tax. The intention is to continue to discourage the trade in second-hand policies (that is, policies purchased from or ceded to another person by the original beneficial owner).

It is now proposed that:

- All risk policies be specifically excluded from the application of capital gains tax (including second-hand policies). The nature of a risk policy prohibits these policies from being regularly traded as a ‘second-hand’ policy because these policies do not have inherent tradable value.

- A specific exemption from capital gains tax will also be introduced in respect of employer-owned long-term insurance policies if the amount to be taxed is included in the gross income of any person, regardless of whether that amount is subsequently exempted from gross income. Therefore, when policy proceeds from an employer-owned insurance policy are exempted from gross income, the exemption should not trigger an adverse capital gains result. In effect, the exemptions should be broad enough to effectively exempt the policy proceeds from the income tax as well as from the capital gains tax regime.

Otherwise, the existing exclusions remain within the capital gains regime for long-term insurance.

#### **IV. Effective date**

The proposed amendments are generally effective for amounts received or accrued on or after 1 March 2012.

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### **2.7. EMPLOYER-OWNED INSURANCE POLICIES: CESSION OF COMPENSATION AND PURE RISK POLICIES**

[Clauses 7(1)(p)(d)(iii), 28(1)(h), 160 and 162; Applicable provisions: Paragraph (d)(iii) of the definition of “gross income” in section 1; subparagraph (gG) of section 10(1); Amendment of section 18 of Act 7 of 2010; Repeal of section 41 of Act 7 of 2010]

#### **I. Background**

##### *A. Employer-owned compensation policies*

Deferred compensation policies (as with share option schemes) were used as a method of providing benefits to selected employees on retirement. This type of policy was a hybrid investment/risk policy. Most often, structured with the weighting towards investment and a small life cover element.

Under this previous regime, the employer enjoyed a deduction in respect of each premium paid upfront on the hybrid investment/risk policy. However, there was no concurrent inclusion of income for the employee in respect of the premiums as long as the employee has no vested right in the policy. In effect this regime allowed for an annual tax mismatch of premiums.

##### *B. Employer-owned pure risk policies*

Employers enter into employer-owned pure risk policies for their own benefit (keyperson policies), or for the benefit of their employees (employer-owned death or permanent disability risk policies). When the employee exits the service of the employer, the need for the employer to continue with the policy ceases.

Instead of allowing the policy to lapse, employers often cede these policies to their ex-employees. Once the employee takes over the policy, the employee will have the obligation to

pay the premiums and have the benefit of being the policyholder. At this stage, there is a cessation of the employer's involvement with the policy upon cession with the employee assuming all risks and entitlements.

## II. Reason for change

Government indicated in 2010 that deferred compensation policies should be discontinued because these policies cause a tax mismatch as discussed above. However, because many of these policies were in existence at the time, it was determined that an exit strategy is needed for the policyholder (employer) to escape the structure.

Pure risk policies do not have any inherent value. Therefore, the cession of a pure risk policy to an employee should not generate a tax event for either the employer or the employee. Despite this lack on inherent value, it is understood that for reasons of health or age the employee may be better off continuing with the risk policy than taking out a new risk policy.

## III. Proposal

### A. *Pre-1 March 2012 compensation plans*

In respect of old deferred compensation plans, a legislative exit route will be made available to policyholders so that these policies can exit the system. The employer will have the option to exercise one of the following exit routes, once the policy has been made paid-up (i.e. when the employer ceases contributing to the policy):

- *Cede the policy:* The employer can cede the policy to the employee. In this case, the value of the policy as at the date of cession will be included in the income of the employee. The income will not be taxable as a "severance benefit" regardless of the circumstances of the cession.
- *Make the policy paid-up:* The employer can elect to receive the proceeds from the policy and thereupon pay those proceeds over to the employee. The employer will be in a tax neutral position with an inclusion and a deduction in respect of the value of the proceeds. The employee will be taxed on the proceeds received from the employer (and these amounts will be included within Pay-As-You-Earn withholding). Again, the proceeds will not be taxable as a "severance benefit", regardless of the circumstances of the payout.

If the employer decides to continue making payments on the policy, the employer will be obliged to tax the employee on the value of the premiums paid as a fringe benefit from 1 March 2012 onwards. Once the policy pays out, the employer will be in a tax neutral position with an inclusion and a deduction in respect of the value of the proceeds (provided that the employer has an obligation to pay over the proceeds). However, the employee will be taxed on the proceeds received from the employer in full (with consequent Pay-As-You-Earn withholding) without regard to the "severance benefit" rules. The net result is disadvantageous from a tax point of view, thereby necessitating the escape routes above.

### B. *Compensation plans from 1 March 2012*

As per the general rule in effect from 1 March 2012, all premiums paid in respect of employer-owned investment policies for the benefit of employees must be included in the income of the

employees as a taxable fringe benefit. As a result, any cession or payout in respect of that insurance policy will not be taxable as long as “all” the premiums paid by the employer have actually been subjected to tax as a fringe benefit in the hands of the employee.

*C. Cession of compensation investment and pure risk policies*

It is proposed that the cession of pure risk policies not generate income in the hands of the employee. This exclusion applies regardless of how the previous policyholder (i.e. the previous employer) treated the policy from a tax point of view.

**IV. Effective date**

The proposed amendments are effective in respect of amounts received or accrued on or after 1 March 2012.

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**2.8. ROAD ACCIDENT FUND PAYOUTS**

[Clause 28(1)(g); Applicable provision: Section 10(1)(gB)]

**I. Background**

*A. Road Accident Fund compensation*

The Road Accident Fund is designed to operate as a national centralised financial pool that provides compensation for damages sustained in motor vehicle accidents (Road Accident Fund Act, 1956 (Act No. 56 of 1996)). Compensation relates to bodily injury and death (including associated direct and indirect costs).

*B. Taxation of lump sums versus annual payments*

The starting point for determining gross income is to include all receipts and accruals other than amounts of a capital nature. In terms of court-related claims, lump sum payments would generally qualify as capital amounts so as to be exempt. On the other hand, annualised payments would fall squarely within gross income. Upfront amounts typically replace permanent capital lost; whereas, annualised amounts typically act as a substitute for lost anticipated gross income.

**II. Reason for change**

Compensation paid by the Road Accident Fund is currently paid in the form of a lump sum. The Road Accident Fund is now planning to additionally allow for claims to be paid in the form annualised amounts spread over several years. The annualised spreading of income often operates as a better method of providing financial security for victims seeking to recover from (or merely survive) serious vehicle accidents. Annualised payments effectively spare the victims from having to undergo the risk of managing lump sums, thereby covering victims and their families over extended periods of hardship.

### **III. Proposal**

While the capital versus ordinary distinction in the case of involuntary compensation is not being questioned, special relief currently exists for various forms of Government payments. This relief for Government payments applies regardless of whether amounts are paid as an annuity or as a lump sum. For instance, workmen's compensation paid pursuant to the Compensation for Occupational Injuries and Diseases Act, 1993 (Act No. 130 of 1993) is fully exempt. This exemption applies regardless of whether the amounts paid are in the form of a lump sum or as annualised payments. In essence, workmen's compensation never fully makes the taxpayer whole from work-related injury, thereby justifying special tax relief.

It is accordingly proposed that payments pursuant to claims against the Road Accident Fund be treated in the same fashion as workmen's compensation. Payments in respect of claims from the Road Accident Fund should be fully exempt regardless of whether the payment is in the form of an upfront lump sum or in the form of annualised payments.

### **IV. Effective date**

The proposed amendment is effective for Road Accident Fund payments received or accrued on or after 1 March 2012.

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## **2.9. EMPLOYEE COMPENSATION FUND ENTITIES**

[Clauses 28(1)(r) and 129(1)(a); Applicable provisions: Sections 10(1)(t); 10(1)(gB) of the Income Tax Act; section 21 of the Compensation Fund; VAT section - Section 8(28) or proviso (xi) to section 1 "enterprise"]

### **I. Background**

#### *A. Regulatory overview*

The Compensation for Occupational Injuries and Diseases Act (COIDA) regulates the compensation relating to the death or personal injury suffered by an employee in the course of employment. The central role-player in respect of COIDA is the Compensation Fund, an entity wholly owned by Government and operated under the supervision of the Compensation Commissioner. Employer contributions to the Compensation Fund are comprised of assessment contributions determined in terms of the Standard Assessment Rate announced in the Government Gazette as set by the Compensation Commissioner. The rates imposed on an employer are based on death/injury risk ratios within the industry in question. The Compensation Commissioner also sets the injury/death benefit payouts to employees (or their dependents).

COIDA also allows for the license of private mutual entities to operate comparable injury/death benefit schemes in lieu of the Compensation Fund (section 30 of the COIDA). Minimum employer contributions to these mutual entities and minimum benefit payouts by these mutual entities are set by the Compensation Commissioner. At present, Federated Employee Mutual (FEM) and Rand Mutual Assurance (RMA) are the sole private entities licensed to provide employee compensation. FEM covers the construction industry, and RMA covers the mining industry. FEM provides benefits solely as required under COIDA;

whereas, RMA provides COIDA as well as additional death/injury benefits. Both entities pre-date COIDA.

### *B. Current tax treatment*

A specific income tax exemption exists for the Compensation Fund under COIDA, thereby allowing for the tax-free growth of the fund. Benefit payouts to employees in terms of COIDA are similarly exempt. The entity-level exemption for the build-up of funds does not apply to private mutual entities licensed under COIDA, but benefit payouts by these entities made in terms of COIDA are exempt. Although the build-up of funds for the private mutual entities is taxable, the build-up of fund reserves for one of the current mutual entities is allegedly exempt under the provisions applicable to public benefit organisations.

The Compensation Fund cannot register for Value-added Tax (VAT) because the Fund operates as a regulated entity under the Public Finance Management Act. Both private mutual entities qualify as vendors under the VAT with premiums payable by employers subject to the VAT just like the payment of any other insurance premiums.

## **II. Reason for change**

As discussed above, although private mutual funds operating under COIDA can provide income tax-free COIDA benefits, no specific comparable income tax exemption exists for private mutual funds that build-up of reserves. In this vein, although one mutual fund is allegedly exempt as a PBO (see above), it is likely that the reserves for this mutual entity will soon become taxable in view of SARS' rightful intention to withdraw the exemption. No reason therefore exists for this uneven treatment, especially to the extent these private mutual entities act in substitution of Government. Similar parity should also exist for VAT. This overall parity of treatment is important to ensure that these entities are not forced to increase premiums or offer lower benefits vis-à-vis the Compensation Fund for the same COIDA benefits

## **III. Proposal**

In view of the above, it is proposed that the relief currently afforded to the Compensation Fund under COIDA be extended to the mutual associations licensed under COIDA. However, in order to receive this entity-level income tax exemption, these licensed mutual entities must solely provide COIDA-required benefits (without any benefits in excess of these amounts). This same condition is required for these mutual entities to be free from VAT registration.

Therefore, FEM will become free from Income Tax and VAT as a result of the proposed amendments. RMA, on the other hand, can only receive the same Income Tax and VAT exemption if the benefits provided in excess of COIDA requirements are segregated from RMA into another entity.

## **IV. Effective date**

For income tax purposes, the proposed amendment will come into operation from 1 January 2012. For VAT purposes, according to general principles, the proposed amendment will apply to all services supplied on or after the date of promulgation of the Bill.



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## **2.10. JUDICIAL LONG DISTANCE COMMUTING**

[Clause 103; Applicable provision: Insertion of subparagraph (8A) into paragraph 7 of the Seventh Schedule; see also (eB) of the “remuneration” definition contained in paragraph 1 of the Fourth Schedule]

### **I. Background**

A taxable fringe benefit arises when employees use employer-owned vehicles for private purposes. Taxation of this fringe benefit is reduced by the distances travelled for business purposes. Daily work commuting (i.e. travel between the taxpayer’s place of residence and place of employment) is not viewed as business travel. Taxpayers claiming the motor vehicle allowance similarly cannot claim the allowance against daily work commuting.

### **II. Reason for change**

Many judges face a unique work commute situation. Judges are often required to serve various courts, many of which are spread far and wide from one another. For instance, some judges may be required to travel long distances to reach the district courts versus the Supreme Court of appeal in Bloemfontein in order to carry out their duties. These judges cannot be expected to regularly shift homes to shorten their shifting work locations. In order to alleviate this situation, judges are afforded the use of Government-owned vehicles to complete these various journeys as part of their compensation packages.

In 2010, the fringe benefit rules for motor vehicles became substantially more restrictive to prevent taxpayers from obtaining undue benefits in respect of employer-provided vehicles. These changes have had the unfortunate effect of adversely impacting judges who utilise Government-owned vehicles for long-distance work commuting.

### **III. Proposal**

Due to their unique circumstances, judges will be allowed to treat their daily work commute as business travel for purposes of determining the fringe benefit impact of employer-provided vehicles. Like all other taxpayers claiming work-related travel, judges will be required to maintain a logbook to record the distances associated with their work-related travel (which will now include work commuting). Judges can claim fringe benefit relief on assessment or obtain monthly relief from Pay-As-You-Earn withholding (by virtue of the 80/20 relief mechanism).

### **IV. Effective date**

The proposed amendments will be effective as from 1 March 2011.

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### **3. INCOME TAX: BUSINESS**

#### **3.1. DIVIDENDS TAX: REMOVAL OF THE VALUE- EXTRACTION TAX (VET)**

[Clauses 7(1)(n-o)(r-u), 73, 76(1)(c); Applicable provisions: Section 1 definition of ‘gross income’, section 57, addition to section 64E, proposed part IX (the VET)]

##### **I. Background**

The proposed Dividends Tax regime shifts the tax liability in respect of dividends from the distributing company to the beneficial owner of the dividend. As part of this change, the ‘dividend’ definition has undergone significant amendments. The new dividend definition encompasses any amount that has been transferred or applied by virtue of any share held in that company. This definition accordingly seeks to move beyond pure dividends declared so as to cover disguised dividends.

In addition, the Value Extraction Tax is intended to replace the current deemed dividend rules associated with the soon-to-be replaced Secondary Tax Companies. The objective of the VET is to trigger a tax when any form of value is extracted from a company for the benefit of connected persons in relation to the paying company. The VET covers several forms of disguised dividends, including disguised dividends resulting from the granting of financial assistance (i.e. discounted loans or advances).

##### **II. Reasons for change**

The determination of whether a payment by a company to its shareholders constitutes a disguised dividend is essentially a question that entirely depends on the facts and circumstances. The shifting of value from a company without a dividend declaration could alternatively stem from some other originating link, such as salary to shareholder-employees, payment for an asset or use thereof, or as an indirect gift by a controlling shareholder.

The VET (like the former deemed dividend regime associated with the soon-to-be-replaced Secondary Tax on Companies) assumes certain forms of value extraction automatically result in a deemed dividend without regard to the facts and circumstances. For instance, when a company pays or settles debts of a third party creditor owed by an indebted shareholder, the automatic result is deemed dividend treatment when the value shift could, in fact, stem from some other cause. This automatic deemed dividend stands in contrast to certain aspects of the “dividend” definition, which assumes that the term “dividend” includes disguised dividends (i.e. by covering payments to shareholders “by virtue of” the underlying shares).

##### **III. Proposal**

###### *A. General facts and circumstances linkage*

It is proposed that the VET regime be completely deleted. The determination of whether value extracted from a company amounts to a dividend or stems from some other cause must be resolved solely by reliance on the facts and circumstances. Consistent with this change, some of the technical “linkage” language associated with the gross income definition will be adjusted to ensure consistency. Whether a value extraction from a company qualifies as a

dividend, salary, payment for the purchase of an asset or use of an asset (amongst others) must be determined through reliance on the same legal connection (e.g. “in respect of” or “as consideration for”).

**Example:**

**Facts:** Company is owned 100 per cent by Individual. At the instance of Individual, Company purchases a car for the benefit of Individual.

**Result:** The zero-rated loan is possible because Individual owns all the shares of Company, thereby being “in respect of” the shares held by Individual. The “in respect of” language goes beyond the “by virtue of” test (which would focus on the technical legal rights associated with separate shares as opposed to a focus on the shares as held by one party in an aggregate).

As part of this change, the impact of value extraction to a person in the form of a donation will be clarified. More specifically, if value is extracted from a company at the instance of a person as a donation to a third party, two transactions have effectively occurred. The value extraction from the company represents some form of constructive dividend to that person, followed by a donation by that person to the third party.

**Example:**

**Facts:** Company X is owned 60 per cent by Individual A and 40 per cent by Individual B. At the instance of Individual A, Company X makes a cash payment of R10 000 to Son (of Individual A) that is received by Son as a donation.

**Result:** The R10 000 cash is being applied to Son by virtue of Individual A’s shares in Company X and should accordingly be viewed as a dividend to Individual A. The R10 000 amount should then be viewed as a donation received by Son from Individual A.

**B. Discounted loans or advances**

Despite the elimination of VET, loans or advances from a company to a shareholder (or any person connected to the shareholders) will still automatically to be a deemed dividend in certain circumstances. This deeming rule will be triggered when a loan or advance has been made to a resident person that is not a company. This rule is retained for the sake of providing certainty in respect of a common practice.

The amount of the dividend that is deemed to have arisen from the loan or advance will be equal to the deemed market-related amount of interest in respect of the loan or advance less the amount of interest that is actually paid. The market-related interest rule is similar to the rules for a interest-free or discounted loans contained in the Seventh Schedule. Moreover, even with regard to the proposed deeming rules, a dividend could still be deemed to occur under the general facts-and-circumstances analysis if a borrower has no intention to repay the capital amount borrowed.

**Example:**

**Facts:** Individual A owns 100 per cent of the equity shares in Company X. Company X provides a loan of R 100 000 to Individual A at an interest rate

of 6 percent. The corresponding current 'official interest rate' at the time of the loan as fixed by the Minister is 8 per cent.

**Result:** Individual A intends to repay the loan over a period of 5 years. The amount to be treated as a dividend will be equal to R 2 000. [R 100 000 (8 per cent - 6 per cent) = R 8 000 – R 6 000]. However if, based on the facts and circumstances, Individual A does not have any intention to repay the loan, the loan capital can be treated as a dividend upfront (that is, when the R 100 000 is made available to Individual A).

The proposed rule accordingly creates an annual charge that is comparable to the discount loan rules involving disguised employee fringe benefits. The exemptions applicable in respect of the Dividends Tax will also be applicable to the rules for discounted loans or advances (for example, inter-company shareholder loans).

#### **IV. Effective date**

The proposed amendment will be effective on the same date as the new Dividends Tax enters force (i.e. distributions received or accrued on or after 1 April 2012).

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### **3.2. DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

[Clauses 7(1)(c-g)(i)(k)(m)(zJ)(zO), 15(1)(b-c), 18, 19, 24(1)(d), 28(1)(l), 34(1)(a), 60, 67(1)(f-g), 68(1)(g), 70(1)(c), 72(1)(f-g), 96, 98, 113(1)(i), 117(1)(a and c), 119(1)(a-c), 120, 122 and 123(1)(b); Applicable provisions: Section 1 and 64D of the Income Tax Act, Paragraph 74 of the Eighth Schedule]

#### **I. Background**

South African and foreign companies may distribute cash or in specie assets to their shareholders. These distributions may constitute a dividend or a return of capital.

Dividends distributed by resident companies generally attract Secondary Tax on Companies ("STC") at company level at a flat rate of 10 per cent. The STC system is to be replaced with a Dividends Tax at shareholder level. Dividend distributions made by non-resident companies are referred to as "foreign dividends" and are included in gross income, subject to certain exemptions.

Return of capital payments fall under a different system of tax than dividends. Return of capital payments are subject to the Capital Gains Tax. The same capital gain rules apply to both domestic and foreign return of capital payments. As a result of changes made in 2010, the main distinction between a dividend versus a return of capital distribution is based on whether the distribution comes from "contributed tax capital." Distributions drawn from contributed tax capital qualify as a return of capital while distributions from other sources qualify as dividends.

## II. Reasons for change

The new Dividends Tax and comprehensive changes to the Companies Act legislation have forced core definitions to be revisited. In 2010, new definitions for domestic and foreign dividends were enacted along with a new definition of equity shares.

While these recent changes are fundamentally correct, the piecemeal nature of these changes creates incongruities and potential anomalies. The relationship of domestic and foreign distributions is also somewhat unclear. A streamlined set of definitions is accordingly required for a cleaner landscape.

## III. Proposal

### A. *Overview*

Three sets of definitions are proposed. Under the first set, payments from domestic companies by virtue of their shares will be treated either as dividends or return of capital. Under the second set, payments from foreign companies by virtue of their shares will be treated either as foreign dividends or foreign return of capital. The third set clarifies the share and equity share definitions.

### B. *(Domestic) dividends and return of capital*

Core aspects of the (domestic) dividend and return of capital definitions provide roughly the same trigger. Both sets of transactions arise from amounts transferred roughly by a domestic company by virtue of the company's issued shares or similar interests, regardless of whether the transfer arises by way distribution or repurchase of the company's own shares. Both sets of transactions exclude the issue by a company of its own shares and general buybacks of a company's own shares (i.e. where the seller on the open market cannot readily identify the purchaser).

The one distinction between (domestic) dividends and that of a return of capital payment relates to contributed tax capital. Return of capital payments must be drawn from the paying company's contributed tax capital (i.e. a tax account stemming from shareholder investments measured in tax terms).

### C. *Foreign dividends and foreign return of capital*

The proposed foreign dividend definition will essentially rely on the foreign income tax law characterisation of the payment of the country in which the company payor is effectively managed. If the country of the company payor does not have any applicable laws in relation to the tax on income, the foreign company law characterisation will prevail. Nonetheless, regardless of any foreign law characterisation, excluded from this definition is the redemption of participatory interests in a foreign collective investment scheme (effectively matching the exclusion of current law).

This definition also takes into account the existence of certain foreign entities that are not recognised as companies for South African company law purposes (e.g. Dutch co-operatives). Certain amounts paid by these entities will lose their status as a foreign dividend to the extent that these amounts are not deductible by that entity under foreign income tax

principles that determine the taxes on income in the country in which that entity is effectively managed.

The definition of a foreign return of capital definition will also be added. This definition roughly mirrors the foreign dividend definition but only includes the residual (that is, non-dividend distributions in respect of shares or similar equity instruments made by the foreign company). Like the foreign dividend definition, the status of a foreign payment depends upon foreign income taxation (or foreign company law characterisation if the country in which the payor resides lacks an income tax).

#### *D. Share and equity share definitions*

The term “shares” and “equity shares” is frequently used throughout the Income Tax Act. In 2010, the term “equity shares” was defined as “any share or similar interest that does not carry any right to participate beyond a specified amount in a distribution.” The equity share definition is fundamentally correct but will be changed to include “similar equity interest” as opposed to “similar interests” to clarify that the definition cannot exclude debt. Reference to “similar equity interest” is meant to cover interests in entities that are similar to companies, such as a member’s interest in a close corporation or a co-operative.

In addition, a “share” definition is proposed. This definition will mirror the “equity share” definition with one caveat. The “share” definition applies regardless of whether the share or similar interest “carries any right to participate beyond a specified amount in a distribution.”

#### *E. Removal of the shareholder definition*

The shareholder definition focuses on both the share register and beneficial ownership. This duality creates confusion because the person named in the share register is not necessarily the beneficial owner of the share (for example, a regulated intermediary). Consistent with the overall philosophy of the Income Tax Act, the focus should solely be on the beneficial owner of the shares. It is also accordingly proposed that the shareholder definition be deleted (because the definition treats both registered and beneficial owners of shares as “shareholders”). The focus should always be on the beneficial owner of the share (that is, “the holder” or “the person who holds the shares”), not the registered owner.

#### *F. Collateral changes*

The above terms are frequently used throughout the Income Tax Act. As a result, the use of the term “dividend” will be clarified as to whether the term is intended to cover domestic versus foreign dividends or a combination of both. The term “distribution” will similarly be clarified as to whether the term includes both dividends and return of capital or simply one kind of distribution. The terms “equity shares” and “shares” are also being reviewed throughout the Income Tax Act to ensure appropriate use. Due to the deletion of the term “shareholder”, the concept will instead be denoted by the use of the words “holder or “hold” to denotes beneficial ownership.

#### **IV. Effective date**

The proposed amendment in respect of dividends and return of capital will generally be effective from 1 January 2012. However, the revised foreign dividend definition will be effective from 1 January 2011.

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### **3.3. DIVIDENDS TAX: ACCRUAL VERSUS CASH ACCOUNTING**

[Clause 76(1)(a) and (c); Applicable provision: Section 64E (2) of the Income Tax Act]

#### **I. Background**

The Secondary Tax on Companies (“STC”) falls on the company declaring the dividend. On 1 April 2012, the STC will be replaced with the Dividends Tax. The Dividends Tax applies at the shareholder-level.

Tax liability for the Dividends Tax will be triggered when the dividend is paid to the shareholder. The dividend will be deemed to be paid on the date on which the dividend accrues to the shareholder. Case law defines accrual as an unconditional entitlement to an amount.

#### **II. Reasons for change**

In many cases (especially in the case of closely-held companies), the date of dividend declaration and the date of dividend payment are the same. However, a delay may exist between declaration and payment. This delay is most prominent in the case of listed companies with these companies using a “last date to register” as an interim date for settling dividend accrual. This issue can also arise in closely-held situations. For example, a closely-held company may declare a dividend far in advance of cash available to clear profits before the entry of new shareholders.

The difference in accrual versus payment often causes unique difficulties when applying tax withholding. Withholding agents (especially regulated intermediaries) cannot practically be expected to withhold cash on dividends without timely physical control over the cash. If foreign dividends from foreign shares listed on the JSE are involved, there is the added problem of foreign currency conversion. If the accrual date precedes the cash payment date, the Rand-to-foreign currency value might fluctuate so that the shareholder receives a different Rand value than the Rand value accrued.

#### **III. Proposal**

Because the concept of accrual often cannot be practically applied in the context of withholding, the timing rules will be changed in favour of actual or constructive payment. Under this revised concept, the Dividends Tax will be triggered when an actual payment of the dividend is made (“actual payment”) or when the dividend becomes payable to the shareholder (that is, on the last date of registration of the dividend in respect of listed shares).

**Example 1:**

**Facts:** Listed Company declares a dividend on 1 March. The last date to register in respect of the dividend is 13 March. The date of payment of the dividend is 20 March.

**Result:** The payment (withholding) date is the date on which the dividend is payable by the company payor (i.e. 13 March).

**Example 2:**

**Facts:** Company (an unlisted company) announces a declaration of a dividend on 1 March with the date of payment to be announced in the future (i.e. date of payment unspecified). On 15 August, a board decision is made for payment to occur on 1 November with the actual payment made accordingly.

**Result:** The applicable date is 1 November (i.e. the date that the dividend is payable).

**Example 3:**

**Facts:** The facts are the same as Example 2, except that the dividend is ultimately cancelled in October (i.e. before actual payment).

**Result:** The Dividends Tax never arises because the dividend is never actually paid or payable.

**IV. Effective date**

The proposed amendment will be effective when the Dividends Tax comes into effect (i.e. 1 April 2012).

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**3.4. DIVIDENDS TAX: IN SPECIE DIVIDENDS**

[Clauses 75, 76(1)(b), 77, 78(1)(a-b), 79, 80, 81, 82, and 118; Applicable income tax provisions: Section 64D (paragraph (b) of the “dividend” definition, section 64E, section 64F[A], section 64G(1), section 64H(1), section 64I, section 64K(1), (3) and (4); paragraph 74 (“date of distribution” definition) of the 8<sup>th</sup> Schedule]

**I. Background**

Companies pay dividends in cash or in kind (i.e. the latter being referred to as dividends in specie). The Secondary Tax on Companies generally imposes tax on companies when declaring dividends. The Dividends Tax will replace the Secondary Tax on Companies. As part of this change, the Dividends Tax will shift technical liability onto the shareholder, but the Dividend Tax will include a withholding tax collection mechanism that is imposed on the payor.

**II. Reason for change**



The taxation of *in specie* dividends poses administrative problems when the method of collection involves withholding. While a company paying the dividend can possibly plan so as to set aside the cash needed to pay the tax for *in specie* dividends, withholding intermediaries will often not be in this position. Cash availability will be especially problematic for regulated intermediaries (e.g. central securities depository participants). Most regulated intermediaries are merely collection agents that are not otherwise required to hold substantial cash reserves.

Another set of issues relates to the valuation of *in specie* dividends. Values may be volatile even over short periods (especially if the *in specie* dividends consist of listed shares). Funds set aside to pay the Dividend Tax may be sufficient at one point in time, but insufficient if the *in specie* asset subsequent increase in value. It should be noted that valuation is also important in the case of determining company-level gain or loss in respect of the assets distributed and for determining the impact of *in specie* return of capital distributions.

### **III. Proposal**

#### *A. Domestic companies making in specie dividends*

A set of special rules will be added for *in specie* dividends in view of the practical cash problems described above. In particular, the proposed shift of liability to a shareholder-level will not apply in the case of *in specie* dividends distributed by domestic companies. Under the new system, the company distributing the *in specie* dividend remains liable for paying the tax. The withholding mechanism for *in specie* dividends of this nature will be rendered irrelevant.

Despite the shift in liability, *in specie* dividends will be eligible for the same exemptions as cash dividends. For instance, *in specie* dividends paid by domestic companies to domestic companies will be exempt like cash dividends. In order for the company payor to receive this exemption, the company must generally receive a declaration of exemption from the beneficial owner by the date that the dividend is paid. The only deviation from the declaration rule involves dividends paid to a domestic group company member or for certain residential property company distributions; in these latter instances, the exemption applies automatically. Tax treaty relief is also available for *in specie* dividends with declarations from beneficial owners similarly required. Lastly, credits stemming from the Secondary Tax on Companies will be available to the same extent as those credits are available for cash dividends.

Administration of *in specie* dividends by domestic companies will operate under roughly the same administration as cash dividends. For instance, the tax payment due date will remain the same (i.e. the last day of the month following the month in which the dividend was paid). However, no refunds are envisioned for late declarations.

#### *B. Foreign in specie dividends*

Unlike domestic *in specie* dividends (see above), South Africa (like all countries) does not have the authority to tax foreign residents in respect of foreign-related payments (i.e. foreign companies paying *in specie* foreign dividends). Therefore, *in specie* dividends declared by foreign companies will not trigger tax for that foreign company. These dividends will instead be subject to the normal tax (at the maximum effective rate of 10 per cent) without regard to the Dividends Tax, even if the foreign dividend is paid in respect of JSE shares.

## **IV. Effective date**

The proposed changes will come into effect when the Dividends Tax comes into effect (i.e. 1 April 2012).

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### **3.5. DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

[Clauses 7(1)(u), 25(1)(i), 28(1)(p), 29, 45, 110 and 116(1)(f-g) and (i); Applicable provisions: Sections 1 definition of "gross income" (paragraph (k)); section 6 quat(1A) and (1B); section 9D(9)(f); 10B]

#### **I. Background**

##### *A. Taxation of dividends paid by domestic companies*

Under current law, the Secondary Tax on Companies generally imposes tax at a rate of 10 per cent on companies declaring dividends. This system is to be replaced with the Dividends tax system. The Dividends Tax will be levied at the shareholder-level at a rate of 10 per cent, with certain exemptions. The liability to withhold the Dividends Tax falls on the company paying the dividend; whereas, the primary liability for the Dividend Tax falls on the beneficial owner of the dividend.

##### *B. Taxation of dividends paid by foreign companies*

Foreign dividends are not subject to the current Secondary Tax on Companies nor will foreign dividends be subject to the new Dividends Tax. Foreign dividends mainly fall outside these regimes (except for foreign cash dividends paid in respect of JSE listed shares). South Africa lacks the ability to directly tax the foreign company paying these dividends, even if paid to a South African resident.

As a general rule, foreign dividends are included in the recipient's gross income and taxed at marginal rates (that is, 28 per cent for companies and up to 40 per cent for individuals). This form of taxation is subject to several exemptions, as follows: (i) the participation exemption, (ii) the previously-taxed income exemption, and (iii) the dual-listed companies' exemption (the last of which will be deleted once the new Dividends Tax comes into effect). In addition, natural persons are entitled to a de minimis exemption of R3 700 on the aggregate of foreign dividends received or accrued during any year of assessment.

A rebate (i.e. a credit) for direct foreign taxes paid in respect of foreign dividends is available as a measure to relieve double taxation. Interest expenditure that is incurred in earning foreign dividends is deductible in determining the taxable income of the taxpayer, but these deductions are ring-fenced against ordinary revenue associated with these foreign dividends.

#### **II. Reasons for change**

At issue is the lack of parity between domestic and foreign dividends. As stated above, taxpayers face a maximum rate of 10 per cent when receiving domestic dividends; whereas,

taxpayers face a maximum 28 or 40 per cent rate when receiving foreign dividends. This disparity is particularly apparent in the case of dual listed companies. Dividends from JSE listed shares in respect of a dual listed company will be subject to the maximum 10 per cent rate; whereas, dividends from shares listed on a foreign exchange in respect of the same company are subject to a maximum 28 per cent or 40 per cent rate.

### III. Proposal

#### A. General rule

The proposed disparity of maximum rates between domestic and foreign dividends will be eliminated. However, foreign dividends cannot become part of the new Dividends Tax because South Africa does not have the ability to generally impose a withholding tax on foreign companies paying a dividend. Therefore, foreign dividends (except foreign dividends in respect of JSE listed shares) will remain within normal income tax system (including the provisional tax and final year of assessment payments). However, the marginal rate system will be adjusted so that the maximum rate does not exceed the 10 per cent rate imposed on domestic dividends. This 10 per cent effective rate will be determined using certain formula rates (e.g. the 30140 exemption for natural persons and the 19128 exemption for companies)

Foreign dividends are subject to four exemptions as listed below:

- (i) Participation exemption exists as under prior law. Under this exemption, foreign dividends will be exempt if received by or accrued to a person who holds more than 10 per cent of the equity share and voting rights in the company declaring the foreign dividend.
- (ii) A new country-to-country participation exemption is now being added. In terms of the country-to-country exemption, a CFC will be allowed to claim the participation exemption without regard to the 10 per cent participation requirement if the foreign dividends are paid by a foreign company which is situated within the same country as the CFC to which the foreign dividend is paid. The country-to-country exemption is being introduced because foreign dividends between companies in the same country are typically exempt (similar to the new Dividend Tax).
- (iii) The previously taxed income exemption.
- (iv) An exemption for cash foreign dividends will be added in respect of JSE listed shares (because these are taxed under the Dividends Tax).

The participation and country-to-country exemptions are subject to an override that mimics the current rule contained in section 10(1)(k)(ii)(dd). In particular the participation exemption and the country-to-country exemptions will not apply if the amount of the foreign dividend:

- is determined directly or indirectly with reference to (or arises from) from any amount payable by any person to any other person; and

- the amount paid or payable is deductible by the payor and not subject to tax in the hands of the recipient taxpayer (or in respect of a recipient CFC, if not taken into account in determining the net income of that CFC).

**Example**

**Facts:** SA Company 1 pays interest on a loan provided by Foreign Company. Another company (SA Company 2) owns 15 per cent of the ordinary shares in Foreign Company. The dividend paid in respect of the preference shares held by SA Company 2 is determined with reference to the interest payable by SA Company 1 in respect of the interest bearing loan from Foreign Company.

**Result:** The foreign dividend paid to SA Company 2 is not subject to the participation exemption because this dividend is determined with reference to a deductible amount of interest payable by SA Company 1.

The participation and the country-to-country exemptions will also not be applicable if the foreign dividend is received by or accrued to any person from a foreign CIS (Note that redemptions or buybacks by a foreign CIS are instead subject to the capital gains regime). In addition, none of the complete exemptions contained in this regime apply if payments are made (in respect of an annuity) out of foreign dividends. This latter anti-avoidance already applies to domestic dividends.

D. Rebates and deductions

The rebate (i.e. credit) for direct foreign taxes paid in respect of foreign dividends will remain. While these rebates only take into account taxable income (thereby excluding foreign dividends exempt by virtue of the participation and previously taxed income exemptions), these rebates will not be directly reduced by the partial income (30/40 or 18/28) exemption. However, these rebates will be subject to the worldwide foreign source-to-total income ratio, just like any other foreign rebates. The worldwide foreign source-to-total income ratio will achieve this result by excluding all exempt income, even the partially (30/40 or 18/28) exempt income, from the numerator with the denominator not being reduced for the partial (30/40 or 18/28) exempt income.

However, the current deduction system for expenses associated with foreign shares will be dropped. Henceforth, no deductions will be allowed for expenses incurred in relation to the acquisition of the foreign shares because no comparable deduction is allowed for expenses associated with domestic shares.

**Example**

**Facts:** Mr. M, a South African resident, pays taxes at a marginal rate of 40 per cent. Mr. M holds 2 per cent of the total equity shares and voting rights in Foreign Company (a company that does not qualify as a controlled foreign company). Foreign Company pays a dividend of R1.2 million to Mr. M, which is subject to foreign withholding taxes of 8 per cent (i.e. R96 000).

**Result:** The R1.2m dividend will be included in Mr. M's gross income. The participation and previously taxed income exemptions do not apply.

However, the dividend is exempt to a ratio of 30/40. Therefore, the amount includable in Mr. M's taxable income in relation to the dividend is R300 000 (1/4th of R1.2 million). Assuming no other income, the South African tax on the foreign dividend is R120 000 (i.e. R300 000 x 40%) less the R96 000 of foreign tax rebates, thereby amounting to R24 000.

#### **IV. Effective date**

In the case of natural person, trusts and comparable taxpayers, the proposed amendment will be effective for dividends received or accrued on or after 1 March 2012. In the case of companies, the proposed amendment will be effective for years of assessment commencing on or after 1 April 2012.

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### **3.6. DIVIDENDS TAX: CONTRIBUTED TAX CAPITAL ADJUSTMENTS**

[Clause 7(1)(b); Applicable provisions: Section 1 ("contributed tax capital" definition); Paragraph 19 of the Eighth Schedule]

#### **I. Background**

##### *A. Dividends versus return of capital distributions*

Company distributions (including buyouts and liquidations) can be classified as dividends or a return of capital. As a general matter, the default position is dividend treatment. However, the transfer of contributed tax capital ("CTC") translates this treatment into a return of capital distribution.

Under the new dividends tax, dividends paid to individual and foreign persons are subject to a 10 per cent charge (with the latter potentially reduced by virtue of tax treaty). Dividends paid to domestic companies are tax-free. The Dividends Tax is largely enforced through a system of withholding imposed on the paying company (or regulated intermediary).

Return of capital creates different results. Gain from return of capital payments to individuals are generally subject to a maximum 10 per cent charge, payments to domestic companies are subject to a 14 percent charge, and payments to foreign persons are largely exempt. Companies making return of capital distributions will be required to inform recipient shareholders so that these shareholders can properly account for the gain in respect of their annual returns.

##### *B. Allocation of CTC*

CTC is a company-level account (not a per share account). The decision to distribute CTC and allocate that CTC is made by the distributing company. However, return of capital distributions in respect of a class of shareholders must be allocated pro rata.

## II. Reason for change

Questions exist about the nature of the rule requiring a pro rata allocation of CTC. More specifically, a forced allocation of CTC may represent an over-declaration for certain shareholders within a class.

## III. Proposal

As under current law, no requirement exists to allocate CTC to a particular distribution. However, if the paying company decides to transfer CTC pursuant to the distribution, the allocation of the CTC available in relation to that class will be clarified. Under the law as revised (and as initially intended), the distributing company will be limited in transferring CTC. In particular, the CTC allocable must “not exceed” the proportion of the shares generating the distribution in relation to the total shares in that class.

### Example

**Facts:** Company Shareholder owns 50 ordinary shares in Company X with a base cost of R38 000. Company X has a total 250 ordinary shares outstanding. The CTC allocable to the class is equal to R400 000. Pursuant to a buyback, Company Shareholder surrenders all 50 of its ordinary shares in exchange for R100 000.

**Result:** Of the R100 000 distributed to Company Shareholder, no more than R80 000 of CTC can be allocated to the retiring shares (1/5<sup>th</sup> of R400 000). The net result is an R80 000 capital distribution and a R20 000 dividend.

## IV. Effective date

The amendment is effective from 1 April 2012

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### 3.7. DIVIDENDS TAX: REVISED TREATMENT OF CAPITAL DISTRIBUTIONS

[Clauses 119(1)(b), 120, 121, and 158; Applicable provisions: Paragraphs 76, 76A and 76B (new) of the 8<sup>th</sup> Schedule to the Income Tax Act; Repeal of section 79 of Act of 2009]

#### I. Background

##### A. *Dividends versus capital distributions*

Dividends and capital distributions can be in the form of either cash or assets. A company declaring a dividend is liable to Secondary Tax on Companies (“STC”) at a rate of 10 per cent. The STC will be replaced with a Dividends Tax at shareholder level at a rate of 10 per cent as from 1 April 2012. Under the Dividends Tax system, amounts distributed are treated as a dividend except to the extent that the distribution reduces contributed tax capital.

Capital distributions are subject to Capital Gains Tax (“CGT”) at the rate of 10, 14 or 20 per cent depending on whether the shareholder is an individual, company or trust. Gain subject

to CGT is generally determined by comparing the capital distribution received or accrued against the applicable base cost of the shares.

### *B. Calculation of capital distribution gains*

In the shareholder's hands, a capital distribution can either result in (i) a reduction of pre-CGT base cost, (ii) an addition to proceeds, or (iii) proceeds from the part-disposal of the shares. This treatment largely depends on the date on which the capital distribution is received or accrued to a shareholder.

A capital distribution occurring after 1 October 2007 triggers a part-disposal of the share with the distribution treated as proceeds. Part-disposal treatment effectively means that only part of the base cost can be applied against the capital distribution proceeds. If the capital distribution occurs before 1 October 2007 with the full disposal of the shares occurring after that date, part-disposal treatment will generally be deemed to arise on 1 July 2011.

### *C. Pre-CGT shares*

Special rules are required for determining the base cost of pre-CGT effective date assets (i.e. assets held before 1 October 2001), including pre-effective date shares. The purpose of these effective date rules is to exclude capital gain arising before CGT was implemented. The value of these pre-CGT effective date assets is determined based on one of three methods (as determined by the taxpayer):

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

Determination of which method applies (and how each method applies) can only be made upon disposal of the relevant asset. In the case of capital distributions involving pre-effective date shares, application of the valuation method applies only in respect of the part-disposal; application of the valuation method for disposal of the remainder is only determined upon disposal of the remainder.

## **II. Reasons for change**

Conceptually, dividends should encompass realised and unrealised undistributed profits. Capital distributions should merely represent a return of the capital (i.e. the return of capital contributions made by the shareholders). However, part-disposal treatment as currently formulated triggers capital gain on amounts that effectively include both realised and unrealised undistributed profits. The net effect is to over-tax capital distributions by only allocating a portion of base cost as an offset when the full base cost associated with the underlying share should be available.

While Government has always understood that return of capital treatment should allow for a full base cost offset, the calculations for pre-CGT effective date shares have always been problematic. Delayed calculation of base cost until disposal has meant that the entire base cost of pre-CGT shares is unknown when a capital distribution is involved.

### III. Proposal

#### A. *Revised treatment for capital distributions*

The capital gain calculation for capital distributions will be re-aligned in accordance with the intended concept. Capital distribution proceeds will be allocated against the full base cost of the underlying share involved in the distribution. These capital distribution proceeds will be applied to reduce the base cost of the underlying shares with capital gain arising to the extent these proceeds exceed base cost. This rule will apply for capital distributions occurring on or after the effective date of this proposal.

#### **Example**

**Facts:** Shareholder A holds all the shares in Company X. The base cost of the shares held by Shareholder A is 150. Company X makes a capital distribution of 400 to Shareholder A.

**Result:** The amount distributed to Shareholder A must first be applied in reduction of the base cost. Therefore, amounts in excess of the base cost (i.e. 400 less 150) will trigger a capital gain in the hands of Shareholder A.

#### B. *Capital distributions in respect of pre-CGT assets*

If a capital distribution involves a share acquired before 1 October 2001, the valuation date rules will be slightly revised. For purposes of these valuation rules, the share will be deemed to be fully acquired as of the capital distribution date. Hence, if the taxpayer elects a valuation date method in respect of a capital distribution, the resulting base cost after the capital distribution will fully apply in respect of the share going forward. No subsequent change of method will be allowed.

#### C. *Special 1 July 2011 deeming rule*

Under current law, capital distributions occurring before 1 October 2007 will trigger a part-disposal on 1 July 2011 if the underlying share is not disposed of before the 1 July 2011 date. If the share is disposed of before 1 July 2011, the capital distribution amount is added to the proceeds of the share disposal. The 1 July 2011 date was utilised when the part-disposal capital distribution rules were initially adopted to provide pre-existing shareholders with time to adjust their affairs. As a further relief measure, shareholders in these circumstances will now have the deemed capital distribution deferred until 1 January 2012. This extended deferral will allow these capital distributions to enjoy the adopted to provide benefits of the new regime (as opposed to part-disposal treatment).

### IV. Effective date

The proposed amendment will be effective for capital distributions that are received or accrued on or after 1 January 2012 and for pre-1 October 2007 distributions to the extent the underlying share is not disposed of before 1 January 2012.



### **3.8. DIVIDENDS TAX: REORGANISATION MITIGATION**

[Clauses 69(1)(f-g) and 71(1)(c), Applicable provisions: Sections 44(10) and 46(5)]

#### **I. Background**

As indicated elsewhere, the Secondary Tax on Companies (“STC”) will be converted into a Dividends Tax as of 1 April 2012. This change will have wide-ranging ramifications within the Income Tax Act.

#### **II. Reasons for change**

The reorganisation rollover rules override or otherwise adjust many provisions within the Income Tax Act, including provisions relating to dividends. Some of these reorganisation rollover rules eliminate or mitigate the impact of otherwise existing taxable dividends. These mitigation provisions will accordingly have to be modified in light of the pending conversion from the STC to the new Dividends Tax.

#### **III. Proposal**

The reorganisation rollover rules contain two overrides in respect of the STC. The first override is contained in the amalgamation rules; the second is contained in the unbundling rules.

##### **A. Non-share consideration in an amalgamation transaction**

Under current law, any non-share consideration received by the amalgamated company shareholders within an amalgamation potentially gives rise to a dividend. This dividend potentially triggers STC. The rules also provide a system for the CTC of the amalgamated company to be shifted to the resultant company.

It is now proposed that the non-share consideration received by the amalgamated company shareholders be treated as distribution that qualifies as either a dividend or return of capital (depending on whether the CTC of the amalgamated company is transferred in the distribution). Any amalgamated company CTC shifted to the resultant company must be reduced by any CTC reduction in the amalgamated company caused by a non-share return of capital distribution within the amalgamation.

##### **B. Amalgamation override**

###### **(1) Dividends Tax override**

Under current law, where the resultant company shares acquired by an amalgamated company in terms of an amalgamated transaction are disposed of to the shareholders of the amalgamated company, the disposal of those shares does not attract STC. It is now proposed that the disposal of the resultant company shares by the amalgamated company to the latter’s shareholders should not give rise to the Dividends tax.

###### **(2) Amalgamations with no consideration**

The relief measures for amalgamation transactions are only available if the resultant company issues shares or assumes the amalgamated company's debts as consideration for the disposal of assets by the amalgamated company. It is now proposed that the resultant company no longer be required to issue any consideration within the amalgamations. This lack of consideration typically arises in respect of amalgamations occurring within a wholly-owned group because shareholders own all of the assets and entities before and after the amalgamation.

#### C. Unbundling override

Under current law, the unbundling of a company is deemed not to be a dividend for STC purposes if part of an unbundling transaction. The net result is the elimination of the STC charge as well as any corresponding STC credits. The unbundling company is also freed from any tax charge associated with any built-in gain or loss in the unbundled shares.

It is now proposed that an unbundling transaction should not give rise to the Dividends Tax, ordinary revenue or a return of capital in the hands of the unbundling company shareholders. The unbundling company is also freed from any built-in tax charge associated with any built-in gain or loss in the unbundled shares.

#### IV. Effective date

The proposed amendment will be effective on the same date as the new Dividends Tax enters force (i.e. distributions received or accrued on or after 1 April 2012).

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### 3.9. DIVIDENDS TAX: COLLECTIVE INVESTMENT SCHEME ADJUSTMENTS (AND ISLAMIC FINANCE RELIEF)

[Clauses 44, 55 and 84; Applicable provisions: Section 25BA and 18A(1) and 64K of the Income Tax Act]

#### I. Background

##### A. *CIS retention of funds*

A collective investment scheme ("CIS") is an investment vehicle that facilitates portfolio investments for investors (technically referred to as unit holders). For income tax purposes, a CIS is treated as a flow-through entity in relation to amounts of a revenue nature. This treatment is subject to the condition that non-capital amounts received by the CIS must be distributed to the unit holders within twelve months after the date of receipt by the CIS. If the CIS does not distribute these amounts within the required 12-month period, the amounts are deemed to be received by the CIS. Retained amounts retain their character (i.e. interest is be taxed as ordinary revenue and dividends are generally exempt).

##### B. *Islamic CIS finance*

With the development of Islamic finance within South Africa, Shariá-compliant CISs have emerged. One pre-requisite of Islamic finance is the required forfeiture of interest and other impermissible income. In view of this pre-requisite, Sharia-compliant CISs are subject to agreements that prevent impermissible amounts from being distributed to unit holders. These CISs instead donate impermissible amounts to various public benefit organisations. The impermissible amounts typically stem from interest received or accrued as well as dividends arising from profits derived from interest.

## II. Reasons for change

### A. *Retained dividend amounts*

A CIS often retains a portion of the dividends and interest received in order to accommodate services payable to the associated management company. In the case of dividends, the amounts retained essentially act as a cession of the dividends to the CIS in exchange for services. This assignment is similar to the purchase of dividends commonly found in cessions, whereby the character of the dividend consideration should be viewed as transformed in ordinary revenue.

### B. *CIS Islamic donations of impermissible amounts*

Although a CIS is entitled to deduct donations to public benefit organisations classified within Part II of the 9th Schedule like other taxpayers, the 10 per cent taxable income limit on deductible donations poses a practical problem. A CIS typically has little or no taxable income because taxable income is retained solely for management fees. This limit is especially problematic for Islamic finance CISs that regularly donate impermissible receipts or accruals.

## III. Proposal

### A. *Revised Tax of CIS dividends*

It is proposed that the Dividends Tax should be applicable to regulated intermediaries (including a CIS) only once payment is made by a regulated intermediary. It is proposed that all dividends be treated as ordinary revenue if retained by the CIS beyond the requisite 12-month period.

#### **Example 1**

**Facts:** CIS holds 800 shares in Domestic Company XYZ. CIS has also independently borrowed 600 Domestic Company ABC shares from pension fund (i.e. the long and short positions have no transactional linkage to one another). On 15 July 2012, Domestic Company XYZ announces a dividend of R1 per share, and Domestic Company ABC announces a dividend of R1 per share. As a result, Domestic Company Shareholder receives R800 dividends from the XYZ shares held long and must pay R600 manufactured dividends in respect of the ABC shares held short. Both the XYZ and ABC shares are substantially similar with CIS using R600 of the XYZ dividends to pay the R600 owed in respect of the ABC shares held short. CIS pays a R200 dividend to the unit holders on 1 December 2012

**Result:** The XYZ dividends retained by CIS to pay the manufactured dividends are treated as taxable ordinary revenue, (see notes on anti-avoidance dividends in respect of borrowed shares). This ordinary revenue is offsets by the loss from the short portion. The R200 dividend attracts Dividend Tax on the date of payment by the CIS (i.e. 1 December 2012).

#### B. CIS donations

The 10 per cent taxable income limit for deductible donations will no longer apply to a CIS. Instead, deductible donations by a CIS will be limited to 0.5 per cent of the weighted average annual value of net CIS assets during the year of assessment in which the donations occur.

#### **Example 2**

**Facts:** CIS (an Islamic CIS) receives a dividend of R1000. Of the R1000, R750 is derived from dividends actively earned by the underlying company and R250 is derived from a money market investment made by the underlying company. CIS X donates the R250 derived from the money market instruments to Public Benefit Organisation

**Result:** The R250 donated to the Public Benefit Organisation will not be subject to the Dividends Tax. This amount will instead be deductible to the extent that this donation does not exceed 0.5 per cent of the weighted average annual value of net CIS assets during the year of assessment in which the donations occurs (see CIS donations below). The R600 dividend will be subject to the Dividends tax when CIS X pays the dividends to the participatory interest holders.

#### IV. Effective date

The proposed amendment will be effective for CIS years of assessment commencing on or after 1 January 2012.

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### 3.10. ANTI-AVOIDANCE: ACQUISITION DEBT ARISING FROM REORGANISATION ROLLOVERS

[Clauses 28(1)(i), 49, 50 and 69(1)(c); Applicable provision: new section 23K Amendment of section 44]

#### I. Background

Taxpayers may not generally deduct interest incurred in respect of loan funding used to acquire shares because shares generally only produce exempt income. However, taxpayers can indirectly obtain a deduction for interest when acquiring shares of a target company when the acquisition is associated with certain rollover reorganisation, especially section 45.

The most common technique for indirectly obtaining an interest deduction for share acquisitions is known as the section 45 debt push-down technique. In its simplest form, the debt push-down technique is used when acquiring all of the shares of a target company. The first step typically involves the purchase of the target company shares with cash from a bridging loan. In the second step, the acquiring company transfers the assets of the target company into a newly formed subsidiary pursuant to a section 45 rollover with the assets paid by the newly formed subsidiary from external bank funding. The target company then liquidates with the bank funding used to pay off the bridging loan. The interest from the bank loan is seemingly viewed as deductible because the loan is linked to the direct acquisition of assets (see ITC 1625).

## **II. Reasons for change**

The reorganisation rollover rules were merely intended to facilitate the transfer of assets in specified circumstances. The rollover rules were never intended to enable interest deductions when those deductions would not otherwise be available. However, the use of the reorganisation rollover rules as a means to allow for interest deductions when acquiring shares is said to be necessary when the seller refuses to sell underlying company assets as opposed to shares. It has also been said that this technique is necessary because the South African tax system is an outlier in respect of global tax systems by disallowing interest when used for share acquisitions.

In many settings, the above use of section 45 and other reorganisation rollover rules does not jeopardise the fiscus. Interest deductions for the borrower are often matched by taxable interest income for the creditor. However, the fiscus is at risk if the interest is paid to parties that are not subject to tax on the interest or that have on-going losses to absorb the interest income.

Unfortunately, the use of section 45 and other reorganisation rollovers as a tool to achieve the mismatch of interest deductions vis-à-vis the exempt receipt of that interest has become a regular feature. The nature of the transactions of concern involves large amounts of debt with many aggressive transactions utilising debt with share-like features (including soft shareholder loans). In the most aggressive schemes, the interest paid is artificial, being re-routed back to the same economic group via tax-free preference share dividends.

It also transpires that companies often use debt to facilitate or enable a liquidation transaction by borrowing money to acquire a target company and subsequently distributing all the assets of the target company followed by a liquidation of the target company. The argument brought forward in deducting the interest expense associated with the acquisition of the shares of the target company is that the interest expense is related (indirectly) to the acquisition of the assets of the target company through a liquidation distribution. The use of section 47 in this manner poses the same risk to the fiscus as the above uses of section 45.

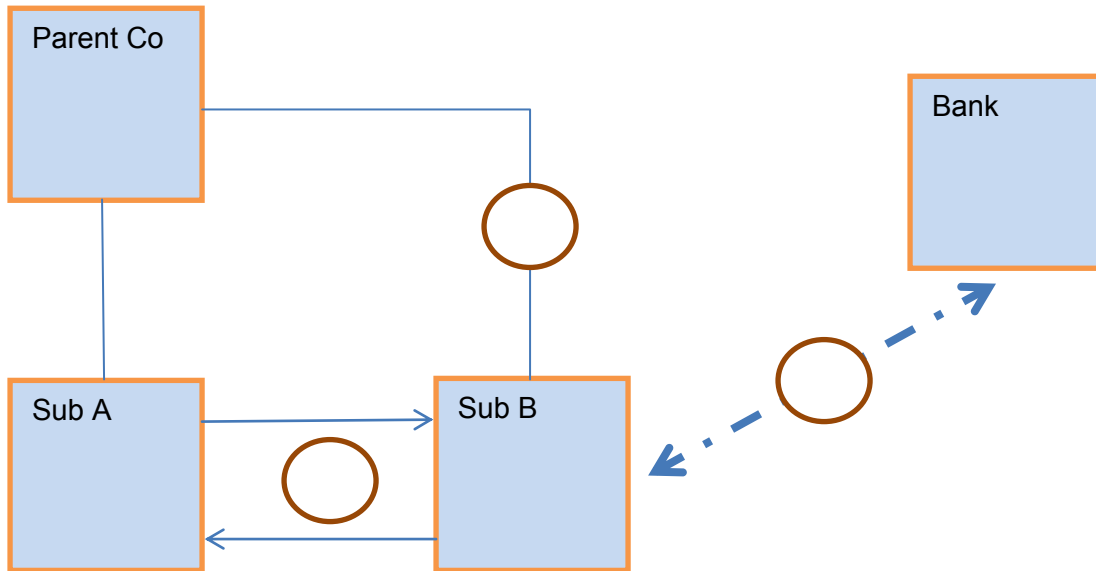
## **III. Proposal**

### **A. Pre-Approval for Interest Deductions**

In terms of the revised proposal, interest deductions in respect of debt used to procure, enable, facilitate or fund section 45 and 47 reorganisations will be controlled (as well as

interest deductions for debt that refinances or otherwise substitutes the initial debt). More specifically, interest associated with this debt will no longer be automatically deductible (see approval process below). This denial of the deduction is limited to the interest incurred by the acquiring company.

If the interest is non-deductible by the payor, the holder of the debt instrument will be treated as receiving exempt income under certain circumstances. In particular, this exemption applies if the payor and the holder of the debt instrument are part of the same group of companies at the time that the debt is issued.



**Example**

**Facts:** Parent Co acquires all of the shares of Sub A mainly with a bridging loan. Sub A has assets with a value of R 1 billion. Parent Co sets up Sub B (newly formed) to acquire all of the assets of Sub A. Sub B then acquires all of the assets of Sub A in exchange for cash. Sub B obtains this cash via a long-term interest bearing loan from Bank. Sub A liquidates with the long-term cash used to repay the bridging loan.

**Result:** The transaction will qualify for intra-group transaction relief, but the interest deduction in respect of the loan to acquire the assets by Sub B will not be automatically allowed more specifically. The interest deduction may only be allowed if the Commissioner is satisfied that the incurral, receipt and accrual of the interest does not significantly erode the tax base (see below).

In order for the acquiring company to obtain a deduction of the interest expenses, taxpayers will generally be required to apply for a directive in order to obtain approval from SARS for the deductibility of the interest expenses. At issue for obtaining this approval is whether the deduction of the interest expense will lead (or likely lead) to a significant reduction of taxable income (or likelihood thereof). In determining whether there will be a significant reduction to

taxable income, all of the debt directly or indirectly associated with acquisition of assets in terms of a reorganisation transaction should be taken into account (over the lifespan of the debt). Indirect debt includes back-to-back loans, refinancing and other related financing.

The criteria envisioned in determining whether approval should be granted by the Commissioner are: (i) the level of debt in relation to the level of equity of the acquiring company, (ii) the estimated interest expense in relation to the estimated income of the acquiring company after the reorganisation transaction, (iii) the debt terms and economic effects of the debt having regard to the debt versus equity features of the debt instrument, (iv) the relationship between the acquiring company and the holder of the debt instrument (i.e. whether the lender is a direct or indirect shareholder), and (v) any other further criteria that the Minister may prescribe. This criteria will be subject to further elaboration in Ministerial legislation.

The Commissioner will also be empowered to impose additional conditions in the directive concerning any changes to the facts presented in the application for approval.

The Minister will also be given the power to exclude transactions from the preapproval process (by regulation). This exclusion is intended as a fast-track mechanism for transactions that represent little or no risk to the tax base (for example, pure intra-group transactions).

#### B. Change in facts and circumstances under which approval is granted

SARS approval will be made based on the facts in existence at the time of the approval request. The approval will cease to apply if there is a material facts and circumstances on which the Commissioner relied in issuing the directive. This approval will also not apply (*ab initio*) if the approval was granted based on fraudulent or misrepresented facts or a material omission.

#### C. Timing of Directive

The directive issued by the Commissioner will be effective from the date of issue of the debt instrument or the date on which the application for the directive was made as described below.

The directive will be effective from the date of debt issue if the application was made:

- on or before 31 December 2011 and the debt instrument is issued before 25 October 2011; or
- within 60 days of the date of issue of the debt instrument and the debt instrument was issued on or after 25 October 2011.

The directive will be effective from the date on which the application is made if the debt instrument was issued:

- before 25 October 2011 and the application was made after 31 December 2011, or
- on or after 25 October 2011 and the application was made later than 60 days after the issue of the debt instrument.

#### D. Amalgamations

Current law allows certain forms of debt to be assumed in a amalgamation without giving rise to Dividends Tax consequences. In particular, for the debt to be permissible, the debt assumed must have been incurred by the target company more 18 months before the amalgamation disposal of the asset or within 18 months if that debt was used to refinance old debt or arose in the normal course of the amalgamated business.

It was never intended that the debt assumed by the acquiring company should be used to facilitate, procure, enable or fund an amalgamation transaction. In order to ensure unintended result does not arise, the amalgamation rules will accordingly be adjusted slightly to remove any arguable implications to the contrary (that is, any debt instrument used or issued to procure, enable, facilitate or fund the amalgamation transaction will be impermissible, even if the debt was incurred by the amalgamated company 18 months before the disposal).

#### IV. Effective date

In respect of debt arising from a section 45 transaction, the proposed amendment will apply in respect of any asset acquired on or after 3 June. In respect of debt arising from a section 47 transaction, the proposed amendment will apply in respect of any asset acquired on or after 3 August 2011. The proposed amendments are intended only to be of a temporary nature (thereby containing a 1 January 2014 sunset clause)

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### 3.11. ANTI-AVOIDANCE: INTRA-GROUP ROLLOVER CONSIDERATION

[Clause 70(1)(b); Applicable provision: Section 45]

#### I. Background

Section 45 provides rollover treatment for the transfer of assets from one company to another as long as both companies are part of the same group of companies. This transfer can be in exchange for cash or in exchange for a note issued by the transferee, but not in exchange for shares issued by the transferee. If the transferor receives a note issued by the transferee, the tax cost equals the fair market value of the note at the time of issue.

#### II. Reasons for change

The fair market value tax cost of the note can give rise to avoidance in the case of appreciated assets because a fair market value tax cost exists for the note, even though the transferor receives rollover treatment for the appreciated assets. This treatment differs from section 42 rollovers, which also allows for deferral of transferred assets. However, unlike



section 45, any consideration issued (i.e. preference shares) in exchange under section 42 have a rollover base cost (as opposed to a fair market value base cost).

In 2007, the tax-free increase in tax cost of section 45 considerations was identified as problematic, but an interim solution was proposed. This interim solution requires re-examination given the on-going problems associated with section 45. The exclusion of any shares as consideration in a section 45 transaction is also problematic, especially since preference shares may pose less of a risk to the fiscus than debt.

### III. Proposal

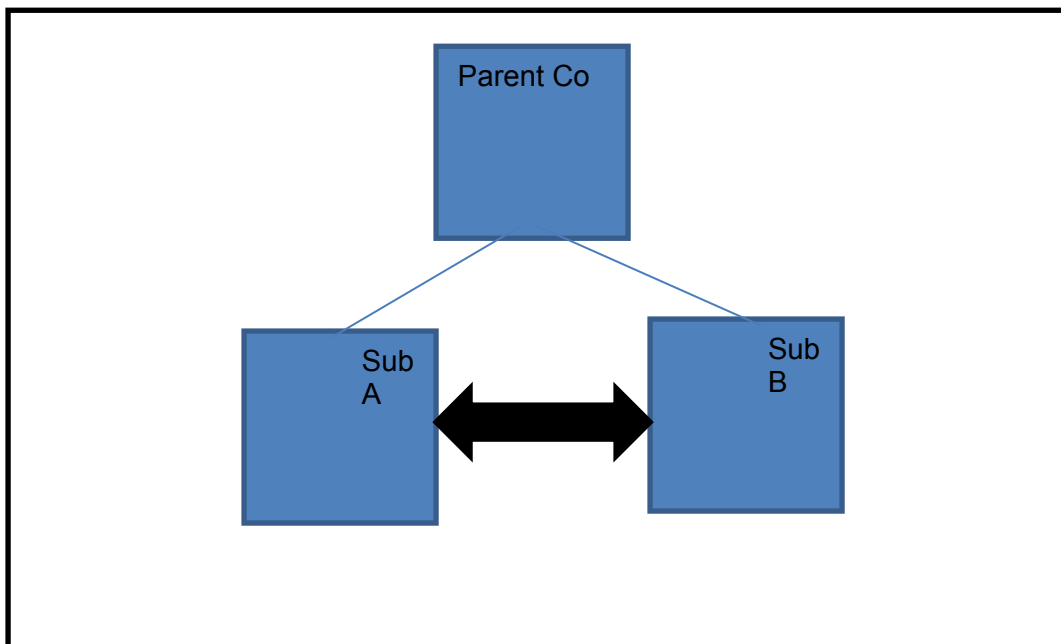
#### A. Permissible use of preference shares

The use of preference shares as consideration for section 45 transferred assets will now be permitted. This use of preference shares does not overlap with section 42, the latter of which excludes preference shares. Preference shares are a useful tool in section 45, especially if the section 45 transfer is part of a shift to owners outside the group (up to 30 per cent). Preference shares are often preferred in this instance because a newly formed entity with partial non-group shareholders often lacks the income to absorb the interest expenses associated with debt.

#### B. Revised tax cost for notes or preference share consideration

The tax cost for notes and preference share consideration within the context of section 45 raises two sets of issues. Rollover tax cost is the most appropriate result (like section 42) if this consideration is transferred to parties outside the group because an elevated tax cost can act as an indirect form of exemption. On the other hand, repayment of a note or preference shares within group should not give rise to taxable gain or income because the repayment represents a mere internal shift.

It is accordingly proposed that notes and preference shares issued as consideration under section 45 have a split impact. These notes and preference shares will have a tax cost of nil if the holder (i.e. Target Company) thereof forms of the same group of companies as the issuer (i.e. acquirer). However, any gain or income from the repayment of notes or preference shares will be exempt if the notes or preference shares are repaid whilst both parties to the notes or preference shares remain together within the same group of companies.



### **EXAMPLE**

**Facts:** Parent Co owns all the shares of Sub A and Sub B. Sub A and Sub B are part of the same group of companies. Sub B wants to acquire some of the assets of Sub A with a market value of R80 million, a book value of R50 million and a tax value of R35 million. Sub A transfers the assets to Sub B. Sub B issues an interest-free loan of R50m (equal to book value) to Sub A in consideration for the acquisition of the assets.

**Result:** The transaction will qualify for the intra-group transaction relief. Sub A will be deemed to have a tax cost of zero in respect of the loan. To the extent that Sub A and Sub B are still members of the same group of companies, any gain or income realised by Sub A as repayment of the loan principle will be disregarded for the purposes of determining Sub A's gain and income.

## **IV. Effective date**

The proposed amendments will apply from 30 August 2011.

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## **3.12. ANTI-AVOIDANCE: INDEPENDENTLY SECURED OR THIRD-PARTY BACKED SHARES**

[Clauses 20 and 21; Applicable provision: 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 (and the interest yield thereon) is payable despite the financial performance of the debtor. Shares, on the other hand, represent a contingent claim by shareholders directly or indirectly based on company profits.
- In tax terms, interest payments on debt are typically deductible by the payer with the same interest payments being includible as income by the payee. Under the new Dividends Tax, dividend payments in respect of shares are not deductible by the payer but are potentially subject to a 10 per cent charge falling on the payee. 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 anti-avoidance rules**

Setting aside the potential impact of commercial law, two sets of legislative tax rules exist that seek to address the differences in respect of debt or share instruments when the

label of those instruments differs from the substance. Stated dividends in respect of shares (informally known as hybrid shares) will be deemed to be interest if instruments labeled as shares contain certain debt features. Conversely, stated interest in respect of debt (informally known as hybrid debt) will not be deductible if instruments labeled as debt contain certain share features.

## II. Reasons for change

### A. Hybrid shares secured by debt

The tax rules preventing the mismatch between the commercial versus tax nature of hybrid shares has been largely ineffective. Commercial law principles are rarely (if ever) asserted in respect of hybrid shares as a means to recharacterise the label in favour of substance. Moreover, in the case of the current legislative anti-avoidance rules, key impermissible debt features (e.g. required redemptions and optional redemptions by holders) can be avoided by extending the utility of these features beyond a three-year period.

These weaknesses within the tax law have led to a set of avoidance schemes that have become costly to the fiscus. The purpose of these schemes is to convert an interest yield into a dividend yield through the use of a series of entities. At some stage within the chain, deductible interest is paid by a domestic taxable entity and roughly the same yield is returned to the same economic group via tax-free preference share dividends from another entity. Within the chain is a tax-free entity (typically a foreign entity wholly outside South African taxing jurisdiction) that holds interest-bearing notes that operates as security for the arrangement. The net effect of the chain is to generate a tax/economic mismatch on the same flow of income.

### B. Hybrid shares backed by third parties

Parties involved in funding often have the freedom to choose debt funding versus preference share funding. While debt funding operates differently than preference share funding in their purest forms, the impact of the two mechanisms can easily be merged by modifying particular funding features. This merging of features allows for preference share funding to replicate most (if not all) of the features of debt while still retaining the tax treatment applicable to preference shares. One of the most common forms of preference share funding operating like debt involves preference shares that are guaranteed by third parties. These third party guarantees come in a variety of forms, such as put and call options triggered upon dividend short-falls as well as direct guarantees.

Many of these third-party backed hybrid arrangements are mainly designed with tax in mind (i.e. the arrangement would have been debt but for undesirable tax consequences). In some of these arrangements, the entity in need of funding has ongoing net losses or is wholly exempt from tax, thereby having no practical need for deductions arising from the incurral of interest. These deductions are accordingly foregone via preference share funding so that the funder (e.g. bank) is exempt upon the receipt of the corresponding yield. In these scenarios, the entity in need of funding is effectively exporting the tax benefits associated with the entity's net losses or exempt position. Taxpayers should not be allowed to mix-and-match their separate tax bases to the detriment of the fiscus.

### III. Proposal

#### A. Overview

The current anti-avoidance hybrid share rules will be divided into two tranches. The first tranche focuses on debt features between the issuer and the holder. The second tranche focuses on debt features held by outside (i.e. third) parties.

#### B. Tranche one: Independently secured hybrid shares

The anti-avoidance rules pertaining to hybrid shares (triggering ordinary revenue) will be expanded slightly to fully cover preference shares whose yield is tied to underlying interest-bearing notes. More specifically, hybrid shares within the anti-avoidance rules are expanded to include instances where (i) a rate of interest or capital amount subscribed is used in calculating the dividend, and (ii) the hybrid share is secured by a financial instrument, which does not qualify as an equity share. These rules will apply without regard to any three-year period (unlike other pre-existing hybrid share rules).

##### **Example**

**Facts:** Company A holds preference shares (that are redeemable in five years) issued by Company B. Company B directly or indirectly holds ordinary shares in Company C with Company C holding interest-bearing notes. Company C is partly owned by an independent financial institution. The dividends payable in respect of the Company A preference shares provide a yield of JIBAR plus three per cent. The interest-bearing bonds provide a yield of JIBAR plus 4 per cent. The notes exist as collateral for the preference shares with Company A having a right to acquire the notes if the yield falls below the JIBAR plus three per cent level.

**Results:** The preference shares are linked to an interest-bearing yield, and the preference shares are secured by financial instruments other than equity shares. The preference shares held by Company A are accordingly viewed as hybrid shares subject to the anti-avoidance rule (i.e. the yield on the shares generates ordinary revenue).

#### C. Third-party backed shares

The general rule seeks to eliminate special purpose vehicles and other outside guarantee mechanisms that allow the holder of preference shares to rely on parties other than the issuer of the preference shares. These mechanisms make the conversion of debt into hybrid shares for tax avoidance all-too-common. If a preference share is to be respected as such, the holder should be mainly looking to the risk of the issuer – not some person.

In view of the above concerns, stated dividends in respect of shares backed by third parties will be treated as ordinary revenue. This ordinary revenue treatment will cover various forms of third party backing, all of which will apply without regard to any three-year rule or other timing requirements. More specifically, third-party backing will be deemed to exist if:

- The holder of the share has a fixed or contingent right to require any party (other than the issuer) to acquire the share, or an obligation exists so that any of those parties is obligated to acquire the share;
- The holder can rely on a fixed or contingent guarantee, indemnity or similar arrangement from a party other than the issuer; or
- The holder has a fixed or contingent right to procure, facilitate or assist with the acquisition of the share or repayment of the value associated with the share (or the issuer is subject to a corresponding obligation).

**Example**

**Facts:** Collective Investment Scheme holds preference shares issued by a Preference Share Company. The preference shares provide a prime plus one yield. To secure the performance of the preference shares, a third-party bank grants a put option to Collective Investment Scheme that is exercisable on the occurrence of certain credit events (e.g. failure of the preference shares to generate the specified yield of prime plus one).

**Results:** The dividends received by Collective Investment Scheme from the preference shares are to be treated as fully taxable ordinary income. This treatment exists because Collective Investment Scheme does not bear the risk of the Preference Share Company due to the put option granted by the third-party bank.

D. Exemption for operating company share acquisitions

One of the unique features of the South African tax system is the system's general disallowance of interest deductions in respect of funds borrowed to acquire shares because the yield on the shares (i.e. dividends) is not generally includible as income. As a result, a company borrowing funds enjoys no tax deduction for the interest incurred if the funds are used to acquire shares while the same interest generates includible income for the creditor. This mismatch places both parties to the borrowed funds in a harsh position, thereby raising the cost of capital to an unsustainable level. In order to eliminate this mismatch, parties borrowing funds to acquire shares (including parties seeking to facilitate black economic empowerment) often use preference share funding. Preference share funding effectively eliminates the includible income for the funder, thereby leaving the overall funding in a net neutral position (no deduction for the yield with no corresponding income). This form of preference share funding often entails third-party backed guarantees in order to be commercially viable.

The new anti-avoidance regime relating to third-party backed shares accordingly contains a special exemption that recognises the need for third-party backed shares when funding is directly or indirectly related to the acquisition of shares of an operating company. Under this exemption, certain forms of third-party backed funding can be disregarded if the funding is used for one of the following four applications:

- a. To acquire equity shares in an operating company;

- b. To indirectly acquire equity shares in an operating by acquiring shares in another company with the funds ultimately used or applied solely to acquire equity shares in an operating company (e.g. back-to-back preference share funding);
- c. To settle any debt (and interest thereon) if the debt was previously incurred for the purpose of acquiring equity shares in an operating company (e.g. to replace bridging loans incurred to acquire shares in an operating company); or
- d. To acquire (by way redemption or otherwise) any preference shares (and accumulated dividends thereon) if the preference share funding was previously incurred for the purpose of acquiring equity shares in an operating company.

For purposes of this exception, an operating company (i.e. the object of the funding) must carry on business continuously and that business must entail the provision of goods or services. Alternatively, the company to be acquired (i.e. the object of the funding) must be a holding company that directly or indirectly controls an active company (i.e. a company that carries on business continuously with a business entailing the provision of goods and services).

Transactions falling within this exception for the acquisition of operating company shares can disregard two types of third-party backed shares: (i) third-party backed guarantees from the issuer (i.e. the party issuing the preference shares), or (ii) third-party backed guarantees from the target company whose shares are acquired (i.e. the object of the funding). These guarantees can come from shareholders that directly or indirectly hold more than 20 per cent of the issuing company or the target company. Alternatively, these guarantees can come from companies that are directly or indirectly controlled by the issuing company or the target company.

#### **Example 1**

**Facts:** Holding Company holds all the shares of Acquiring Company that acquires all of the ordinary shares in Operating Company with funding from Bank. Acquiring Company issues preference shares to Bank as a funding mechanism. As security for the preference share funding, Holding Company of the Acquiring Company issues a guarantee in favour of Bank that is exercisable if Acquiring Company defaults on the obligation to provide the required yield on the preference shares issued.

**Results:** The exception to third-party backed funding applies. The guarantee by Holding Company will not taint the preference shares.

#### **Example 2**

**Facts:** Black Economic Empowerment Company acquires all of the ordinary shares of Holding Company with funding from Bank. Black Economic Empowerment Company issues preference shares to Bank as a funding mechanism. Holding Company holds all of the shares of Subsidiary, a company that actively and continuously engages in the provision of goods. As security for the preference share funding, Subsidiary issues a guarantee in favour of the Bank that is exercisable if

Black Economic Empowerment Company defaults on the obligation to provide the required yield on the preference shares issued.

**Result:** The exception to third-party backed funding applies. The guarantee by Subsidiary will not taint the preference shares.

#### **IV. Effective date**

The proposed amendment applies to dividends received or accrued on or after 1 April 2012 in respect of hybrid shares secured by debt. The proposed amendment in respect of third party backed shares applies to dividends received or accrued on or after 1 October 2012.

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### **3.13. ANTI-AVODANCE: DIVIDEND CESSIONS**

[Clauses 14, 28(1)(o) and 89; Applicable provision: section 6sex; proviso (ee) to section 10(1)(k)(i)]

#### **I. Background**

Domestic companies are subject to secondary tax on companies (STC) at 10 per cent when distributing dividends; these dividends are exempt from tax when received or accrued by shareholders. Once the new Dividends Tax is in place, the 10 per cent tax on dividends will no longer be borne by the company paying the dividend but by the eventual recipient. This new tax on dividends contains a number of exemptions (such as the exemption for dividends paid to domestic companies).

Parties often enter into cession contracts whereby a cedent transfers rights to a cessionary. These cessions include the cession of dividends otherwise associated with underlying shares. Cessions may occur when dividend rights are ceded before or after the declaration of dividends. Cessions of this nature are typically undertaken in exchange for consideration. These cessions are generally effective and the amounts ceded typically retain their character as dividends.

#### **II. Reasons for change**

As a general matter, taxpayers treat dividend cessions as a mere assignment of dividends from a cedent (e.g. the holder of shares initially entitled to the dividend) to a cessionary (i.e. the assignee). However, in many circumstances, the character of a ceded dividend is effectively transformed once the dividend is separated from any meaningful stake in the underlying shares. Stated differently, the cessionary is merely purchasing an income stream – an event that makes the receipt of the income distinct from the distribution of the underlying dividend.

At a theoretical level, two differing policies are at stake. Domestic companies receiving dividends are exempt to prevent multi-tier taxation. Distributed profits going through a chain of domestic companies should generally be taxed only once (under the STC, the charge typically arose at the beginning; under the new Dividends Tax, the charge will typically arise at the end). On the other hand, the progressivity principle demands that each taxpayer

(including companies) be fully subject to tax at ordinary rates. While the progressivity principle should give way to the principle against multiple-level taxation as a general matter, this compromise becomes questionable when the company beneficiary of a dividend lacks any meaningful interest in the underlying shares giving rise to the dividend. In the case of a dividend cession, the cessionary receiving the dividend has no interest in the underlying shares and should accordingly be fully taxed under the progressivity principle.

The lack of balance outlined above has given rise to a host of avoidance schemes. Many companies regularly purchase dividends via cessions solely due to their tax-free nature so as to undermine the tax system. These purchases would simply not exist but for tax arbitrage. Dividend cessions occurring after dividend declaration especially lack any non-tax commercial rationale. Still worse, these cessions are often accompanied by seemingly deductible finance schemes, whereby the link between the tax-free income and the deductible finance is artificially broken. The net effect is a book tax disparity with taxpayers achieving neutrality on their financial books along with a net tax deduction.

### **III. Proposal**

#### **A. Overall concept**

The policy around dividend exemptions is not at stake. Domestic and foreign companies (and trusts) receiving dividends will remain exempt (or subject to tax at a reduced rate) if these companies have a meaningful underlying stake in the company paying dividends. To be meaningful, the company (or trust) receiving the dividend must be exposed to the risk of profit and loss associated with the underlying share. Failure to achieve this meaningful interest will result in tax at ordinary rates.

The proposal will mainly eliminate the tax-free nature of dividends obtained by way of cession and for dividends in respect of shares held only momentarily. Dividends received shortly before the disposal of trading stock will also be subject to tax as ordinary revenue. These pre-sale dividends are effectively part of the sales trading stock proceeds,

#### **B. Technical trigger**

Proposed taxation of certain dividends at ordinary rates applies solely to domestic and foreign companies (or trusts) receiving (domestic or foreign) dividends. Natural persons fall outside this ordinary treatment because the disconnect between dividends received by natural persons and the underlying shares may be driven by other non-tax factors (e.g. testamentary trusts offering dividend streams to heirs without the heirs having any underlying interest in the underlying distributing shares).

Ordinary treatment under the proposal will arise under either one of two triggering events. The first trigger is an automatic trigger for dividends from all shares; the second trigger arises only if the underlying shares are held as trading stock.

**Automatic Trigger:** Ordinary revenue treatment (i.e. the loss of exemption) for dividends arises whenever a company benefiting from dividends fails to hold the underlying shares from the beginning of the date that the dividend was declared until the close of the date when the dividend is received and accrued. This rule applies without regard to whether the underlying shares are held as trading stock or as capital.



Trading Stock: Under this second trigger, ordinary revenue treatment additionally applies whenever a company benefiting from those dividends holds the underlying shares as trading stock and the dividend is received or accrued within 45 days before disposal of the share.

Note on offsetting positions: For purposes of the above timing calculation, taxpayers benefiting from dividends cannot take into account days whereby the taxpayer has offsetting positions in respect of the underlying distributing shares. For instance, if a taxpayer holds distributing shares in the long position and at the same time has in place a short position to hedge the risk in respect of those long shares, the holding in the long position will be disregarded for the duration of the hedge.

#### **Example 1**

**Facts:** Distributing Domestic Company declares dividends on 10 March 2012 in respect of the Distributing Domestic Company shares. On 11 March 2012, Domestic Company X acquires R5 million of Distributing Domestic Company ordinary dividends by way of cession. Distributing Domestic Company pays the declared dividends on 2 April 2012.

**Result:** The dividends ceded to Domestic Company X are taxed as ordinary revenue. No exemption applies because the shares are never held by Domestic Company X on the relevant dates.

#### **Example 2**

**Facts:** Distributing Domestic Company declares dividends on 12 June 2012 in respect of its ordinary shares and pays those dividends on 10 July. Domestic Company Shareholder owns the ordinary shares from 5 July 2012 until 15 July 2012 and accordingly receives the 10 July dividends. Domestic Company Shareholder holds the shares as trading stock until disposal on 15 July 2012.

**Result:** The dividends received by Domestic Company Shareholder are taxed as ordinary revenue. No exemption applies because the underlying trading stock shares are not held for the requisite 45 day period before disposal.

#### **Example 3**

**Facts:** On 20 March 2012, Domestic Company Shareholder acquires Distributing Domestic Company ordinary shares for investment capital purposes. On 15 September 2014, Domestic Company Shareholder changes the investment intent in respect of the ordinary shares to trading stock. Dividends are declared in respect of the ordinary shares on 20 September and paid on 1 October 2012. On the 10 October 2012, Domestic Company Shareholder sells the ordinary shares.

**Result:** The dividends paid to Distributed Company Shareholder are treated as ordinary revenue. The dividends are not exempt because the dividends are received or accrued within 45 days before disposal (the fact that shares are held for over two years before is irrelevant).

## Shares held via trusts

Dividends received through trusts require special considerations because two levels are involved. The ultimate beneficiary has an interest in the trust, and the trust has an interest in the underlying distributing shares. In these circumstances, the company beneficiary must have a vested interest in the underlying shares through the trust that satisfies both anti-avoidance rules.

### **Example**

**Facts:** Discretionary Trust acquired Domestic Distributing Company ordinary shares in 2010 for investment purposes. On 15 January 2014, Domestic Distributing Company pays dividends in respect of its ordinary shares. The Discretionary Trust allocates these dividends to Domestic Company Beneficiary.

**Result:** The dividends received by Domestic Company Beneficiary are taxed as ordinary revenue. No exemption applies because Domestic Company Beneficiary never holds a vested interest in the underlying ordinary shares.

## Tax rebates (i.e. credits)

As outlined above, the newly proposed rules apply to three sets of dividends: (i) dividends between domestic companies, (ii) foreign dividends received or accrued by domestic companies, and (iii) domestic dividends received or accrued by foreign companies. The latter two scenarios require tax rebates (i.e. credits) to offset double taxation. In the second scenario (foreign dividends received by domestic companies), foreign tax rebates are already available against any South African taxes otherwise due. At stake is the third scenario (domestic dividends received by foreign companies). In the third scenario, the dividends at issue may be subject to the Dividends Tax in addition to being taxed at ordinary rates under the normal tax. To the extent this situation arises, the foreign shareholder is eligible to receive rebates (credits) against the normal tax for Dividends Tax already paid.

### **Example**

**Facts:** Distributing Domestic Company declares dividends on 10 October 2012 in respect of its ordinary shares. On 11 October 2012, Foreign Company Shareholder acquires R4 million of Distributing Domestic Company dividends by way of cession. Distributing Domestic Company pays the declared dividends on 2 April 2012. These dividends are fully subject to the Dividends Tax (without any tax treaty reduction).

**Result:** The dividends ceded to Foreign Company Shareholder are taxed as ordinary revenue. No exemption applies because the shares are never held on the relevant dates. However, the normal tax on the dividends can be reduced for the Dividends Tax paid.

#### **IV. Effective date**

This amendment is effective once the Dividends Tax goes into effect

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### **3.14. ANTI-AVOIDANCE: DIVIDENDS IN RESPECT OF BORROWED SHARES**

[Clause 28(1)(o); Applicable provisions: provisos (ff) and (gg) to section 10(1)(k)(i) (ff)(gg)]

#### **I. Background**

Share lending is the practice of lending shares from an investor's portfolio to satisfy the temporary needs of another party (i.e. the borrower). The borrower typically sells the shares after the borrowing, thereby going short in respect of the share (i.e. thereby taking the risk that the shares will increase in value).

Share lending requires the borrower to keep the lender in a similar position even though the shares have been loaned. This parity is often achieved by having the borrower pay over to the lender "in lieu of" dividends arising in respect of borrowed shares during the lending period. These "in lieu of" amounts are known as manufactured dividends. Manufactured dividends are often deductible for the borrowing payor and treated as ordinary revenue for the lending payee.

#### **II. Reasons for change**

If a company holds identical shares in both long and short positions, the dividends in respect of both positions should leave the taxpayer economically neutral. The company is entitled to dividends on the one hand but must pay the same amount as manufactured dividends on the other. If both the long and short positions are linked, the dividends received or accrued are typically exempt and the manufactured dividends incurred are ineligible for deductions.

However, if the link between the long and short positions is broken, the taxpayer will still receive or accrue an exempt dividend while possibly being able to deduct the manufactured dividends incurred. Many schemes exist that serve to break this link with the taxpayer in a net tax loss position while leaving the taxpayer economically neutral. The lender in these schemes is typically an exempt party (e.g. an exempt pension fund or the exempt policyholder fund of a long-term insurer).

#### **III. Proposal**

The tax treatment of long and short positions in respect of dividends held in identical shares should be neutralised to the extent both positions offset each other. More specifically, if a company taxpayer receives dividends in respect of shares held, these dividends should be treated as taxable ordinary revenue to the extent the manufactured dividends are incurred in respect of identical shares borrowed. No factual connection is required between the long and short positions for this ordinary treatment to apply. In addition, any dividend in respect of borrowed shares will be treated as ordinary revenue.

### **Example**

**Facts:** Domestic Company Shareholder holds 300 shares in Domestic Company XYZ. Domestic Company Shareholder has also independently borrowed 180 Domestic Company XYZ shares from pension fund (i.e. the long and short positions have no transactional linkage to one another). On 15 July 2012, Domestic Company XYZ announces a dividend of R2 per share. As a result, Domestic Company Shareholder receives R600 dividends from the XYZ shares held long and must pay R360 manufactured dividends in respect of the XYZ shares held short.

**Result:** Dividends received or accrued on the long position are not exempt to the extent any “in lieu of” dividends are incurred in respect of identical shares held in the short position. As a result, of the R600 dividends received or accrued in respect of the XYZ shares, R360 of these dividends are fully taxable as ordinary revenue.

## **IV. Effective date**

This amendment is effective once the Dividends Tax goes into effect.

## **3.15. ANTI-AVOIDANCE: DEBT WITHOUT SET MATURITY DATES**

[Clause 28(1)(m), 46, 109, 112 and 157; Applicable provisions: Section 8g; definitions of “date of redemption”; “demand instrument” and term in section 24J]

### **I. Background**

Interest is commonly payable or receivable in respect of debt instruments (or interest is implied through various mechanisms, such as a redemption feature). Specific rules exist that are used to calculate the in accrual and accrual of interest per specific period. In essence, these rules require an interest calculation that is based on the present value all future income streams payable or receivable by transacting parties (technically referred to as the “yield to maturity” calculation). The duration of the “term” of the interest forms an important part of the “yield to maturity” calculation formula with the maturity date (i.e. date of redemption) acting as a key marker.

### **II. Reasons for change**

A concern exists that taxpayers are distorting the interest calculation rules by manipulating the maturity date. Some debt instruments arguably fall outside the interest calculation when they simply lack a maturity date. Payments on some instruments contain a final maturity date with early contingency dates. These instruments distort the calculation because the tax system focuses on the final maturity date when in fact the contingencies will most probably be triggered before. Other instruments are payable on demand so that the maturity date can technically fall anywhere between initial issue and the date demand is actually made. The nature of all these instruments creates difficulties even when created primarily for commercial reasons.

### **III. Proposal**

#### **A. Overview**

In view of the above, a specific set of rules will be added to cover all three instruments outlined: (i) debt without a maturity date (known as perpetual debt), (ii) debt instruments with uncertain maturity dates, and (iii) demand instruments. Perpetual debt will be removed from the debt instrument rules; whereas, special maturity date rules will be added for the other two instruments.

#### **B. Perpetual debt**

Perpetual debt (i.e. a debt instrument lacking a maturity date) is essentially equivalent to shares (and indeed financial accounting fully takes this form into debt as such). Payments in respect of perpetual debt will accordingly be treated as dividends for both the payor and payee. As a result, payments in respect of perpetual debt will no longer be deductible with the payment instead being potentially subject to the new Dividends Tax.

#### **C. Debt instruments with uncertain maturity dates**

As stated above, a debt instrument may have a final maturity date with one or more maturity dates that may trigger termination before the final maturity date. In these circumstances, the yield to maturity calculation for these debt instruments will be based on the date that the termination will most likely occur based on the balance of probabilities. In addition, rights to renew or extend will be taken into account to extent these rights will more likely than not be exercised based on the balance of probabilities. It should be noted that all of these dates may change over time as facts and circumstances deviate from initial premises (thereby requiring annual adjustments).

#### **D. Demand instruments**

Instruments payable on demand create total uncertainty because the final maturity date is essentially unknown. Therefore, for the sake of simplicity, the term of the instrument is deemed to last for a one year period (i.e. 365 days). Therefore, the “yield to maturity” calculation will be automatically determined solely with reference to the present value of the amounts payable and receivable for that one year period.

### **IV. Effective date**

In terms of the “perpetual debt” amendment, the amendment will apply to all amounts incurred and accrued on or after 1 April 2012 (consistent with the effective date of the new Dividends Tax). The other amendments will be effective in respect of amounts incurred or accrued during years of assessment commencing on or after 1 January 2012.

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### **3.16. ANTI-AVOIDANCE: DIVIDEND STRIPPING ADJUSTMENTS**

[Clauses 28(1)(m), 46, 109, 112 and 157; Applicable provisions: Section 10(1)(k); 22B; paragraphs 43A and 19 of the 8<sup>th</sup> Schedule; Amendment of section 69 of Act 17 of 2009]

## **I. Background**

### *A. Pre-sale purchaser-funded dividends*

Pending anti-avoidance rules exist that deem certain pre-sale dividends as ordinary revenue or capital gain proceeds when those dividends are associated with the disposal of target controlled (i.e. more than 50 per cent owned) company shares. These anti-avoidance rules apply only in respect of resident shareholders and resident target companies.

The anti-avoidance rules are aimed at situations where pre-sale dividends stem from purchaser funding. In these instances, the target controlled company to be disposed of typically borrows funds guaranteed or backed by the purchaser and uses the funds to distribute dividends to the selling shareholder (with the purchaser group ultimately repaying the loan). The effect of these pre-sale dividends is to reduce the explicit selling price of the target company shares. In tax terms, the result is a potentially tax-free dividend if the selling shareholder is a company with the tax-free dividend acting as an economic substitute for taxable sale proceeds. The anti-avoidance rules accordingly convert the tax-free dividends into ordinary revenue or capital gain proceeds (depending on whether the shares are capital or ordinary in nature).

### *B. Extra-ordinary dividends*

An older set of anti-avoidance rules exist to prevent extra-ordinary dividend stripping that significantly devalues underlying shares before disposal. The concern in this circumstance is the distribution of extra-ordinary tax-free dividends in respect of shares (held as capital) followed by a capital loss upon disposal of the shares (with the loss stemming from the devaluation of the shares caused by the dividend). The anti-avoidance rules essentially eliminate the capital loss.

## **II. Reasons for change**

The landscape for both domestic and foreign dividends will change dramatically in 2012 with both domestic and foreign dividends generally taxable at an effective rate of 10 per cent. Both domestic and foreign dividends will also have a revised set of exemptions.

With these changes, the anti-avoidance dividend stripping rules need to account for the revised landscape. More specifically, the rules need to account for cross-border dividends (dividends coming in and out of South Africa) in addition to the current limitations imposed solely on dividends between domestic companies. The anti-avoidance rules for extra-ordinary dividends additionally need to be re-aligned for the revised set of dividend exemptions.

## **III. Proposal**

### *A. New coverage for cross-border dividends*

As stated above, the existing anti-avoidance dividend stripping rules apply only in respect of domestic dividends distributed to domestic companies. It is proposed that the anti-avoidance

provisions be extended to additionally cover (i) foreign company dividends to South African shareholders, and (ii) domestic company dividends to foreign company shareholders.

*B. Revised tainted dividends involved in extra-ordinary dividends*

The goal of the extra-ordinary dividend stripping rules is to target extra-ordinary exempt dividends followed by artificial losses on share disposals. The proposed rules clarify the law regarding the (exempt) dividend triggering event and update definitions to fully reflect the current landscape. (Note: This provision has little practical impact on foreign shareholders because foreign shareholders generally fall outside the capital gains system unless the shares relate to an immovable property company).

*C. Note on tax rebates (credits) to prevent double taxation*

If a taxpayer receives dividends already subject to the Dividends Tax, a rebate is available to reduce normal taxes or capital gains otherwise due (i.e. the same rebate as for the ordinary revenue treatment arising from non-at risk dividends and manufactured dividends).

**IV. Effective date**

This amendment is effective once the Dividends Tax goes into effect.

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**3.17. ISLAMIC FINANCE: ADJUSTMENTS TO THE 2010 LEGISLATION**

[Clauses 54, 132 and 149; Applicable provisions: Section 24JA (1)(“Murabaha” definition), 24JA(4); section 3A(1) of the Transfer Duty Act; section 8A of the Value Added Tax Act; and section 8A of the Securities Transfer Tax Act]

**I. Background**

Legislation was enacted in 2010 that recognises certain forms of Islamic finance as equivalent to traditional finance entailing interest. One of these products involves Murabaha arrangements (as well as the Mudaraba arrangement).

**A. Murabaha arrangement**

The Murabaha is a mark-up financing transaction generally offered by financial institutions to ensure that a client can obtain financing for the purchase of various assets (e.g. fixed property and equipment). The financial institution will purchase an asset (from a third party) at the instruction of the client and sell the asset to the client at a pre-agreed price. The pre-agreed price represents the cost of the asset acquisition plus a “profit” mark-up.

Under the 2010 legislation, banks offering finance pursuant to a Murabaha arrangement are deemed not to be involved in the acquisition or disposal of the asset that is the object of the arrangement. The client is deemed to be acquiring the asset directly from the seller for the cost incurred by the bank (on the client’s behalf) and at the time the bank acquires the asset. This deeming of a direct acquisition by the client eliminates adverse indirect tax (e.g. Value-added Tax) consequences for the bank that do not exist in the case of traditional finance.

The “profit” mark-up allocation by the bank is deemed to be interest. It should be noted that the same principles explicitly apply to Murabaha arrangements that entail financing by collective investment schemes to banks.

#### B. Diminishing musharaka arrangement

Diminishing Musharaka is a partnership arrangement generally used for project financing. Under this arrangement, the client and the bank jointly acquire various assets. Alternatively, the bank acquires an ownership interest in an asset that is already owned by the client in return for financing of a development or refurbishment project. In both circumstances, the Bank’s share in the asset is further divided into smaller units. The bank and the client enter into another agreement in terms of which the client undertakes to purchase the bank’s proportionate interest over time through the periodic purchase of individual units.

### II. Reasons for change

#### A. Murabaha

As stated above, the current ambit of the Islamic finance provisions dealing with Murabaha arrangements cater mainly for ‘bank-to-client’ finance (or if the funds came from a collective investment scheme to a bank). These Islamic finance provisions do not apply to arrangements in which the bank borrows funds from other parties. After further analysis, it has been decided that no reason exists to limit this form of Marabaha (deposit) finance. Whether the bank offers the finance or receives the finance (as a deposit) should make no policy difference. In either circumstance as long as a bank is involved in either side of the transaction, the Marabaha arrangement is seeking to achieve the same equivalent result as traditional financing.

When a client acquires the asset from the bank in most murabaha transactions, the 30-day period between the first sale and the second sale is often insufficient (due to circumstances outside the parties’ control). For instance, if bank purchases goods from a foreign jurisdiction on behalf of the client, shipping issues may delay the sale dates because the bank may not resell the goods until the bank has physical control of the goods.

#### B. Diminishing Musharaka

The current straight line method for calculating income in respect of diminishing musharaka is not in line with the actual calculation. The actual calculation follows the yield-to-maturity method (i.e. as in section 24J), but the legislation allocates amounts on a straight-line basis.

### III. Proposal

#### A. Murabaha

It is proposed that the scope of Murabaha arrangements be extended to cater for clients that provide financing (e.g deposits) to the bank. Hence, all legal entities and natural persons can now benefit from Marabaha financing to or from banks.

As a collateral matter, it is proposed that the term be extended from a 30-day period to a 12-month period. However, a condition will be added that no receipts or accruals must be



derived from the property during the interim period held by the financier (other than from the second disposal of the property). It should be further noted that anomalies exist within the current Murabaha arrangement framework in relation to certain indirect taxes (e.g. the Securities Transfer Tax) that arguably prevent the legislation from having the desired non-adverse result. These anomalies will be eliminated.

#### B. Diminishing Musharaka

It is proposed that the agreement should be the basis for determining the interest (i.e. profit) element. More specifically, the mark-up of the bank will be deemed to be interest. The deemed interest will be calculated by comparing the installment against the bank's cost of the proportional interest in the asset annually disposed of by the bank to the client. The net effect of this proposal is to reach the same compounding method result as section 24J.

##### **Example**

**Facts:** Individual X identifies property for R2 million and approaches the Bank for financing using the Diminishing Musharaka arrangement. Individual X pays R 500 000 and the Bank funds R 1 500 000 towards the purchase of the property. Individual X will purchase 1 percent of the Bank's interest over the period of 10 years.

**Result:** Each payment made by Individual X to the Bank indirectly represents part capital repayment and part deemed interest. The R1 500 000 in the Bank's books will be the capital outstanding that individual X must settle. Assuming in year 1, individual X pays R165 000 for a one per cent interest, the deemed interest element will equal R150 000 (R165 000 less R15 000).

#### C. General Overall

It is proposed that all Islamic finance amounts deemed to be interest be treated as such for Income Tax purposes. The net result will be automatic application of the interest de *minimis* exemption and the cross-border exemption.

### IV. Effective date

This amendment will become effective on the date determined by the Minister (envisioned to be set for early 2012).

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### 3.18. ISLAMIC FINANCE: PROPOSED SUKUK

[Clauses 3(1)(b), 54 and 129(1)(b); Applicable provisions: sections 24J and 24JA; Value-Added Tax: Amendment of section 1]

#### I. Background

In 2010, Government introduced several provisions dealing with the tax treatment of Shariá compliant arrangements. These provisions mainly provide parity of tax treatment between Islamic finance products vis-à-vis conventional banking products. As part of this reform, the tax system now accommodates the following forms of Shariá compliant arrangements: (i)

“diminishing musharaka”, (ii) “mudaraba”, and (iii) “murabaha”. The net effect of these accommodations is to treat these forms of Sharia compliant financing as comparable to conventional “debt instruments”, thereby eliminating anomalies relating to income tax, value-added tax (VAT), transfer duty and securities transfer tax.

## **II. Reasons for change**

Creation of an enabling framework for Islamic finance requires more than enacting accommodating tax legislation. Islamic financing, like conventional financing, requires government bonds as a “risk-free” standard so as to set the pricing for all other privately issued Islamic bonds. Moreover, Islamic finance providers typically utilise (and even require) Government bonds for regulating cash-flow and for balancing portfolios.

In the case of banks, the need for Government-issued Islamic bonds is more acute. All banks must hold a certain percentage of investments in interest bearing instruments (including Government bonds) in terms of banking regulations. Yet, Islamic banks are religiously precluded from yielding economic benefits from interest bearing investments according to Shariá law, even if required by local banking regulations. In order to balance both religious and regulatory interests, truly proper Islamic banks surrender the interest received in respect of these investments. This lack of return places Islamic banking at a competitive disadvantage in comparison with conventional banks, thereby lowering the overall yield of Islamic savings products.

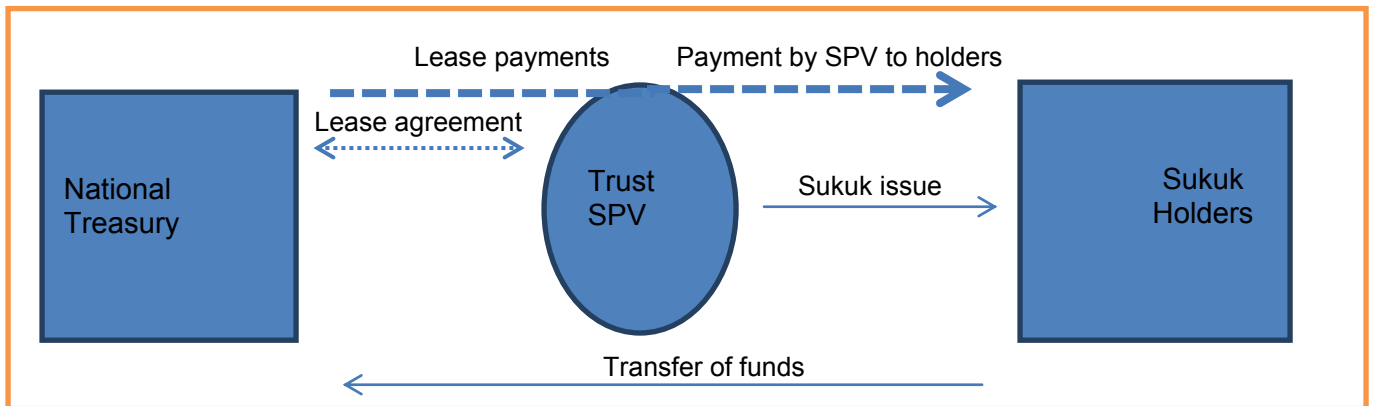
To date, Government has never issued any form of Islamic bond (known as a Sukuk). Moreover, current tax legislation fails to accommodate any meaningful potential for a Government Sukuk because these products typically come in the form of an “Ijara” financing arrangement. Ijara financing roughly equates to conventional finance leasing. While the tax system contains anti-avoidance rules to restrict certain practices associated with finance leasing, the tax system does not treat financing leasing as equivalent to interest.

## **III. Proposal**

### *A. Proposed Government Sukuk*

In view of the above, Government plans to issue a Sukuk to serve as a central focal point for Islamic finance. This Sukuk will come in the form of Ijara so that the bond falls within the dominant global standard for Government issued Sukuks. At this stage, the bond is planned to be issued locally. Strong take-up is expected by local banks and other financial institutions actively engaged in Islamic financing. Demand for local Islamic bonds also exists from certain retail investors.

In essence, an Ijara-styled Sukuk is an Islamic certificate of investment evidencing an investor’s proportional beneficial interest in an underlying asset (or in a comparable usufruct). In the case of the product proposed, the structure envisaged by the National Treasury is as follows:



- *Step 1:* Identification of immovable property (e.g. a government building or facility) for use by a special purpose vehicle (SPV) in the form of trust (i.e. acting as a conduit entity).
- *Step 2:* Transfer of beneficial ownership (or a usufruct) in the immovable property to the SPV. As part of this step, investors will provide funds to the SPV. These funds will then be passed onto National Treasury in exchange for the beneficial ownership (or usufruct) in the immovable property.
- *Step 3:* National Treasury will simultaneously lease back the beneficial ownership (or usufruct) over a period of years. The lease payments provided to the SPV will be allocated to the investors after subtracting an appropriate administration service fee. The lease charge will be based on the market-related cost of funding provided by the investors.
- *Step 4:* At the close of the lease period, National Treasury will repurchase the beneficial interest (or usufruct) held by the SPV at the initial cost to the SPV (with the final payments again being allocated among the investors). This repurchase price will effectively act as a repayment of principal (i.e. capital) at the end of the term.

It should also be noted that the overall arrangement must be sanctioned by Islamic scholars to ensure that the arrangement satisfies Sharia law.

#### *B. Tax adjustments*

Applicable tax principles of present law unfortunately work against the proposed Government Sukuk by triggering multiple adverse tax consequences that do not exist for conventional Government bonds. This tax burden will accordingly be eased so that the overall arrangement operates essentially as interest.

Firstly, the deemed sale by Government to the trust and subsequent repurchase will be ignored for income tax purpose.

Secondly, it is now proposed that the yield on the underlying asset (e.g. the lease payment in respect of the immovable property) held by the SPV will be similarly taxed as interest for income tax purposes.

This deemed “interest” yield of the SPV will automatically flow-through to the investors by virtue of the fact that the SPV is an entity in the nature of a trust (i.e. is a conduit under current law).

The proposed amendments will also eliminate adverse indirect tax charges currently associated with the structure.

- In particular, any potential transfer duties associated with the acquisition by the SPV will be eliminated. No transfer duties currently exist in respect of the repurchase by National Treasury because Government acquisitions are already exempt from transfer duty.
- The SPV will be deemed not to be an “enterprise” in order to eliminate any potential associated VAT charge with the SPV

#### **IV. Effective date**

The proposed amendment will be effective on a date to be determined by the Minister (envisioned to be set for early 2012).

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### **3.19. INCENTIVE: INDUSTRIAL POLICY PROJECT REVISION**

[Clause 37(1)(a-d); Applicable provisions: Sections 12I (2) and (9) of the of the Income Tax Act]

#### **I. Background**

An additional tax allowance (on top of the normal allowances available) for industrial policy projects was introduced in 2008 to benefit all manufacturing projects. The purpose of the incentive is to promote international competitiveness with other countries that similarly utilise the tax system to attract large industrial projects. The incentive offers special tax benefits to greenfield investments (i.e. new industrial projects) and brownfield investments (i.e. expansions or upgrades of existing industrial projects) with enhanced emphasis on the former. In order to receive this allowance, approval from an adjudication committee is required, which makes its determination based on pre-determined criteria with the committee approvals restricted to R20 billion of deductions for all industrial projects in total.

The main focus of the incentive is to promote capital expenditure. Greenfield projects receive an additional 55 per cent allowance, and brownfield projects receive a 35 per cent additional allowance. The allowances, however, are subject to certain limitations. A ceiling on the allowance of R900 or R550 million per project is imposed for greenfield projects (depending on whether the project is preferred or merely qualifying). A ceiling on the allowance of R500 or R350 million per project is imposed for brownfield projects (depending on whether project is preferred or merely qualifying).

A secondary focus of the incentive is skills training. Training effectively receives a double deduction for a six-year period. The additional training deduction is subject to two ceilings – a

ceiling of R36 000 per employee and a R30 million or R20 million ceiling per project (depending on whether the project is preferred or merely qualifying).

## **II. Reasons for change**

Government is seeking to renew its efforts to enhance the Industrial Development Zone (IDZ) regime initiated by the Department of Trade and Industry. The purpose of the IDZ regime is to encourage industrial development within certain geographical areas in order to effectively facilitate the policy of the Department of Trade and Industry. Yet, the additional allowance for industrial projects barely takes the IDZ into account (awarding only one point for an IDZ location when the adjudicating committee reviews applications via the regulatory criteria).

Early Government experience with the incentive also reveals some small shortcomings. These shortcomings exist in both the legislation and in the accompanying regulations.

## **III. Proposal**

### *A. Promotion of IDZ's*

In view of the above, the industrial project allowance will be enhanced in respect of IDZs. Instead of a 55 per cent additional allowance for greenfield projects, the additional allowance for greenfield projects will be increased to 100 per cent. Instead of a 35 per cent additional allowance for brownfield projects, the additional allowance for brownfield projects will be increased to 75 per cent. The regulatory point scoring criteria will also be shifted to enhance approval (and preferred status) within IDZ areas.

### *B. Minor anomalies*

Under current law, additional capital incentives for industrial projects are subject to an overall R20 billion ceiling as stated above. However, the training allowance lacks any comparable aggregate ceiling. Training allowances will accordingly become part of the same aggregate ceiling to ensure the costs of the incentive are better controlled by Government.

The incentive also fails to contain deadweight losses for the fiscus as intended. The incentive is for projects that would not otherwise occur. In that vein, it was always intended that possible approval be given only toward project assets that are acquired and contracted after the approval date (not for projects already under way). The wording suggests otherwise and will accordingly be corrected.

## **IV. Effective Date**

The proposed amendments will be effective for projects approved on or after 1 January 2012.

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## **3.20. INCENTIVE: VENTURE CAPITAL COMPANY REVISIONS**

[Clauses 24(10(e) and 38; Applicable provisions: Section 12J; see also section 9C(2A)]

### **I. Background**

Government enacted the venture capital company (VCC) tax regime in 2008. The purpose of the VCC is to create a pooling mechanism for investors to channel funds into small businesses and junior mining operations. The VCC itself (based on the private equity model) is intended to act as an “angel investor” for these small businesses and junior mining companies by providing equity and supportive management services. The VCC is expected to typically acquire a major stake in these entities until these entities reach a certain level of growth with the VCC selling these entities for profits upon the entity’s maturity. The VCC model requires this incubation period to last between 5 and 10 years. Most of the small businesses and junior mining operations involved are high risk – with a few large “winners” generating profits that should exceed the lack of profit in respect of the remainder.

Taxpayers investing in a VCC generate an upfront deduction for the investment (whereas most equity investments are non-deductible) with a recoupment upon withdrawal. The VCC has three sets of requirements: (i) investor-level requirements for the deduction, (ii) criteria for determining whether the investor-pooling entity qualifies as a VCC, (iii) criteria for determining whether the VCC is investing in a qualifying small business company or a junior mining company. The VCC itself requires pre-approval from SARS to initiate operations.

## **II. Reasons for change**

To date, the VCC regime has not been successful. Applications have been few and no VCC has been successfully initiated to date. It is contended that the investment benefits are too small. It is also contended that the VCC, small business and junior mining criteria are too restrictive. The restrictive that criteria mean that the VCC cannot operate in accordance with the private equity model upon which the regime is founded. The lengthy restrictive criteria have also rendered the regime far too complex, making operation of the VCC unsustainable.

## **III. Proposal**

### *A. Overview*

Given the above concerns, a general relaxation of requirements is proposed so that investor pooling of equity funds through VCC can be achieved as intended. The general relaxation will also be balanced with minimal anti-avoidance requirements to ensure that the regime does not give rise to tax deductions that provide little or no assistance to the target group intended.

### *B. Investor criteria*

The general ceilings and prohibitions associated with investors seeking a deduction will be completely removed. The current “natural person” limitation will be removed, meaning that all taxpayers (e.g. legal entities) can now freely obtain deductions for investing in a VCC. The R750 000 investment and other ceilings will be similarly removed.

In lieu of the above criteria, three anti-avoidance criteria are added.

- Firstly, the deduction will not be available to investors who become connected persons to the VCC as a result of, or upon completion, of the investment. As a

practical matter, the connected person test is generally triggered at a more than 50 per cent level or 20 per cent level depending upon the facts. These rules ensure that taxpayers cannot obtain a deduction merely by cycling funds among closely connected parties (as opposed to obtaining a new independent investment).

- Secondly, the deduction will only be allowed if the investments in the VCC are pure equity investments (investments with debt-like features will be completely disallowed). In essence, the channeled funds must bear the economic risk and loss associated with the profit model of the VCC.
- Thirdly, the investment must place the investor genuinely “at-risk.” No issue arises if the investor funds the investment from the investor’s own resources. However, if the investment stems from a loan or a credit facility, the investor must bear the risk of the loan or the credit facility (i.e. the loan or credit facility must be a fully recourse loan that must be repaid even if the VCC does not reach the investment objectives intended). Moreover, a loan or credit facility will not be deemed to satisfy the “at-risk” criteria if the loan or credit facility is directly or indirectly provided by the VCC. Loans or credit facilities must also be repayable within 5-years to avoid “time-value of money” schemes (schemes where the repayment is delayed for so long that the repayment is meaningless after inflation is taken into account).

### *C. Venture Capital Company Criteria*

The VCC criteria will be significantly relaxed. The goal again is to simplify the regime by eliminating overly burdensome requirements. More specifically, the following amendments are proposed:

- Firstly, VCCs will not be disqualified merely because the VCC lists on the JSE. The goal is to pool private investments; no reason exists to prohibit this form of pooling.
- Secondly, the VCC can now form part of a group (either as a controlled group company or a controlling group company). However, note that deductions for investors are limited to persons who are not connected persons (see above) and that some ownership limitations still exist in respect of qualifying (small business or junior mining) investments (see below).
- Thirdly, the prohibition against having more than 20 per cent passive income in a single year will be dropped so that temporary cash build-ups do not undermine the regime. However, the VCC must still spend at least 80 per cent of its expenditure for qualifying (small business and junior mining) companies from date of the VCC’s approval from SARS. The 80 per cent requirement should be sufficient by itself to ensure (by applying objective principles) that the VCC is directed to its objective.

- Fourthly, the minimum investment requirements will be dropped as contradictory to the regime. The VCC will no longer be required to invest a minimum of R30 million to acquire a (small business) qualifying company or a minimum of R150 million to acquire a (junior mining) qualifying company.
- Fifthly, the diversification requirements will be slightly eased. Under current law, the VCC can invest no more than 15 per cent of its total expenditure in any one qualifying (small business or junior mining) company. The percentage will be increased to 20 per cent. Hence, a VCC can satisfy the minimum criteria by investing in a minimum of five qualifying companies.

#### *D. Qualifying (investee) companies*

The rules associated with qualifying (investee) companies will be relaxed. In the main, a VCC must invest at least 80 per cent of its expenditure in qualifying (investee companies). At present, qualifying (small business) companies cannot have a book value exceeding R10 million and qualifying (junior mining) companies cannot have a book value exceeding R100 million. These maximum thresholds are unrealistically low and will accordingly be increased. It is proposed that the maximum book value threshold for qualifying (small business) companies cannot exceed R20 million and qualifying (junior mining) companies cannot exceed R300 million.

The qualifying company ownership restrictions are also being relaxed. Under current law, qualifying investee companies may not be more than 50 per cent owned by the VCC. This requirement runs counter to the VCC (private equity) model because private equity funds often maintain temporary control of qualifying companies during the incubation period for enhanced management. The ownership prohibition will accordingly be relaxed so the VCC can own up to 70 per cent. The 30 per cent limitation ensures that the small business attracts independent players.

As a final matter, the prohibition against franchisees will be dropped. VCCs can now freely invest in qualifying (small business) companies operating as franchisees. Small businesses of this nature often need outside equity support to initiate or expand operations.

#### **IV. Effective date**

The proposed amendment will be generally effective for years of assessment commencing from 1 January 2012.

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### **3.21. INCENTIVE: RESEARCH AND DEVELOPMENT REVISIONS**

[Clauses 32, 33(1)(a-c), 40 and 48; Applicable provision: Sections 11D; Amendment of section 12C; Amendment of section 13 and 23B]

#### **I. Background**

##### *A. Overview*



The income tax system contains an incentive for R&D in order to promote increased private sector R&D investment in South Africa, to enhance its role as an R&D innovation hub and to promote R&D innovation led industrial development and job opportunities. The incentive has two main aspects: (i) a 150 per cent deduction for R&D non-capital expenditure, and (ii) an accelerated 50:30:20 per cent write off over three years for R&D buildings, plant, machinery, utensils, articles and improvements.

*B. R&D non-capital expenditure (150 per cent)*

In order for R&D non-capital expenditure to be entitled to a 150 per cent deduction, this expenditure must be directly attributable to R&D undertaken in South Africa. R&D can either be: (i) the discovery of novel, practical and non-obvious information, or (ii) the devising, developing or creation of inventions, designs, computer programs or knowledge essential to their use. R&D must additionally be of a scientific or technological nature, and must either be: (i) used for production of the taxpayer's income, or (ii) discovered, devised, developed or created for purposes of deriving the taxpayer's income.

The legislation contains certain "exclusions" such as the following: exploration and prospecting relating to minerals or oil and gas, management or internal business processes, trademarks, social sciences or humanities, or market research or sales or marketing promotion. Banking, financial services and insurance businesses are excluded per se from the relief.

*C. Accelerated (50:30:20) write offs*

Buildings, plant, machinery, implements, utensils and articles obtain a 50:30:20 write off over three years if dedicated to R&D. The definition of R&D for this purpose (as well as the "exclusions" noted above) is the same as the definition for non-capital expenditure. The rules for this write-off are consistent with other accelerated write-offs (including potential recoupment upon disposal that effectively recaptures prior write offs).

*D. R&D third-party funding arrangements*

Parties undertaking R&D activities often do so on behalf of others (those funding the activities). To the extent these circumstances exist, the parties funding the R&D obtain the 150 per cent deduction as opposed to the parties undertaking the R&D activities. However, the 150 per cent deduction shifts to the party undertaking the activity if the funder cannot deduct the amount funded (e.g. because the funder is tax-exempt or outside the tax system).

## **II. Reason for change**

As is common place internationally, the lack of a concrete and precise definition of R&D has given rise to of the following problems:

- Firstly, concerns exist that while the definition has been broadened to cover as many industrial R&D activities as possible, specific areas remain unclear. This uncertainty gives rise to a need to clarify activities and expenditure related to R&D that are eligible to qualify.

- Secondly, legitimate value-added R&D is often subject to unnecessary uncertainty and audit scrutiny due to lack of R&D expertise among auditors who naturally specialise in law and accounting.

On the technical side, the incentive continues to give rise to certain anomalies. One recurring issue is how to ensure that the incentive is properly applied when the R&D is funded by outside parties. In this circumstance, funder payment for R&D services undertaken by another is unnecessarily giving rise to an audit claim that the funding mechanism amounts to a recoupment, thereby neutralising the incentive when R&D services are performed on behalf of another.

### **III. Proposal**

#### *A. Overview*

The deduction relating to R&D expenditures will be simplified and streamlined for ease of use. Under the revised regime, all R&D expenditures will be separated into one of three categories. Firstly, all expenditures incurred in respect of eligible R&D activities will qualify for the automatic deduction even if these expenditures are capital in nature. Secondly, the additional 50 per cent uplift will only apply to R&D expenditures that have been approved by the Department of Science and Technology (DST).

The purpose of this DST intervention is to ensure that additional allowances are initiated like Government grants with taxpayers being provided well upfront certainty that the originating cause (in the nature of R&D) of the additional allowance will be respected by SARS upon audit. Lastly, all R&D expenditures that do not qualify for the automatic deduction will remain eligible for deductions if the R&D satisfies the basic deduction formula.

#### *B. R&D definitions*

The definition of R&D will be wholly revised to better reflect Government's intention to incentivise activities that constitute technical and scientific R&D in a commercial sense (as opposed to routine upgrades or applications). Additionally, revisions to the definition will be driven by the objective to allow for novel adjustments to pre-existing products or processes. As existed under the previous regime, the proposed relief will apply if the taxpayer carries out R&D activities in the production of income. (as opposed to R&D activities conducted by taxpayers merely as a hobby). More specifically, R&D must consist of:

Systematic investigative or systematic experimental activities involving "appreciable elements of novelty" or "high levels of technical risk" that are carried on:

- to discover non-obvious scientific or technological knowledge; or
- to create, develop or significantly improve inventions, designs, computer programs or knowledge (as statutorily defined) to enhance a new or improved function or an improvement of performance, an improvement of reliability or an improvement of quality.

## C. R & D expenditure

### 1. Automatic deduction

As under current law, the definition of R&D contains explicit exclusions to eliminate deadweight loss and dubious arguments to the contrary. Expenditures incurred by a taxpayer in respect of R&D activities (undertaken by or for the benefit of the taxpayer) will be fully deductible for the basic 100 percent deduction without pre-approval as long as these expenditures:

- are incurred solely and directly in respect of separately identifiable R&D activities (thereby eliminating general physical and administrative overheads);
- are undertaken solely within South Africa;
- are incurred in the production of income and in carrying on any trade

R&D activities will remain deductible even if the activities culminate in an intangible asset (i.e. the expenditure incurred is of a capital nature because the expenditures culminate in a capitalised asset).

**Example:**

**Facts:** Company X regularly engages in R&D activities associated with manufacturing. Company Y hires Company X to perform manufacturing R&D to create certain products on Company Y's behalf. Company X incurs R80 000 expenses and charges Company Y R115 000 (i.e. cost plus a profit mark-up).

**Result:** Company X can potentially deduct R80 000 and Company Y can potentially deduct up to R115 000. The result is the same regardless of whether the R&D potentially results in an identifiable intangible asset.

### 2. 50 percent uplift

Taxpayers will receive an additional uplift in respect of expenditures incurred for R&D activities. More specifically, to qualify under the proposed relief, expenditures must satisfy the following criteria:

- the expenditures must be approved by the adjudication committee led by the DST.
- the expenditures must be incurred in respect of R&D activities undertaken from the date that a successful application for approval of the R&D expenditures is submitted to the DST.

Additionally, where expenditures have been incurred by taxpayers who undertake R&D activities (funded by others), the party responsible for determining or altering the research methodology will be the only party eligible for the 50 per cent uplift.

**Example:**

**Facts:** Company Y often engages in R&D activities associated with medical development. Company Y hires Subcontracting Company to perform R&D for clinical trials by creating certain products on Company Y's behalf. Although Company Y delegates some of the R&D activities, Company Y is solely responsible for determining the research methodology applied. Subcontracting Company incurs R100 000 expenses and charges Company Y R130 000 (i.e. cost plus a profit mark-up).

**Result:** Company Y may potentially deduct R130 000, and Subcontracting Company may potentially deduct up to R100 000. However, only Company Y qualifies for the 50 percent uplift since Company Y is responsible for determining the research methodology.

3. Basic deduction (under section 11a)

As a general matter, all expenditures listed below do not qualify for the basic 100 percent deduction or the additional 50 percent uplift. However, these expenditures will remain eligible for a general deduction. More specifically, these expenditures include the following:

- Market research, market testing, or sales promotions;
- R&D expenditures associated with human resources management, payroll, legal, finance and audit;
- Routine testing, analysis, the collection of information and quality control in the normal course of business (unrelated to a significant R&D project);
- Research and development to enhance internal business processes (e.g. typical computer software) except where that research and development is conducted for external exploitation for sale or license to customers;
- Social sciences, including the arts and humanities;
- Oil and gas exploration or mineral prospecting, except R&D carried out to develop technology used for oil and gas or mineral exploration;
- Expenditures to create or develop financial instruments or financial products (e.g. development of financial derivatives);
- Expenditures to create or enhance trademarks or goodwill.
- Expenditures incurred or allowances granted for the acquisition of pre-existing inventions, designs or computer programs (i.e. the acquisition of assets eligible for allowances under sections 11(gB) and (gC));

**Example:**

**Facts:** Company X is engaged in a South African bottling distribution business. Company X frequently engages in R&D activities that are solely undertaken in order to improve the efficiency of the bottling plant. Company X incurs R300 000 expenses for R&D in respect of the creation of bottling processes.

**Result:** The R300 000 expenditure falls outside the revised regime. This expenditure merely constitutes enhances Company X's internal business processes. However, Company X can potentially deduct R300 000 under the basic deduction formula.

**Example:**

**Facts:** Company Y frequently engages in R&D activities for the development of a software system for use by small businesses. Company Y incurs R200 000 expenses for R&D in respect of the software development. Company Y then licenses the software for recurring use by small business owners.

**Result:** Company Y will qualify for the basic R&D regime and possibly for 50 percent uplift on the R200 000 expenditure incurred for R&D. Despite the R&Ds relationship to internal business process, the software development is dedicated to external exploitation (i.e. licence to customers).

*D. R&D funding*

As discussed above, current law provides special rules when one party undertakes R&D activities on behalf of another (i.e. the funder). In most cases, the funding party obtains the uplift as opposed to the party undertaking the activity.

Under the proposed relief, only the party who is responsible for determining the research methodology will be eligible to qualify for the 50 per cent uplift. Only this party has full knowledge and information associated with the R&D process to properly interact with government as to the facts relating to the R&D activity.

Under the revised regime, special rules exist when R&D is indirectly supported by Government. More specifically, the 50 per cent additional allowance applies to private funders when funding R&D that is undertaken by exempt Government-owned entities (e.g. universities and the Council for Scientific and Industrial Research). This form of funding is important to enhance pre-existing centres of R&D activity. On the other hand, if taxpayers receive an exempt Government grant to undertake R&D, the 50 per cent additional allowance does not apply to the extent of the grant (to prevent double dipping).

In wholly private settings, a choice for use of the 50 per cent additional allowance exists in the case of domestic groups of companies. The domestic company that determines or applies the methodology for the R&D activity can seek approval for the uplift or the

funding group member can seek approval. If the funding party obtains approval for the 50 per cent additional allowance, the allowance is available only to the extent of the expenditure incurred by the other company directly and solely for the R&D activities undertaken (thereby eliminating the 50 per cent uplift for the profit charged). This rule for company groups is roughly the same as the pre-existing R&D regime.

Lastly, the law will be clarified in respect of recoupments. Parties undertaking R&D on behalf of another should not be viewed as having recouped the expenditure merely because these parties are undertaking R&D on behalf of another (by charging a corresponding service fee). Implications in current law suggesting otherwise will be removed; only the general rule of recoupment will apply.

#### *E. Approval committee processes*

The approvals committee for R&D projects will operate in much the same way as the adjudication committee relating to the Industrial Policy Project incentive. The committee must not only review the initial approval for recommendation to the appropriate Minister (DST in this case) but also engage in monitoring and reporting on an annual basis. The approvals committee will consist of three members appointed by the Minister of Science and Technology and four members appointed by the Minister of Finance. The respective committee appointees must be “persons full-time employed by the Department of Science and Technology” and “persons full-time employed by the National Treasury or the South African Revenue Services”.

#### *F. Applications procedure*

As an initial matter, R&D activities will require DST approval in order for taxpayers to qualify for the 50 percent uplift. In this vein, new and pre-existing R&D projects will qualify for the 50 percent uplift from the date that a successful application (for approval of the expenditures) is submitted by the taxpayer to the DST. To this end, approval need not precede project inception.

##### **Example:**

**Facts:** Company regularly engages in R&D activities associated with agricultural development. Company starts an R&D project in 2012 and incurs R120 000 as expenditures for R&D. Company incurs additional R&D expenditure of R40 000 for the project in 2013. Company submits its application for approval to the adjudication committee in 2013.

**Result:** The amount R40 000 of eligible for the R&D 50 percent uplift depends on when the application is submitted in 2013. None of the R120 000 is eligible for the uplift.

The approvals committee will evaluate all applications and make a determination to approve any application of R&D activities that is innovative in nature and which requires specialised skills. Additional requirements may be added by regulation

As stated above, although no DST approval is required in order for taxpayers to qualify for the basic 100 R&D deduction, it is envisioned that the DST will play an increased role for interpretative purposes. More specifically, SARS will be empowered to share information with the DST. This collaboration will enable SARS to gain access to DST expertise when interpreting the definition of R&D.

*G. Accelerated write off for R&D assets*

New and unused R&D machinery or plant (or improvements thereto) owned by the taxpayer will be eligible to obtain an accelerated write off over four years. The net effect is a four-year accelerated write-off at a 40:20:20:20 rate. On the other hand, R&D buildings owned by the taxpayer will be eligible for a 5 percent write-off over 20 years. This write-off again applies without resort to pre-approval.

#### **IV. Effective date**

The proposed legislation will be effective for R&D expenditures incurred on or after 1 April 2012 (or a later date announced by the Minister). The revised regime will also contain a sunset clause.

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### **3.22. INCENTIVE: FILM PRODUCTION REVISIONS**

[Clauses 28(1)(s), 39 and 51 Applicable provisions: Sections 12O and 24F]

#### **I. Background**

*A. Film tax allowance*

South Africa's income tax system contains an incentive to stimulate the production of films within South Africa. The current incentive comes in the form of an allowance (i.e. a 100 per cent upfront deduction for film production that would otherwise be non-deductible as capital in nature). However, if the investor supplying the funds obtains those funds through borrowing, the deduction applies only to the extent that the investor is at risk in respect of that borrowing. This allowance contains a myriad of requirements, many of which seek to ensure that the costs relate to production while others seek to ensure that the film is largely local in nature.

*B. South African Film and Television Production and Co-Production Incentive from the Department of Trade and Industry (DTI)*

In order to provide South African film production with initial cash-flows that are designed to operate as a catalyst for investment, the DTI provides an incentive for eligible films (called the South African Film and Television Production and Co-Production Incentive, which became operative on 30 June 2004). The funds of an awarded incentive are released in tranches based on the fulfilment by the producers of certain film production milestones. To this end, incentive funds are typically only awarded once the investors have made an initial injection of their own funds (toward the total production budget) with additional DTI incentive funds added as specified film milestones are reached. In particular, equal amounts of the incentive funds are disbursed in tranches upon:

- The date that confirmation that the completion bond is registered;
- The date that principal photography commences;
- The date that principal photography is complete;
- The date of completion of the final mix (i.e. roughly the date that the film is ready for distribution); and
- The date that the applicant submits the final claim to the DTI.

The DTI incentive contains certain procedural criteria (see DTI programme guidelines for South African Film and Television Production and Co-productions issued 28 January 2008). These criteria include the required creation of a domestic company to act as a special purpose corporate vehicle (SPCV). The purpose of the SPCV is to separately account for DTI funding (and investor funding) as applied to film production costs (in terms of financial reporting and in terms of other requirements such as black economic empowerment). The income tax contains ancillary rules in support of the DTI incentive by treating the incentive as exempt income for the SPCV. The incentive can be passed tax-free onto the film owners.

Investor access to the DTI incentive typically occurs in the form of a loan repayment, a cession, or as a dividend from the SPCV. Investor involvement with the SPCV generally depends on whether the DTI incentive is awarded before or after film production.

- If film production begins after having secured the DTI incentive, investors make an initial loan to the SPCV so that the SPCV can use investor funds to make the film. The investors are then repaid a portion of their initial loan as the SPCV collects the DTI incentive upon film production reaching certain milestones as outlined above.
- If film production begins before having secured the DTI incentive, investors again make an initial loan to the SPCV upfront so that the SPCV can use investor funds to make the film with the loans partly repaid via the DTI incentive at the end of the process once DTI funds are secured.

It should be noted that no investor should ever receive more from the DTI than a partial return of their funding. The DTI incentive is designed only as partial subsidy.

### *C. Nature of film income*

The profits of film production come at several levels. As an initial matter, it is hoped that film profits are made through cinema release. Successful films typically generate subsequent profit through distribution via DVD or through television programming. Less than successful films go straight to DVD or television. Investors obtain the fruits of their investment through “exploitation rights” (that generate proportionate sales, licensing income and ancillary revenue).

### *D. Role of the collection account management agreement*



Although producers and investors retain ownership of film production rights, the parties involved typically enter into a collection account management agreement with an independent third party (i.e. the collection account manager (CAM)). Basically, the primary function of the CAM is to administer the collection and distribution of revenues to investors arising from their “exploitation rights” (relating to cinema, DVD and television rights, etc.). The CAM function is one of pure agent for allocating funds among investors.

## **II. Reasons for change**

The upfront allowance for film production has largely been unsuccessful. Still worse, the incentive has created fertile ground for tax schemes, whereby certain investors mainly sought to obtain deductions with little regard for the underlying film. In these circumstances, the allowance has been more of an incentive for tax advisors and other financial facilitators as opposed to the development of a viable film industry.

The main problem with the incentive is the incentive’s emphasis on cost – the greater the cost, the greater the incentive. This emphasis has caused certain taxpayers to generate artificial losses. While “at risk” rules exist to curb this practice, it is questionable whether these rules have been fully effective.

At an audit level, SARS has properly sought to intervene in order to protect the fiscus. However, this intervention has meant that many legitimate investors have avoided the incentive due to the audit risk. Still others continue to utilise the incentive with the goal of subsidising “cultural” films not intended for profit (i.e. as a self-styled deduction for amounts that would not be deductible if contributed to a public benefit organisation designed to promote culture).

## **III. Proposal**

### *A. Overview*

In view of the above, the accelerated write-off will be removed and replaced by an exemption. More specifically, income for exploitation rights allocable to initial investors (from qualifying films) will be wholly exempt. This change in focus will eliminate the incentive to escalate costs. However, taxpayers will be entitled to claim a limited net loss for expenditures after a two-year period. Taxpayers claiming this net loss will lose the benefit of the exemption going forward.

### *B. Qualifying criteria*

In order to qualify for an exemption, taxpayers must satisfy the following criteria:

- The production must be derived from a film;
- The film must be approved as a local production or co-production;
- The income must be allocable to the initial investors;
- The income must be derived in respect of exploitation rights; and
- The income must fall within a 10-year period.

### *1. Film requirement*

In respect of the first requirement, the production must qualify as a feature, documentary or animation as defined by the DTI programme guidelines (see DTI programme guidelines for South African Film and Television Production and Co-productions issued 28 January 2008). More specifically,

- A feature film entails:
  - A film commonly screened as the main attraction in commercial cinemas;
  - A film with a duration of no less than 90 minutes (or in the case of a large format (IMAX) film, no less than 45 minutes); and
  - A film shot and processed to commercial theatrical release standards for cinema exhibition or television broadcast, direct-to-video or DVD.
- A documentary entails:
  - A non-fictional informative or educational programme or series recording real people or events that may involve some dramatisation;
  - A programme no less than 90 minutes in length (or in the case of a large format (IMAX) film, no less than 45 minutes); and
  - A programme shot and processed to commercial theatrical release standards for cinema exhibition, television broadcast, direct-to-video or DVD (including a series limited to 13 episodes).
- An animation entails:
  - A sequence of frames that, when played in order at sufficient speed, presents a smoothly moving image for broadcast, projection, new media and network use in an entertaining, educational, informative or instructive manner; and
  - Hand-drawn images (2d animation), digitised video, computer-generated images (3D and flash animation), live action objects or a combination thereof.

### *2. Pre-approval required*

As a second requirement, both local productions and co-productions must be pre-approved by the National Film and Video Foundation (NFVF) in order to qualify for relief. Approval is available for both local productions and co-productions (the latter falling within the definition of a co-production film pursuant to a formal international agreement between South Africa and another country concerning the co-production of films).

Approval by the NFVF of a film either as a local production or co-production must be granted in view of the scoring criteria (to be released by the NFVF) for assessment as a South African film (i.e. a film with significant local South African content). The NFVF will operate in an oversight and monitoring capacity to ensure that the exemption applies to genuine profit-seeking films.

### 3. *Initial investors*

As a general matter, two sets of investors may be involved in film production. Firstly, “pre-production investors” join before principal photography begins; while secondly, “mid-production investors” often join a production after film photography. For both sets of investors, the exemption will automatically apply. Mid-production investors will, however, not be eligible for the exemption where funds are provided for purposes other than to buffer against funding shortfalls that could eventuate during production (i.e. to compensate pre-production investors).

The exemption is limited to these initial and new investors because these parties are the ones taking the key risks associated with production of the film. In addition, the incentive does not apply to broadcasters as defined in section 1 of the Broadcasters Act, 1999 (Act No. 4 of 1999), and connected persons thereto. Investments in these scenarios contain a guaranteed level of profit because the films are produced merely for pre-determined sales or use by the broadcaster.

#### **Example:**

**Facts:** A and B (who are pre-production investors) own the production rights to produce a local film, which is completed in 2016. Principal photography is stopped in 2014 due to a shortfall in funding. C and D join as mid-production investors (after principal photography but before completion date) and receive proportionate exploitation rights for providing funding to buffer against the shortfall. After completion of production of the film, Investors A, B, C and D collect their proportionate exploitation rights (i.e. 25 percent) to revenue from subsequent film sales by X who is a registered distributor. Investor C sells all allocable exploitation rights to Investor Y for R180 000. The film generates income of R1.4 million after all disbursements are paid.

**Result:** Investors A, B, C and D obtain a full exemption in respect of their proportionate income of R350 000 since their income is earned pursuant to their exploitation rights held as of the date of completion. C also obtains a full exemption in respect of R180 000 of the exploitation rights sold to Investor Y. Y’s income of R350 000 is fully taxable after production since Y acquired the exploitation right from C after completion date.

### 4. *Exploitation rights*

The rights at issue (giving rise to exemption) must relate to exploitation (sales and licensing) rights associated with underlying film. More specifically, the profits must be wholly dependent on the production of a viable film. Therefore, the exemption does not apply to the extent any payments are subject to any guaranteed minimums.

These rules effectively seek to exclude income from set salaries and loan repayments. However, it should be noted that parties taking salary compensation in the form of exploitation rights need not sacrifice the exemption. The exemption fully applies to the extent that these rights are fully dependent on film profits (i.e. film participants can take contingent film rights in lieu of salary).

**Example:**

**Facts:** A is a film producer that owns the production rights to produce a local film which is completed in 2014. Upon completion of the film, A has exploitation rights that entitles A to receive 10 per cent of the proceeds from film sales with a minimum of R100 000. The film generates a total of R3 million of income after all disbursements are paid.

**Result:** A's allocable income pursuant to his exploitation rights from film sales is R300 000. A will obtain a full exemption on the income of R200 000 but not on the income of R100 000 because this latter amount is guaranteed (i.e. probably linked to A's salary).

## 5. Losses

As a general matter, expenditures and losses cannot be deducted if the associated income is exempt (i.e. lacks production of income under the general deduction formula). Limited protection will nonetheless be granted to taxpayers to protect their downside risk. Taxpayers may therefore claim a deduction for expenditures incurred if those expenditures exceed the total receipts and accruals in respect of the exploitation rights. To this end, taxpayers may claim this net loss during any year of assessment commencing only on or after two years following the date of completion of the film. All income pursuant to a taxpayer's allocable exploitation rights will be taxable from the beginning of the year following the claimed deduction (i.e. the exemption permanently falls away from that point onwards).

Despite the above, Taxpayers will not be allowed to claim a deduction for losses if the investor funds are obtained on loan, credit or similar financing. This prohibition ensures that only funds at risk qualify for the proposed relief.

**Example 1**

**Facts:** A is a film producer that owns the production rights to produce a local film which is completed in 2014. A's expenditure incurred in respect of the exploitation rights held is R4 million. A has exploitation rights that entitles A to receive 40 percent of the film proceeds. The film generates income after all disbursements are paid of which R2.4 million is allocated to A. A has a loss of R1.6 million that A claims as a deduction in 2016.

**Result:** A will obtain a full exemption in respect of its proportionate income of R2.4 million since A earns this income pursuant to A's allocable exploitation rights held as of the date of completion. A may potentially deduct the loss R1.6 million. However, any income from the qualifying film that A earns pursuant to A's allocable exploitation rights from 2017 onwards will be taxable.

### **Example 2**

**Facts:** B is a film producer that owns the production rights to produce a local film which is completed in 2012. B's expenditure incurred in respect of the exploitation rights held is R1.5 million. B has exploitation rights that entitle B to receive 10 percent of the proceeds from subsequent film sales. B also receives funding from the DTI for R100 000. The film generates income of which R300 000 is allocated to B. B has a loss of R1.1 million that B claims as a deduction for in 2017.

**Result:** B will obtain a full exemption in respect of its proportionate income of R300 000 since B earns this income pursuant to B's allocable exploitation rights held as of the date of completion. B's income of R100 000 will also be fully exempt because the funds stem from the DTI grant (see below). A may potentially deduct the net loss of R700 000- (R1.1 million minus R300 000 minus R100 000). Any income from the qualifying film that A earns pursuant to A's allocable exploitation rights will be taxable from 2018 onwards.

## *6. Ten-year period*

As stated above, exempt film income lasts only for a ten-year period (and to the extent that the taxpayer does not claim a net loss – see above). The ten-year period begins on the date that the film production is completed (i.e. roughly the date that the film is ready for distribution). As stated previously, the exemption covers all receipts and accruals (i.e. in respect of all sale and licensing rights) associated with the film (e.g. cinema, DVD and television).

### *A. Procedural requirements*

Like all newer incentives, a policy stance is taken that on-going reporting is required to measure the economic success of the incentive and to guard against tax avoidance. The NFVF will act as the key point for collecting information. Reporting must be done via the SPCV or by a CAM approved via regulation. Taxpayers will be given a choice so as to reduce their administration costs depending on their circumstances. The reporting requirement will last for the same period as the potential exemption (i.e. up to 10 years).

### *B. DTI incentive*

The DTI incentive will remain exempt in the hands of the SPCV. The DTI exemption will continue to apply to amounts paid over by the SPCV to the initial investors and will remain limited to the extent of the amount loaned or invested by the applicable investors in the film.

#### **IV. Effective date**

The proposed legislation will contain a flexible cut-off date to assist taxpayers currently involved in film production to qualify for relief under the pre-existing upfront allowance. More specifically, taxpayers will be eligible for the pre-existing allowance where principal photography has commenced before 1 January 2012 but only where expenditures (for film production) have been incurred before 1 January 2013. Relief under the proposed regime will begin to apply where principal photography has commenced on or after 1 January 2012. The revised incentive has a sunset clause of 1 January 2017.

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### **3.23. SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF**

[Clauses 97, 99, 100, 131, 133(1)(a) and 141; Applicable provisions: paragraph 3; Amendment of paragraph 8 of the Sixth Schedule and paragraph 10 of the 6<sup>th</sup> Schedule of the Income Tax Act; Value-Added Tax: Amendment of section 10 and 23]

#### **I. Background**

The turnover tax system seeks to encourage the informal sector and other small businesses to enter the tax system by lowering the barriers of entry associated with the normal income tax system. In essence, small businesses under the turnover tax system are subject to a low rate of tax on a gross basis without deductions. The turnover tax potentially applies to businesses with an annual turnover of up to R1 million.

#### **II. Reason for change**

Two years after introduction, the objectives of the turnover tax have not been realised. Only a small number of taxpayers have registered for the turnover tax, most of which have migrated from pre-existing registration under the normal income tax. While all of the reasons associated with these difficulties are still under examination, certain design aspects of the turnover tax appear to be problematic. Most notably, the rate structure may be too high for many informal businesses. The prohibition from being registered under the value-added tax may also be partly to blame because many businesses must be so registered if these businesses are to be viewed as credible by clients. The three-year lock-in period may also be a deterrent to businesses registering for the turnover tax.

#### **III. Proposal**

In view of the above, the attributes associated with the turnover tax will be enhanced. First and foremost, the rate structure will be alleviated. The turnover band to which the zero rate of tax is applicable will be increased from R100 000 to R150 000. The other rates will also be reduced from one, three, five and seven per cent down to one, two, four and six per cent. Secondly, the value-added tax and the turnover tax will be completely de-linked. Vendors registered under the value-added tax may now freely register under the turnover tax if these taxpayers believe that it is in their best interests to do so.

On a related note to the extent SARS uncovers a wholly unregistered informal business, SARS will have the power to register the business for turnover tax or income tax. This power will ensure that taxpayers cannot alternate between both tax systems as a mechanism to artificially slow the audit process. SARS will also have the power to note certain details of businesses and their owners if those businesses are not legally compelled to register for tax and submit tax returns.

Lastly, the three-year lock-in period will be relaxed by doing away with the exit and re-entry rules. This relaxation effectively means that a micro business can voluntarily exit the turnover tax system at the end of any year of assessment. However taxpayers that exit the turnover tax will no longer be allowed to re-enter the turnover tax system. The new system was not designed to be a “lesser of “ system with taxpayers regularly switching between the normal and the turnover tax on an opportunistic basis to pay less tax.

#### **IV. Effective date**

Changes to the rates will be effective from years of assessment commencing from 1 March 2011. The other proposed amendments will be effective from years of assessment commencing from 1 March 2012, or from 1 January 2012.

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## **4. INCOME TAX: INTERNATIONAL**

### **4.1. INCENTIVE: HEADQUARTER COMPANY ADJUSTMENTS**

[Clauses 7(1)(x), 27, 67(1)(a-b) and 116(1)(a) and (c-e); Applicable provisions: Sections 1, Insertion of 9I, 9D, 10(1)(k)(ii), 20C, 31(3), 41(1) and paragraph 64B of the Income Tax Act]

#### **I. Background**

In 2010, a new tax regime was enacted to ensure that the tax system did not act as a barrier to the use of South Africa as regional headquarter company (mainly for the Sub-Saharan African continent). The new regime cleared three hurdles – relief from tax on dividends (to and from the headquarter company), relief from the controlled foreign company deemed income rules and relief from transfer pricing (including thin capitalisation) in respect of back-to-back loans.

In order to qualify as a headquarter company, a South African company must satisfy three criteria:

- Minimum participation by shareholders: Each shareholder of the headquarter company must hold at least 20 percent of the headquarter company's equity.
- 80-20 tax value: Eighty per cent of the tax cost of the assets held by the headquarter company (in the form of equity shares held, amounts loaned or intellectual property) should represent investments in foreign subsidiaries in which the headquarter company beneficially holds at least 20 per cent of the equity.
- 80-20 receipts and accruals: Eighty per cent of the total receipts and accruals of the headquarter company must be derived from foreign subsidiaries in which the headquarter company holds at least 20 per cent of the equity. These receipts and accruals include management fees, interest, royalties and dividends.

In respect of the first two requirements, the headquarter company must have always complied with these requirements in respect of each year of assessment since the company's inception. These requirements equally apply (i) to existing companies that wish to enter the regime and (ii) to new companies going forward.

## II. Reasons for change

Early experience with the headquarter company regime suggests that certain anomalies need to be removed that render the regime partially impractical. Early information suggests that certain parties are seeking to utilise the regime to undermine certain aspects of the pre-existing tax base. Lastly, many companies inadvertently fall into the regime with no desire to remain.

## III. Proposal

### A. Election and annual reporting

National Treasury has increasingly taken the position that incentives require annual reporting in order to measure their success and to protect against risks. Reporting is also necessary from a fiscal management point of view in order to measure the tax expenditure of the concession granted. No reason exists for the headquarter company regime to fall outside this paradigm.

In the main, the entry into the headquarter company regime will be voluntary and not automatic. A resident company that meets the qualifying criteria can simply elect into the regime by submitting a prescribed form to notify SARS of the election. This election will be annual and will be valid from the beginning of the year of assessment for which the election is made.

Taxpayers within this relief must further submit annual information to National Treasury as required (in the form and manner prescribed). It is envisioned that the required reporting in this area will be fairly minimal.

### B. Qualifying criteria



1. *Reduced minimum participation by shareholders*

Under current law, each shareholder of a headquarter company must hold at least 20 percent of the total equity shares and voting rights. The participation threshold will be reduced to 10 per cent in line with the reduced participation exemption threshold applicable to all residents holding foreign shares.

2. *Relaxation of the 80-20 asset test*

The revised 10 per cent participation requirement will also be incorporated into the asset test. Thus, 80 per cent of the total costs of the assets of the headquarter company (in the form of debt, equity or licensed intellectual property) must represent investments in subsidiaries in which the headquarter company holds a minimum 10 per cent participation interest.

The 80 per cent asset test will be further relaxed in some respects. More specifically, the 80 percent asset requirement will no longer be determined with reference to cash or bank deposits payable on demand. These assets are being removed from the calculation because funds of this nature may inadvertently arise and be held for extended periods without any intention of tax avoidance (when simple planning could avoid this problem without any additional tax charge).

3. *Relaxation of the 80-20 receipts and accruals test*

The requirement that 80 per cent of the total receipts and accruals of a headquarter company must be derived from foreign subsidiaries in which the headquarter company holds a minimum 10 per cent participation interest has been significantly relaxed. The 80 per cent income test operates as a backstop to the 80 per cent asset requirement so that foreign subsidiary income bears some relationship to the foreign assets. As a backstop, this test can be relaxed.

Firstly, receipts and accruals will no longer be used as a benchmark for the income test due to the broad nature and uncertainty created by this benchmark. Instead, gross income will be used in line with the legislature's initial conceptual intention. Receipts and accruals falling outside the tax net will accordingly be ignored (e.g. receipts of share dividends).

Secondly, the 80 per cent threshold will be dropped to 50 per cent. The new 50 per cent threshold will continue apply to specified items of passive income (interest, royalty, dividends, service fees and rental) that form part of the gross income of the headquarter company with preferences for transactions with 10 per cent foreign subsidiaries. The list of specified items (and preferences) to which the 50 per cent threshold applies will now include lease payments. Specified passive income (and preferences) also excludes currency exchange differences. This exclusion for foreign exchange gains will apply if the gains are attributable to exchange items to which the headquarter company is a party.

In addition, a safe harbour will exist for small headquarter operations with total gross income of less than R5 million. This safe harbour will provide flexibility during start up phases of headquarter operations.

#### *C. Change of participation exemption*

The capital gains tax participation exemption will be retained with the qualifying participation threshold reduced to 10 per cent. The holding period of the foreign equity shares will remain 18 months, but restrictions as to whom the headquarter company can dispose of its foreign interest will be lifted. Headquarter companies can therefore dispose of their foreign interests to any person tax-free.

Because of this advantageous tax position for the headquarter company, the shares held in the headquarter company by South African residents will no longer be eligible for the participation exemption. However, foreign residents holding shares in a headquarter company will continue to be exempt if the shares are not attributable to a permanent establishment in South Africa.

#### *D. Deemed tax migration*

A headquarter company effectively operates partially outside of South African taxing jurisdiction. Under current law, this partial outside status is recognised in the reorganisation rules, which treat headquarter companies as non-resident (i.e. generally ineligible to participate in rollover treatment). The new legislation maintains this reorganisation exclusion by not treating a headquarter company as a company for reorganisation purposes. Consistent with this treatment, a shift to South African headquarter status will trigger a deemed sale by the headquarter company of all its assets held before becoming a headquarter company. This change will reduce the opportunity for taxpayers to utilise the headquarter company regime solely to undermine the pre-existing tax base (i.e. as an escape hatch for taxable gain).

### **IV. Effective date**

The amendment will come into effect on 1 January 2011 (same date as the initial regime).

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## **4.2. UNIFICATION OF THE SOURCE RULES**

[Clauses 11(1)(a-d), 22, 58, 61(1)(a), and 101(1)(b); Applicable provisions: Sections 1, 6quat, 9 10(1)(k)(ii), 20C, 31(3), S35(1); S37 AJ; 41(1), amendment to paragraph 1 of the Seventh schedule and paragraph 64B of the Eighth Schedule of the Income Tax Act]

### **I. Background**

South African residents are taxed on the basis of their world-wide income with foreign sourced income eligible for tax rebates (credits) in respect of foreign tax proven to be payable. Non-residents are only subject to tax on the basis of income derived from sources within (or deemed to be within) South Africa.

The Income Tax Act does not comprehensively define the term “source”. The source of income is instead initially determined with reference to the common law. In terms of the common law (see *CIR v Lever Brothers & Unilever Ltd* (1946 AD)), the determination of source generally involves the doctrine of originating cause involving the following two levels of analysis:

- What is the originating cause of the income; and
- What is the location of that originating cause?

In respect of some categories of income, the Income Tax Act contains deeming rules. These deeming rules create deemed South African source income in addition to South African source income under the common law. These deemed source rules cover interest, royalties and capital gains (amongst others). Foreign source income exists only once it is determined that the income is neither actual South African source under common law principles nor deemed South African source under income tax legislation.

## **II. Reasons for change**

The current source rules give rise to uncertainty, thereby imposing additional costs in respect of cross-border activities with little or no benefit for the fiscus. Part of this uncertainty stems from differing interpretations about the application of common law. The statutory regime relating to source is also somewhat scattered throughout the Income Tax Act. All of these technical source issues make South Africa a less attractive regional holding company destination from a tax perspective. Current source rules also add unnecessary costs for South African companies operating abroad (especially into Africa)

On a policy level, the source rules must be revisited in light of the paradigm shift in regards to the South African tax system that occurred ten years ago. More specifically, the core of the source principles were formulated when South Africa operated on a source-plus basis with little change occurring once South Africa moved to a residency-minus system. The growing South African tax treaty network also raises the need for re-examination of how the domestic source rules should apply to the residual list of countries lying outside the treaty network.

## **III. Proposal**

### **A. Overview**

In order to remedy the above uncertainties and anomalies, a new uniform system of source is proposed. The new system will represent a combination of the common law, pre-existing statutory law and tax treaty principles. The starting point for these uniform source rules will loosely reflect implicit tax treaty principles (with a few added built-in protections) so that the South African system is globally aligned. The common law will remain as a residual method for certain categories of income. In terms of format, the new uniform set of source rules will eliminate the concept of deemed source.

As under current law, foreign residents are subject to South African tax only in respect of South African source income. South African residents remain fully subject to worldwide tax but may be eligible for foreign tax credits in respect of foreign source income.

## B. Source Categories

### 1. *Dividends*

#### *a. Current law*

Under current law, two new sets of definitions were recently added in respect of dividends – the definition of “dividend” (which mainly covers domestic dividends), and the definition of “foreign dividend” (which covers dividends from non-resident companies). The explicit source rules for dividends depend on the common law, which mainly focuses on the share register.

#### *b. OECD model treaty principles*

The source determination under OECD model treaty principles focuses on tax residence. Therefore, a dividend will be locally sourced (subject to the “tie-breaker” rules) if the distributing company is a resident. Residence is based on the country where that company was formed or established or where that company’s effective management resides.

#### *c. Proposal*

Source will be designed to reach roughly the same outcome as the OECD principles. The South African source rules of dividends will be clarified so that dividends from domestic resident companies will be South African sourced with “foreign dividends” being foreign sourced. The “share register” concept of common law will no longer be relevant.

### 2. *Interest*

#### *a. Current law*

The current source rules for interest are determined through a combination of common law and deeming legislation. The common law rules follow the doctrine of originating cause. The originating cause for interest is viewed as the supply of credit and the location of the originating cause is the place where that credit is supplied. Therefore, interest is sourced in South Africa if credit is provided in South Africa (typically by a South African credit provider). In addition, the legislative rules deem interest to be sourced in South Africa if the interest is derived from the utilisation or application of funds within South Africa. South African residents paying interest are presumed to be utilising or applying funds within South Africa.

#### *b. OECD model tax treaty principles*

OECD model tax treaty principles focus on the tax residence of the payor (i.e. the debtor incurring the interest). However, if payment arises from (i.e. has an economic connection to) a permanent establishment located in the source country, the focus shifts to the source country.

#### *c. Proposal*

The source of interest will largely be determined using implicit OECD principles. The determination of source of interest will now be based on a two-part test, namely (i) the residence of the debtor paying/incurred the interest, or (ii) the place in which the loan funds are utilisation or applied. Therefore, interest will be sourced in South Africa if (i) paid by a South African resident, or (ii) if the interest is derived from use or application in South Africa (e.g. from a South African permanent establishment). The proposal removes any current law focus on the credit provider.

Moreover, the pending 10 per cent interest withholding regime to be applied in respect of payments to certain non-resident persons will be clarified. Under this clarification, the withholding regime will apply only to South African sourced interest paid or payable to non-resident persons.

### 3. *Royalties*

#### *a. Current Law*

The current source rules for royalties are determined through a combination of common law and deeming legislation. The common law doctrine of originating cause for determining the source of royalties focuses on where the intellectual property producing the royalty was created, devised or developed. In addition, legislation deems royalties to be South African sourced if the royalties relate to the use, right of use or the grant of permission to use the intellectual property within South Africa. For purposes of 12 per cent royalty withholding, South African source royalties include closely-related imparting of knowledge, assistance or services.

#### *b. OECD model tax treaty principles*

The OECD model tax treaty principles follow the principles used for interest. Once again, source will be based on the tax residence of the party paying the royalties or on royalties having an economic link with a permanent establishment.

#### *c. Proposal*

The determination of source in respect of royalties will again largely follow OECD tax treaty principles. Firstly, source will be based on the residence of the party paying the royalties. In addition, South African source royalties will exist if the royalties relate to the use, right of use or grant of permission to use intellectual property within South Africa. The proposal removes any focus on the party creating, devising or developing intellectual property (thereby removing the current disincentive to generate intellectual property within South Africa).

#### *d. Proposal for ancillary services*

The determination of source in respect of know-how will also be based on a two-part test, namely; (i) the residence of the payor except where the payment for the know-how is attributable to a permanent establishment of the payor located outside South Africa; or (ii) where the know-how will be used or applied in South Africa.

### 4. *Services, pensions/annuities and government services*

a. Current reliance on common law

The source determination for services is based solely on the common law. This source determination largely focuses on the place where the services are rendered (with some minority arguments in favour of the dominant activity giving rise to those services). If services are rendered partly within and partly outside South Africa, the allocation of source is based entirely on the facts and circumstances (e.g. time and value addition). The basic common law source rules for services will remain unchanged.

b. Proposal for private pensions/annuities

The proposed rules for determining the source of private pensions or annuities derived from services will follow exactly the same principles as the source determination for service income. More specifically, the source for these annuity and pension payments will be based on the source of the underlying services giving rise to those payments. Therefore, if the underlying services are rendered within South Africa, the associated annuities and pensions will be viewed as South African source. If the annuities and pensions relate to mixed services (i.e. services rendered within and without South Africa), the allocation will be based on time spent. These rules are essentially the same as pre-existing law, except for the two-out-of-ten year election.

c. Proposal for Government services and associated annuities/pensions

Much like current law, the source of services for (or on behalf of) the various tiers of government will be deemed to be South African sourced without regard to where those services were rendered. Government pensions and annuities will be treated similarly. This rule will cover Government in a broad sense (the national, provincial and municipal spheres, the holding of any public office as well as any entity falling within the PFMA or the MFMA).

5. Gains from the disposal of assets

Gains in respect of immovable property are sourced in South Africa if the immovable property is situated in South Africa. Special look-through rules apply if ownership exists through company shares and 80 per cent or more of the market value of the company shares stems from the immovable property. The source determination for gains in respect of movable property is based on the residence of the person disposing of the movable property (i.e. if the party disposing of the property is a South African resident, the disposal will be deemed to be South African sourced). The notion of deemed source will be eliminated.

6. Exchange differences rules

A new special source rule for currency gains will exist that mirrors the disposal of asset source rules. Under this approach, exchange differences will be sourced in South Africa if these differences arise from exchange items attributable to a South African resident or attributable to a South African permanent establishment of a non-resident.

In view of their alignment with OECD model tax treaty principles, the current legislative source rules will essentially remain. However, the notion of deemed source will be eliminated, leaving the legislative determination as the sole determination.

#### 7. Residual doctrine of originating cause

In the case of dividends, interest, royalties, and gains from the disposal of assets and exchange gains, the doctrine of originating cause will no longer apply. Therefore, items of income of this kind that fall outside the South African sourced categories listed above will be explicitly treated as foreign source income.

Otherwise, the doctrine of originating cause (initiated in CIR v Lever Brothers & Unilever Ltd (1946 AD)) will implicitly remain as a residual category. In other words, this doctrine will remain in respect of any residual item of income falling outside the main categories described above (e.g. rental income and insurance premiums).

### IV. Effective date

The proposed amendment will apply to receipts and accruals in respect of years of assessment commencing on or after 1 January 2012.

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### 4.3. SPECIAL FOREIGN TAX CREDIT FOR MANAGEMENT FEES

[Clauses 12 and 13; Applicable provision: Section 6quin; 6quat(1C) and (1D) of the Income Tax Act]

#### I. Background

South African residents are taxed on their worldwide income. However, South African residents are entitled to a tax rebate (i.e. credit) against normal South African tax in respect foreign taxes proven to be payable. Amongst other requirements, these credits are conditioned on the foreign taxes being applied to foreign sourced income. In other words, no foreign tax credits are available in respect of South African sourced income.

#### II. Reasons for change

A number of African jurisdictions impose withholding taxes in respect of services (especially management services) rendered abroad if funded by payments from their home jurisdictions. These withholding taxes are sometimes imposed even when tax treaties suggest that the practice should be otherwise. African imposition of these withholding taxes in respect of South African sourced services is no exception.

The net result of these African withholding taxes is double taxation with little relief. The South African tax system does not provide credits in respect of these foreign withholding taxes because these taxes lack of a proper foreign source nexus. Only partial relief is afforded through the allowance of a deduction. While the South African position is theoretically correct, the practical implication of this position is adverse to South Africa's objective of becoming a regional financial centre. As long as this theoretically correct position is maintained, the only

viable solution for regional operations is to shift their management location to a low-taxed or no-taxed location so as to avoid double taxation.

### **III. Proposal**

In view of the above, it is proposed that a new limited foreign tax credit be introduced. The scope of this foreign tax credit will be limited solely to foreign withholding taxes imposed in respect of services rendered in South Africa. These tax credits will be limited solely to South African taxes otherwise imposed on the same service income after taking applicable deductions into account. Foreign withholding taxes in excess of the South African tax cannot be carried over (i.e. the excess is lost). However, this limited foreign tax credit will, not be available if the taxpayer is claiming deductions in respect of the same foreign taxes.

To claim this limited foreign tax credit, a resident taxpayer must submit a declaration to SARS within 60 days from the date on which the amount is withheld. SARS will use this information to reduce or eliminate the foreign tax if that tax operates in violation of tax treaty commitments. To the extent the foreign tax remains despite this effort, the new foreign tax credit can be claimed. If the matter regarding the imposition of the foreign tax is then resolved and the undue foreign tax is ultimately refunded to the taxpayer, the credit will be reversed.

### **IV. Effective date**

The proposed amendment will come into effect in respect of foreign taxes imposed or withheld in respect of years of assessment commencing on or after 1 January 2012. The effective date of the SARS reporting requirements will come into effect on a date set by the Commissioner.

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#### **4.4. TIMING OF FOREIGN TAX REBATES**

[Clause 11(1)(a-d) and (g); Applicable provision: Section 6quat]

##### **I. Background**

Residents with taxable income attributable to income from foreign sources are eligible for tax rebates (i.e. credits) against South African taxes otherwise due and payable. These foreign taxes must “proved to be payable.”

The rebate system contains special rules to prevent timing mismatches between the South African income tax systems versus the applicable foreign tax system. More specifically, situations may arise in which the foreign tax ultimately due may differ from the foreign tax initially claimed (with the ultimate amount either falling short or exceeding the initial amount). Under the circumstances, SARS may re-open tax years (to the benefit or detriment of taxpayers) for a period of six years from date of assessment.

##### **II. Reasons for change**

While the tax system (as outlined above) recognises some mismatches between South African taxes due versus foreign taxes due, this recognition is incomplete. The initial mismatch envisioned mainly focuses on foreign tax deviations relating to disputes (e.g. audit



challenges, refund claims and litigation). However, this form of mismatch is only part of the picture. Many other timing mismatches arise from differences as to when the South African tax system recognises taxable income versus the timing recognition of the applicable foreign tax system.

One common timing mismatch arises from cross-border debt. In the case of cross-border debt loaned by a South African company, South Africa generally recognises income on an accrual basis while many countries impose withholding taxes on a cash basis. As a result, the South African tax system recognises the underlying income before the income is recognised by the foreign country imposing the withholding tax. If the systems are not coordinated, the South African lender still receives tax rebates at a later date but the timing of those rebates often undercuts their value as a tax offset.

### III. Proposal

Foreign tax rebates will be adjusted to ensure that these rebates are better matched against the time when the South African tax system recognises the underlying taxable income. More specifically, foreign tax rebates will be matched against the year in which the South African tax system recognises the underlying foreign taxable income. This matching will ensure that rebates will apply when these rebates are of the greatest practical use for South African taxpayers.

#### **Example**

**Facts:** South African Holding Company owns all the shares of Foreign Subsidiary (located in Foreign Country). A cross-border R5 million loan exists between the two entities with South African Holding Company acting as the creditor and Foreign Subsidiary acting as debtor. In 2013, R750 000 of interest accrues on the loan in respect of the South African tax system. The interest is paid in 2014 with Foreign Country X imposing withholding in 2014.

**Result:** South African Holding Company can re-open the 2013 year of assessment due to the withholding tax imposed by Foreign Country X in 2014. This foreign withholding tax can then be applied as a foreign rebate against South African taxes otherwise due for the 2013 year of assessment.

### IV. Effective date

The proposed amendment will be effective for years of assessment commencing on or after 1 April 2012.

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## 4.5. REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME

[Clauses 11(1)(e-f), 25(1)(d), (g),(h), (j-l) and (n) and 116(1)(b),(h) and (j); Applicable Provisions: Sections 9D and paragraph 64B of the Income Tax Act]

### I. Background

The CFC regime taxes certain income generated by South African controlled foreign companies on an accrual basis. More specifically, the CFC rules impose tax on South African residents in respect of their proportionate share of CFC tainted income.

A CFC is any foreign company in which South African residents own more than a 50 per cent interest in the profits or capital of the company or by means of voting rights. Tainted income consists of passive (or highly mobile) income as well as diversionary income. Passive income includes interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums, similar income and associated capital gains. Diversionary income generally includes income derived from suspect transactions between a CFC and a resident that will likely lead to transfer pricing concerns. Tainted (passive or diversionary) income is fully taxable in South Africa because CFC ownership of this income poses a high risk to the tax base.

The CFC attribution rules are subject to various exemptions, such as the foreign business establishment exemption, a *de minimis* exemption, a high-foreign tax exemption and related party exemptions. From a policy perspective, all of these exemptions are part of a framework that seeks to strike a fair balance between protecting the tax base and the need for South African multinationals to be internationally competitive.

## **II. Reasons for change**

The CFC regime is in its tenth year anniversary. While the regime closed many obvious loopholes, the ten-year mark creates a useful opportunity for reflection based on practical experience. In the main, the CFC regime has largely closed the straight forward movement of passive income offshore and the comparable use of shell companies to divert income offshore through unsustainable transfer pricing. Nonetheless, problems remain.

The tainted income calculation is overly complex and creates uncertainties. For instance, the overly rigid nature of the regime triggers tainted income for non-tax driven commercial income and often allows taxpayers to artificially manipulate problematic income so as to avoid tainted treatment, especially in the case of diversionary-type transactions. Certain interpretations have also emerged that seemingly allow taxpayers to create a marginal nexus in respect of employment or activity to tax havens so as to claim exemption when the “supposedly” exempt income lacks any meaningful economic substance. Lastly, the CFC regime additionally contains certain elections and ruling mechanisms that add complexity with little benefit for the tax system.

## **III. Proposal**

### **A. Overview**

In view of the above, the core calculations associated with the tainted income determination will be simplified. Certain tests will be more closely integrated with transfer pricing without current reliance on overly objective (and misdirected) criteria. Tainted income treatment of mobile income will also be segregated into discrete elements so as to be more closely aligned with the relevant issues of concern.

Overall, the current changes provide simplicity, certainty and strengthen the rules to guard against the possible erosion of the South African tax base. It is intended that these changes

close structural deficiencies in the system and make the rules more targeted in line with the regime's underlying purpose without undermining the country's international competitiveness.

*B. Income attributable to a foreign business establishment (FBE)*

The current FBE exemption assumes that only the income relating to a substantive business can be "attributable to" a FBE. The amendment will highlight this assumption by expressly providing that income will only be attributable to a FBE once arm's length transfer pricing principles are taken into account. In line with this proposal, attribution to a FBE must account for the functions performed, assets used and the various risks of the foreign business establishment. Mere connection of income to a FBE via legal agreements and similar artifices will not be sufficient. Indeed, this arm's length connection has always been the stated intention behind the "attributable to" standard.

*C. Simplification of the diversionary income rules*

Under current law, three sets of diversionary rules exist. The first set of rules seeks to prevent the use of CFCs to shift income offshore when the import of goods is involved. The second set seeks to prevent the use of CFCs to shift income offshore when the export of goods is involved. The third set seeks to prevent the use of CFCs when the import of services is involved. Diversionary income is viewed as tainted CFC income even if attributable to a FBE.

The overly mechanical nature of the diversionary rules has caused problems for both legitimate commercial activities and for the meaningful protection of the fiscus. Non-tax motivated commercial activities often become trapped by the mechanical rules while the overly rigid nature of the rules allow for tax avoidance in the case of more flexible non-tax motivated activities. While the unintended commercial impact of these rules has been substantially mitigated with the introduction of the high-foreign tax exemption, the underlying concerns remain. In view of these concerns, the following changes are proposed:

1. *Imported goods:* The rigid mechanical nature of the diversionary rules in respect of imported goods from CFCs will be entirely removed. Instead, the imported goods diversionary rules will be triggered only if three (simplified) conditions exist:
  - Firstly, as envisioned under current law, a CFC must be disposing of goods directly to a connected South African resident as under existing law. In addition, the newly proposed regime will alternatively cover disposals indirectly made to these same connected South African residents. The indirect rule essentially seeks to capture a CFC's disposal of goods ultimately destined for import to a connected South African resident (thereby ending the practice of interposing shell companies so as to break the import link).
  - Secondly, the sales income of a CFC must be subject to a foreign rate of tax that falls below 50 per cent of the South African company rate (i.e. 14 per cent) after taking tax credits into account. In other words, the CFC must be located in a low-tax jurisdiction.

- Thirdly, the sales income must not be attributable to the activities of a permanent establishment (as defined in the O.E.C.D. Model Tax Treaty Convention) located in the CFC's country of residence. In other words, the CFC sale destined for South African import will be triggered if sales income is simply associated with various forms of "preparatory and auxiliary activities" or with activities outside the CFC's country of residence. Like the revised FBE test, the test of "attribution" will require a transfer pricing analysis.
2. *Exported goods*: The diversionary rules associated with South African exports to a CFC will be completely removed. Additional protection is not required because the value-adding activities largely occur on-shore – all of which make the task of enforcing arm's length transfer pricing principles more manageable.
  3. *Imported services*: The current diversionary rules associated with services imported from a CFC will be retained in their current form. Under these rules, CFC income relating to services rendered by a CFC to a South African connected party are taxable, unless the CFC meets a higher business activity test as measured by objective criterion.

#### D. Removal of the transfer pricing penalty

Under current law, transfer pricing violations involving a CFC trigger tainted treatment for all amounts derived from the suspect transaction, not just the reallocation of misallocated income. This "all-or-nothing" rule is misdirected and will accordingly be deleted.

#### E. Mobile income

As a general rule (and consistent with current law), mobile income accruing to a CFC will be automatically taxable unless specific exemptions relevant to that income stream apply. As under current law, the FBE exemption will not apply even though the mobile income may be attributable to FBE activities. Unlike current law which mixes mobile income into one set of rules, targeted mobile income will be covered under four broad but distinct categories:– (1) financial instruments, (2) rentals and sales of tangible movable property, (3) royalties and disposals of intellectual property, and (4) insurance premiums.

##### 1. *Financial instrument income*

Income from financial instruments includes income from debts, shares, derivatives instruments and financial leases. The concept of 'financial instrument' is defined broadly in (see section 1). Income from financial instruments also consist of capital gains derived from the disposal of these instruments. Lastly, income from financial instruments includes exchange differences determined in respect of those financial instruments.

Income from financial instruments derived by a CFC will be taxable unless: (i) the CFC is a bank, financial services provider or insurer, or (ii) the income is subject to the working capital exemption. However, for the exemption to apply, the income must not result in a tax deduction for a South African connected person. These exemptions already exist under current law but are being streamlined in line with initially intended principles.

a. Bank, financial service provider or insurer exemption

Financial instrument income will not be tainted if the income arises from the principal trading activities of a bank, financial services provider or insurer (other than a treasury operation or captive insurer). More specifically, in order to qualify for the exemption, (i) the CFC must carry on principal trading activities of a bank, financial services provider or insurer through a FBE, (ii) the financial instrument must be attributable to that FBE, and (iii) the activities of the CFC should not constitute activities of a treasury operation or captive insurer. A determination of whether a CFC is a treasury operation or captive insurer is based on facts and circumstances analysis.

However, notwithstanding this facts and circumstances analysis, financial instrument CFC this income will additionally be denied relief as a treasury operation if:

- The CFC fails to conduct more of its principal trading activities in the country in which the FBE is located than any other country;
- The CFC does not regularly accept deposits or make loans to clients who are unconnected persons; or
- The amounts derived from the principal trading activities of the CFC with unconnected persons are less than 50 per cent of the total amounts attributable to the activities of the foreign business establishment of that CFC.

Similarly, notwithstanding the facts and circumstances test used to determine whether a CFC is a captive insurer, the financial instrument CFC income will additionally be denied relief as a captive insurer if:

- The CFC fails to conduct more of its principal trading activities in the country in which the FBE is located than any other country;
- The principal trading activities of the CFC do not involve the regular transaction of the business of an insurer with clients who are not connected persons; or
- The amounts derived from the principal trading activities of the CFC with unconnected persons are less than 50 per cent of the total amounts attributable to the activities of the foreign business establishment of that CFC.

As a side point, it should further be noted that the new financial instrument income dispensation provides a special exemption pertaining to section 24I exchange differences relating to financial instruments. In order to qualify for this additional exemption, the exchange differences must arise in the ordinary course of the core business of the CFC. This dispensation will not apply if the

exchange difference is attributable to the activities of a treasury operation or captive insurer (as set out above).

b. Working capital exemption

The working capital exemption will replace the current 10 per cent *de minimis* exemption. The working capital exemption will apply only if tainted financial instrument income is associated with financial instrument receipts and accruals that do not exceed 5 per cent of total CFC receipts and accruals. It should be noted that the working capital *de minimis* exemption does not apply to other forms of mobile income because working capital is typically only held in the form of financial instruments.

c. South African deductible payment override

The above exemptions will not apply in respect of financial instrument income associated with a deduction from the same or an interdependent financial instrument. This anti-avoidance rule applies because of the high tax avoidance risk posed by this mobile income. The purpose of the rule is to prevent the round-tripping of amounts to undercut the tax system (as an additional mechanism on top of the general anti-avoidance rule, the latter of which takes into account alleged business purposes). Oftentimes, deductible payments relating financial instruments (especially debt) goes offshore tax-free and returns to South Africa in the form of an exempt dividend income, (while effectively remaining within the same corporate group).

**Example:**

**Facts:** SA Company 1 owns all the shares of SA Company 2 and CFC, the latter of which is an active banking company located in Country X. CFC has a loan book of R100 million comprising of loans advanced mainly to unconnected persons located in Country X. CFC is also owed R2 million on loan account from SA Company 2 at a 12 per cent interest rate. SA Company 2 uses the R2 million to finance its trading operations.

**Result:** The 12 per cent interest received by CFC is not eligible for the principal banking activity exception. The exception does not apply even though the loan is part of CFC's commercial banking activities and not attributable to treasury operations. The reason for this exclusion is that SA Company 2 will claim a deduction in respect of that interest and SA Company 2 is a connected person in relation to the CFC.

2. *Insurance premiums*

Insurance premiums derived by a CFC will generally be taxable. However, an exception exists if the income is derived from the CFC's principal trading activities

of an insurer unless the insurer is a captive. These tests are largely based on the facts and circumstances, but an insurer will always be deemed to be a captive if:

- i. The CFC fails to conduct more of its principal trading activities in its country in which the FBE is located than any other country; or
- ii. The principal trading activities of the CFC do not involve the regular transaction of the business of an insurer with clients who are not connected persons; or
- iii. The amounts derived from the principal trading activities of the CFC with unconnected persons are less than 50 per cent of the total amounts attributable to the activities of the foreign business establishment of that CFC.

### *3. Intellectual property (royalties and sales)*

The current rules applicable to royalties and capital gains from the disposal of intellectual property will be largely retained in their current form. In the main, royalties and intellectual property gains derived by a CFC will be taxable unless the CFC actively develops the underlying intellectual property. These relief mechanisms will not apply if the intellectual property is tainted. Tainted intellectual property largely involves intellectual property that was once within the South African tax net.

### *4. Immovable (rentals and sales)*

Rentals derived by a CFC from the leasing of immovable property will be exempt from tainted mobile income treatment. The disposal of immovable property will be similarly eligible for the FBE exemption without deviation. Despite their passive nature, these forms of passive income fall outside the mobility issues of concern.

### *5. Tangible movables (rentals and sales)*

Rentals derived by a CFC from the leasing of movables will be fully taxable unless the lease is an operating lease or a financial instrument. The exemption of operating leases covers genuine leasing operations where the lessor substantially bears the economic risk of the assets involved. More specifically, the expression "operating lease" will be defined as a lease of movable property concluded by a lessor if:

- The property can be hired by members of the general public for a period of no more than 5 years;
- The costs or activities of maintenance and repairs occasioned by normal wear and tear are borne by the lessor; and
- The lessee does not assume liability for the loss or destruction of the property, except if the lessee has failed to take proper care.

Relief under this dispensation excludes financial instruments such as finance leases. Typical finance leases effectively transfer the economic life of those assets; or

somehow, the lessee bears the ultimate risk and rewards associated with ownership of an asset. These leases will instead be tested under the financial instrument provisions.

Capital gains from the disposal of the tangible movable property will be entitled to the FBE exemption without deviation

#### F. Miscellaneous

As part of the simplification, a number of miscellaneous provisions will be deleted and streamlined. These provisions entail complexity that outweighs their potential benefits.

##### *1. Shift to a ten per cent threshold*

The ownership thresholds in respect of the dividend and capital gain participation exemptions in relation to foreign shares will be reduced from 20 per cent down to 10 per cent. This lower threshold is consistent with the global economic concept of direct foreign investment. In view of this reduction, the election to be treated as a CFC for foreign companies between the 10 and 20 per cent range will be deleted.

##### *2. High tax exemption and elections*

Currently, a person that holds 10-to-20 per cent of a foreign company can elect to treat that foreign company as a CFC and further elect out of the CFC exemptions. As a result, the CFC income will be taxable on an accrual basis, with the CFC income carrying foreign tax credits.

The introduction of the high tax exemption meant that a person who elects to treat a 10-20 per cent held foreign company as a CFC and further elects out of the CFC exemptions could no longer claim foreign tax credits. This result was never intended. A special temporary dispensation will thus be provided during the phase-out period of the elections. In a nutshell, any person who elects to treat a foreign company as a CFC without the foreign business establishment exemption may also elect out of the high tax exemption so as to be eligible for foreign tax credits.

##### *3. Removal of rulings option*

The CFC rules currently provide SARS with the authority to waive the potential taint caused by certain of the current diversionary rules. In light of the proposed changes, the CFC ruling system will be deleted as superfluous

#### **IV. Effective date**

The proposed amendments will generally apply to the net income of a CFC relating to a shareholder-taxpayer with a year of assessment beginning on or after 1 April 2012. The transitional rule relating to the high-tax exemption in regard to the 10-to-20 percent election will be backdated to 1 January 2011.



## **4.6. CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

[Clauses 68(1)(a-d) and (f), 69(1)(a) and (k), 71(1)(a-b) and (d) and 72(1)(a-e) and (h-i);  
Applicable Provisions: Sections 42, 44, 46 and 47 of the Income Tax Act and paragraph  
64B(2)(b) of the Eighth Schedule to the Income Tax Act]

### **I. Background**

Resident companies can restructure their affairs through various transactions falling within the reorganisation rollover rules. Rollover relief means that the transactions themselves are exempt, but any gain is deferred until a later disposal. These rollover transactions can take the form of asset-for-share transactions, amalgamations, intra-group transfers, unbundlings and liquidations. This relief is premised on the fact that the parties at issue have merely transformed their interests in the underlying assets as opposed to a cash-out of underlying risks. These relief measures are not available to the restructuring of foreign operations (except in very limited circumstances).

A simpler and narrower set of parallel relief provisions exist for offshore restructurings, known as the capital gains participation exemption. Under this exemption, gain is wholly exempt (not simply deferred) when residents and CFCs dispose of equity shares in a 20 per cent held foreign company. However, this exemption is generally available only if the foreign shares are transferred to a totally independent foreign resident or to a CFC under the same South African group of companies (without any intention of resale to South African residents). The restructuring of CFC assets can also qualify for tax relief if disposed of within the confines of the foreign business establishment exemption or if the disposal occurs within a high-taxed country.

### **II. Reasons for change**

Many South African multinationals seek to restructure their offshore operations. These restructurings often occur when multinationals acquire foreign companies with inconveniently located subsidiaries and seek to move these foreign subsidiaries into more efficient locations within the group. In light of the current economic downturn, these restructurings have accelerated in order to realise economies of scale and to increase internal efficiency, thereby keeping South African multinationals globally competitive.

The current participation exemption applicable to offshore restructurings has a number of shortcomings. On the one hand, the regime is too narrow – allowing some restructurings while inadvertently excluding others (e.g. certain transactions lacking an actual disposal of shares or certain transfers to South African companies within the same group). On the other hand, the breadth of the exemption poses a risk to the tax base with some taxpayers seeking an internal restructuring solely to elevate the base cost of their shares, followed by a taxable sale with artificially reduced gain (due to the elevated base cost). A balance must therefore be struck between facilitating restructurings and preventing tax avoidance.

### **III. Proposal**

#### *A. Overview*

In view of the above, the domestic corporate restructuring rollover rules will be extended to include the restructuring of offshore companies that remain under the control of the same South

African group of companies. More specifically, the asset-for-share, amalgamation, unbundling and liquidation rules will be revised to cover offshore restructurings within this framework.

It should be noted that the extension of the reorganisation rollover rules to cover foreign restructurings was always intended, but this extension was delayed until many issues involving offshore CFCs could be resolved and simplified. For instance, the initial system of indirect credits has been dropped and a simplified exclusion exists for high-taxed foreign country income.

## *B. Extension of the reorganisation rollover regime*

### *1. Asset-for-share transactions*

Asset-for-share relief is mainly limited to the transfer of assets between residents. This relief will now be extended to cover the transfer of foreign company equity shares to CFCs (thereby allowing intra-group foreign share-for-share transactions). This extended asset-for-share relief is premised on the fact that reorganisation rollovers should not result in the tax-free externalisation of corporate value outside the South African group. In particular, this extended rollover relief will allow for the transfer of foreign equity shares (in addition to other pre-existing requirements for asset-for-share transfers) if:

- (i) the transferor holds a qualifying interest (i.e. 20 per cent equity shares and voting rights) in the transferee; and
- (ii) the transferee constitutes a controlled foreign company in relation to the transferee or any group company.

Foreign asset-for-share rollovers will also be subject to a charge if the qualifying criteria is not maintained for a period of 18 months after the transaction. More specifically, the transferee must remain a CFC remain within the group, and the transferor must maintain a qualifying interest in the transferee for at least 18 months. Failure to comply with these requirements will trigger a gain for the transferor.

#### ***Example***

***Facts:*** Foreign Parent owns all the shares of South African Holding Company. South African Holding Company owns all the shares of CFC and 45 per cent of the shares of Foreign Company (FC). CFC owns the other 55 per cent of the shares of CFC. South African Holding Company transfers all of its shares in FC to CFC.

#### ***Result:***

The foreign share-for-share rollover relief will apply because FC became a controlled foreign company immediately after the disposal, and FC remains part of the same group. However, gain will be triggered if CFC status or group status is lost within 18 months (or qualifying interest status is lost).

## 2. Amalgamation transaction:

Current amalgamation rollover relief is only available if the resultant company is a resident. Thus, a resident company can be merged into another resident company or a foreign company can be merged inbound into a resident company. This rule will be extended to cover the amalgamation, merger or conversion of a foreign company into certain resultant foreign companies. As in the current rules, the amalgamated foreign company must transfer all of its assets (other than assets used to settle debts incurred in the ordinary course of business).

This extended rollover relief for foreign amalgamations applies (in addition to other pre-existing requirements for asset-for-share transfers) if:

- (i) the amalgamated company and the resultant company form part of the same group of companies,
- (ii) the resultant company constitutes a CFC in relation to resident group company, and

As discussed elsewhere in this explanatory memorandum, the resultant company need not issue shares in exchange for the assets of the amalgamated company (note: many connected party foreign amalgamations do not involve any transfer of shares).

### **Example**

**Facts:** South African Parent company owns all the shares of CFC 1, which in turn owns all the shares of CFC 2 and CFC 3. CFC 2 transfers all its assets to CFC 3. Following the transfer, CFC2's existence is terminated in terms of foreign law. CFC 3 does not issue any shares to CFC 2 (because CFC 1 already owns all of the CFC 3 shares).

**Result:** The amalgamation of CFC2 into CFC3 will qualify for rollover relief.

## 3. Unbundling transactions

The current unbundling rules already allow for the unbundling of foreign companies. This relief, however, is limited to situations involving 95 per cent ownership.

The unbundling of foreign companies will be aligned to the newly revised rules. More specifically, this extended rollover relief will allow for the unbundling of foreign holding companies to other foreign companies if:

- (i) the unbundled company constitutes a controlled foreign company, and
- (ii) the unbundling company and its shareholders form part of the same group of companies (with foreign companies viewed as part of the group for this purpose despite their foreign status).

- (iii) The unbundling company must hold at least 50 per cent of the equity shares of the unbundled company before the transaction

**Example:**

**Facts:** South Africa Company owns all the equity shares of CFC1. CFC1 owns 80 per cent of the shares of CFC 2. A foreign company owns the remaining 20 per cent of the equity shares of CFC 2. In turn, CFC 2 owns all the shares of CFC3. In order to create a flatter structure, CFC 2 distributes all the equity shares held in CFC 3 to CFC1 and the Foreign Company in accordance with their effective shareholding in CFC2. CFC 1 and CFC2 do not elect out of the unbundling provisions.

**Results:** The distribution of the CFC3 shares to CFC 1 (and Foreign Company) will qualify for rollover relief as an unbundling transaction.

#### 4. Liquidation transaction

Current liquidation rollover relief covers the liquidation of companies into domestic holding companies. The liquidation rollover rules will additionally allow for liquidation into group CFCs revised rules. More specifically, this extended rollover relief will allow for the liquidation into foreign holding companies if:

- (i) the liquidating company and the holding company form part of the same group of companies (with foreign companies viewed as part of the group for this purpose despite their foreign status), and
- (ii) the holding company constitutes a controlled foreign company in relation to group company that is a resident.

#### 5. Note on participation exemption

The capital gains tax participation exemption for the transfer of equity shares to totally independent foreign residents will temporarily remain. The participation exemption will be re-examined in 2012 when the offshore reorganisation rules are refined.

### IV. Effective date

The proposed amendments will generally apply in respect of transactions entered into on or after 1 January 2012.

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## 4.7. OFFSHORE CELL COMPANIES

[Clauses 25(1)(a-c); Applicable provisions: Section 9D, 10 (1) (k) (ii) (dd) of the Income Tax Act and Paragraph 64B of the Eighth Schedule to the Act]

### I. Background

#### A. Taxation of offshore operations

South African residents are subject to tax on a worldwide basis (i.e. foreign activities of a South African resident are fully within the South African tax net). In addition, South African tax indirectly applies to tainted activities conducted by controlled foreign companies (CFCs). Control of a foreign company generally exists if South African residents own more than 50 per cent of the participation and voting rights of the foreign company. CFC activities subject to indirect taxation mainly include passive income (e.g. interest and royalties) and diversionary income (i.e. income readily susceptible to transfer pricing manipulation).

CFCs engaged in business as an insurer may or may not be subject to indirect taxation. If a CFC generates most of its revenue from independent customers, no indirect taxation applies. On the other hand, captive foreign insurers (i.e. foreign subsidiaries largely earning premiums from fellow group companies) are fully subject to indirect taxation because their accumulated profits essentially represent passive reserves for the group. As a result, the tax law places CFC captive insurers on par with domestic captives – full taxation with a deduction for premiums set aside for reserves to be paid in short order.

### *B. Roll of foreign statutory cell companies*

Foreign statutory cell companies (technically, often referred to as “protected cell companies” or “segregated account companies”) effectively operate as multiple limited liability companies, separated into legally distinct cells. These cell companies are often found in the jurisdictions of Bermuda, Guernsey, Gibraltar, Isle of Man, Jersey, Vermont, Mauritius and Seychelles. The cell company is a single legal entity that operates in two distinct parts. These parts are the core and the other cells. There is only one core, but there may be an infinite number of other cells. The core is owned by the founding members of the company who are the service providers and central managers of the company as a whole. The other cells are designed to isolate risk for their “customer” users. Cell companies often issue two classes of shares namely: (i) ordinary voting shares issued to the practical owners of the core, and (ii) non-voting preference shares issued to the “customers” using the other cells (with a separate class of preference shares issued to each set of owners of each separate cell).

In the case of cell company insurers, each of the other (non-core) cells is funded by the insured’s own capital contributions and premiums collected. The insured cell participant can only collect payouts via the insurance agreement and typically can only receive distributions upon termination of the cell’s functions. Cells operate under a limited liability principle with each cell having full limited liability protection against the other cells (i.e. the creditors of the other cells cannot make claims against the cell). However, the core can be subject to the claims of other cells in limited circumstances.

## **II. Reasons for change**

While it is undisputed that offshore cell captives often have legitimate non-tax commercial uses, these cells essentially operate as offshore captive insurers. Offshore captive insurers are generally subject to indirect tax under the CFC regime because the excess build-up of reserves is essentially passive income. No reason exists to allow offshore cell companies to be treated differently. Hence, as a matter of parity, offshore cells should fall within the South African CFC regime.

The other issue of parity is between domestic cell companies (governed by contract) and foreign cell companies. Both cell companies essentially provide the same functions and

almost the same level of limited liability. Yet, lack of CFC treatment for each offshore cell provides these cells with significant tax advantages over domestic cells.

### III. Proposal

#### A. CFC imputation

In view of the above, it is proposed that the CFC rules be adjusted so that each cell of a foreign statutory cell company will be treated as a separate stand-alone foreign company for all section 9D purposes. Therefore, if one or more South African residents hold more than 50 per cent of the participation rights in an offshore cell, the cell will be deemed to be a CFC without regard to ownership in the other cells. CFC treatment for the cell typically triggers income tax for the participant cell owners to the extent that the cell generates tainted income.

For purposes of the above rule, a cell exists if the cell is part of a legal entity formed, established (or converted) under foreign law, whereby the foreign law forming, establishing (or creating the entity by way of conversion):

- segregates the assets of the entity into cells that are structurally independent;
- links or attributes specified assets and liabilities to those cells; or
- does not allow for claims to be made against the legal entity as a whole unrelated to cellular assets to be made against the cell merely because the legal entity as a whole is liable or obligated to satisfy those liabilities or obligations.

This amendment is not intended to apply to standard-investment type unit trusts. The amendment's application will be limited to protected cell companies engaged in the insurance business.

#### **Example 1**

**Facts:** Protected cell company (PCC) is located in Foreign Country X with the core managed and controlled by Country X's residents. The PCC has 100 cells; one cell (Cell 1) is owned by South African Company. The PCC is engaged in the business of insurance with each cell offering a different insurance package to each cell participant. Cell 1 provides insurance solely to South African Company (and some of its group members).

**Result:** The CFC status of Cell 1 will be tested separately. Because South African Company economically controls the cell, the cell qualifies as a CFC. The proportionate tainted amount of the net income of the cell will be attributed to the South African Company. All passive income of the cell will be tainted because the cell qualifies as a captive insurer when standing alone. However, Cell 1 may be entitled to deductions as a short-term insurer (i.e. section 28).

### IV. Effective Date

The proposed amendment will apply to the net income of a CFC relating to a shareholder-taxpayer year of assessment beginning on or after 1 April 2012.

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#### **4.8. TRANSFER PRICING: SECONDARY ADJUSTMENTS**

[Clauses 25(1)(e), 57 and 165; Applicable provisions: Section 9D(2A), 31 of the Income Tax Act and the Repeal of section 56 of Act 7 of 2010]

##### **I. Background**

###### *A. Transfer pricing rules*

South Africa's transfer pricing rules apply arm's length principles to transactions, operations or schemes that have been entered into between connected persons with such terms and conditions that would not have been entered into between independent persons. The 2010 legislative amendments introduced certain modernisation changes to these transfer pricing rules in accordance with the OECD guidelines. The new wording of the section also removes certain previous uncertainties.

###### *B. Deemed dividends*

Under current law, deemed dividend rules exist as a measure targeted at minimising the avoidance of the Secondary Tax on Companies through the transfer of certain benefits to a non-resident company without a formal declaration of a dividend. These deemed dividend rules contained a provision relating to transfer pricing adjustments. More specifically, a deemed dividend arises from any additional income (or reduced loss) of a South African company stemming from the adjustment. The purpose of this deemed dividend provision is to account for the removal of value from a South African company due to the company transacting with connected persons on a non-arm's length basis. In transfer pricing terms, this removal of value would constitute a "secondary adjustment". Advanced tax systems make secondary adjustments in one form or another.

##### **II. Reason for change**

Transfer pricing adjustments (generally referred to as "primary adjustments") aim to ensure an arm's length allocation of the taxable profits. However, the primary adjustment under current rules not place the financial position of the parties to the transaction onto an arm's length basis because this primary adjustment only accounts for taxable income, not actual income. In order to address this non-arm's length financial position of the parties, some countries require secondary adjustments. The deemed dividend rules under current law essentially seek to replicate this concept of secondary adjustments.

##### **III. Proposal**

###### *A. Power to make secondary adjustments*

The automatic deemed dividend rules stemming from a transfer pricing adjustment will not continue in the new Dividends Tax regime. Instead, the law will be modified to directly cater for

secondary adjustments arising from transfer pricing primary adjustments. The OECD refers to a secondary adjustment within the following context: “To make the actual allocation of profits consistent with the primary transfer pricing adjustment, some countries having proposed a transfer pricing adjustment will assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly.”

In view of the above, the amount of the primary adjustment will be deemed to be a loan by the South African taxpayer to the non-resident. This deemed loan will thus constitute an affected transaction, which will require the taxpayer to calculate an arm’s length rate of interest on the deemed loan. The rate of interest should be calculated under the arm’s length principle and will be deemed to be payable until the deemed loan is repaid to the South African taxpayer that has been subject to a primary adjustment. However, it is intended that the primary adjustment will not be treated as loan to the extent that adjustment is repaid to the South African taxpayer by the end of the year of assessment in which the primary adjustment is made.

**Example**

**Facts:** Foreign Parent pays R1 million for goods provided by South African Subsidiary. South African Subsidiary records taxable income based on the receipt of R1 million for the goods sold to Foreign Parent. The arm’s length price for the goods is R1.2 million.

**Result:** A primary adjustment to the transaction in terms of section 31, whereby the taxable income of the South African Subsidiary will be increased to reflect the arm’s length price of R1.2 million. The differential of R200 000 will constitute a deemed loan (for the purposes of section 31) by South African Subsidiary to Foreign Parent in respect of which an arm’s length interest rate must be attached. It is intended that a secondary adjustment will not be triggered if the deemed loan is repaid by the end of the year of assessment in which the primary adjustment under section 31 is made.

If the loan remains unpaid, interest of R12 000 (R200 000 x 6%) (assuming an arm’s length interest rate of 6% per annum) will accrue to the South African Subsidiary. Interest will continue to accrue every year of assessment thereafter until the deemed loan is repaid.

*B. Expansion of the transfer pricing rules*

The revised transfer pricing rules technically allow only for the recalculation of “taxable income”, thereby limiting transfer pricing adjustments solely to the normal tax. It is proposed that this recalculation cover all taxes within the Income Tax Act (including the new Dividends Tax).

**IV. Effective date**

The proposed amendment will be effective for years of assessment commencing on or after 1 April 2012.



## **4.9. SINGLE CHARGE FOR COMPANY EMIGRATION**

[Clauses 26 and 108; Applicable provisions: Section 9H, 64P(2)(d) 64P(3)(d), 64P(4)(d) & 64P(5)(d), paragraph 12 of the 8th Schedule to the Income Tax Act]

### **I. Background**

A company can be said to have migrated when that company ceases to be a tax resident in South Africa. One method for effecting this migration entails a company shift of its place of effective management to another tax jurisdiction (even if the company continues some or all of its operations in South Africa). This re-domiciling from South Africa to a foreign jurisdiction triggers certain tax consequences.

At the company-level, the company migration of effective management is deemed to be a disposal for capital gains tax purposes. In particular, the migrating company is deemed to have generally disposed of its assets at market value on the day before ceasing to be a resident and repurchasing those same assets at the same market value. However, assets that remain within the capital gains tax net will be excluded from this deemed disposal (and market value repurchase).

A company migration additionally triggers a deemed dividend for purposes of the Secondary Tax on Companies. This deemed dividend treatment is limited to company profits and reserves immediately before the company ceases to be a resident. Many aspects of this deemed dividend treatment were initially to be carried over into the Value Extraction Tax (to be imposed when the new Dividends tax comes into effect).

### **II. Reason for change**

When a company migrates, the event can theoretically be viewed in one of two ways - firstly as a sale and repurchase of assets by the entity, or secondly as a liquidation followed by a reincorporation. However, the current policy regarding the migration of companies is an inconsistent combination of both concepts. The imposition of a tax on dividends is also problematic at the shareholder-level because these shareholders do not receive any cash at any point during the migration (and any actual dividend under the new Dividend Tax falling within similar circumstances may be exempt). A simplified regime is therefore required that is both more theoretically defensible and more administratively viable.

### **III. Proposal**

It is proposed that a single set of company-level tax be imposed when a company ceases to be a South African tax resident by virtue of a change in effective management. This event will trigger either capital gain or ordinary revenue. No deemed dividend treatment will result. The disposal will be deemed to take place on the date immediately before the date of the change of residence.

More specifically, assets held by the existing company on the day before cessation as a resident will be deemed disposed at arm's length value. These entities are subject to the charge because these entities are already exiting the tax net. All of these assets will then be deemed repurchased at the same market value. Appreciating assets held as trading stock will trigger ordinary revenue; appreciating assets of a capital nature will trigger capital gains

(and possibly recoupment). As under existing law, exceptions will exist for assets remaining within South African taxing jurisdiction and for certain share incentive schemes. Further, as indicated under the discussion pertaining to headquarter company adjustments, a similar exit charge will be levied at the headquarter company level for any resident company that enters the headquarter company regime.

#### **IV. Effective date**

This proposed amendment will be effective for cessations occurring on or after the new Dividend Tax comes into effect (i.e. on or after 1 April 2012).

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### **4.10. CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS**

[Clauses 26 and 108; Applicable provisions: Section 37JA, 37K, 37L, and 37M and 37N of the Income Tax Act]

#### **I. Background**

In 2010, Government announced its intention to narrow the cross-border interest exemption in line with international global tax practice. The effect of this narrowing is that interest paid to a non-resident will generally be subject to a withholding tax at the rate of ten per cent. The proposed charge will take effect from 1 January 2013 (to provide time for Government to renegotiate certain tax treaties). However, this withholding tax will be subject to a list of exemptions, such as the exemption for interest from bonds issued by any sphere of Government or in respect of listed debt instruments.

Under the current withholding mechanisms, the person making payment of cross-border interest must withhold. This withheld amount must be paid over to SARS within 14 days after the end of the month during which the amount is withheld.

#### **II. Reasons for change**

Although most substantive issues relating to the new withholding tax on interest have been resolved during the 2010 legislative cycle, a few issues relating to the administrative mechanisms remain. Some of these issues include: the nature of the liability, payment due dates and the provision for refunds.

#### **III. Proposal**

In view of the above, it is proposed that the following administrative refinements be made. Firstly, the law will clarify that the beneficial owner is primarily liable unless the tax is paid by another (typically the withholding agent). Secondly, the due date will be moved in line with the dividends withholding tax (i.e. the close of the month following the month). Lastly, the revised rules set a three year time limit for refunds from SARS for amounts wrongfully withheld (with only the beneficial owner being entitled to claim). All of these rules are being aligned in accordance with the new Dividends Tax.

#### **IV. Effective date**

The proposed amendment will be effective on the date when the withholding tax on cross-border interest is implemented.

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#### **4.11. FOREIGN CURRENCY: REPEAL OF CAPITAL GAIN RULES**

[Clauses 111 and 124; Applicable Provisions: Part XIII, Paragraph 43(4) of the Eighth Schedule and Section 24I(2) of the Income Tax Act]

##### **I. Background**

Gains and losses in respect of foreign exchange items (i.e. currency, debt, currency forward contracts and currency option contracts) are generally governed by section 24I. Section 24I annually accounts for unrealised gains and losses with these unrealised amounts taken into account as ordinary revenue or loss.

Currency units and debt of natural persons (and certain trusts) generally fall outside of the section 24I paradigm and are instead subject to capital gains tax on a realisation basis. Realisation for this purpose generally means the conversion of foreign currency (or debt) into a different currency or into a non-monetary asset. This form of gain or loss is based on the pooling method. To determine gain or loss under the pooling method, one must first establish a base cost for the pool of foreign currency. Proceeds from disposals of foreign currency are then measured against a proportionate share of this pooled base cost.

##### **II. Reasons for change**

While taxation of foreign currency gains and losses is theoretically sound, this form of taxation is extremely complicated. Taxpayers are often required to spend significant time and resources to review ordinary day-to-day currency movements solely for purposes of the tax computation. These costs often far outweigh the actual tax at stake.

##### **III. Proposal**

For the reasons outlined above, the capital gain or loss rules (Part XIII of the Schedule) relating to currency monetary items will be repealed. As a result, gain or loss from foreign currency units (and foreign debt) held by natural persons will no longer be taken into account.

A secondary proposal also amends the capital gain or loss provisions mainly associated with non-monetary assets denominated in foreign currency. These rules will be revised to ensure that a creditor's disposal of foreign debt does not give rise to currency capital gain or loss with other gain or loss aspects remaining within the tax system. Going forward, gain or loss for natural persons (and certain trusts) will be solely measured based on differences calculated utilising the foreign currency denomination with the gain or loss translated into Rands after the differences are determined. For instance, if a taxpayer holds a zero-coupon bond worth 100 pounds and sells the bond for 110 Pounds, the gain will be calculated at 10 Pounds with the 10 Pound gain converted into Rands based on the currency during the year of assessment. The Rand-Pound currency differentials between purchase and sale will not be taken into account.

#### **IV. Effective date**

The proposed repeal will be effective for years of assessment commencing from 1 March 2011.

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#### **4.12. FOREIGN CURRENCY: FOREIGN SHARE ACQUISITIONS HEDGES**

[Clause 52; Applicable Provision: Section 24I(11A) of the Income Tax Act]

##### **I. Background**

Section 24I recognises exchange differences for tax purposes on an annual basis irrespective of realisation. However, if the exchange difference relates to the acquisition of foreign equity shares, the currency recognition is waived largely in line with accounting principles. The purpose of this waiver is to ensure matching – the hedge in this case is being matched against a substantial equity stake in a foreign company (the latter of which does not trigger recognition of currency exchange differences on an annual basis).

In terms of formal requirements, the hedge must be associated with a 20 per cent acquisition of a foreign company by South African residents and is only applicable if the foreign company becomes a controlled foreign company (CFC) after the acquisition. The hedge currency gain or loss must also not be reflected in applicable accounting statements. On the disposal of the hedged equity shares, the currency gain or loss will be taken into account for capital gains purposes through a corresponding adjustment to the base cost of the equity shares. Thus, the relief operates similar to a rollover with the added benefit of converting ordinary revenue into capital gain (that may ultimately be exempt by virtue of the participation exemption).

##### **II. Reasons for change**

The currency recognition waiver requirements for Income Tax purposes are much tighter than necessary – going beyond the requirements for accounting non-recognition. The tax rules require a 20 per cent acquisition; whereas, accounting would not discriminate against smaller acquisitions that are part of a creeping acquisition that leave a substantial equity stake.

The CFC requirement is also excessive – accounting does not require more than 50 per cent control. In addition, the CFC requirement oftentimes creates problems when the target foreign company is subject to foreign ownership restrictions in the foreign country concerned (i.e. a foreign ownership restriction preventing South African control).

Lastly, because of the resident requirement, the waiver will not apply if the foreign share acquisition is indirectly performed through a CFC. No reason appears to exist for excluding CFC acquisitions.

##### **III. Proposal**

In view of the above, the currency waiver requirements in respect of hedges associated with foreign share acquisitions will be liberalised. The foreign target must simply be at least 20 per cent owned upon completion of the acquisition. The CFC requirement will be deleted. In addition, non-resident acquiring persons (e.g. CFCs) can participate in the relief.

#### **IV. Effective date**

The proposed amendments will apply in respect of years of assessment commencing from 1 January 2012.

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### **5. VALUE-ADDED TAX**

#### **5.1. TEMPORARY RELIEF FOR THE RENTAL OF RESIDENTIAL PROPERTY BY DEVELOPERS**

[Clauses 133(1)(b) & 139; Applicable Value-Added Tax Act provision: section 18(B) and section 10(7) of the VAT Act]

##### **I. Background**

###### *A. Basic concepts*

The supply of fixed property by a VAT vendor is subject to VAT at the standard rate of 14 per cent. The standard rate applies irrespective of how that fixed property is used in the hands of the purchaser.

If the purchaser intends to use the fixed property for residential purposes (either as a dwelling or for residential rental), VAT becomes a permanent cost to the purchaser. The policy rationale for leaving residential rentals outside the VAT base is to ensure that residential rental properties and owner-occupied residential properties are placed on par (i.e. are neutral) to one another.

On the other hand, if the purchaser is a VAT vendor that acquires fixed property for resale (or for commercial rentals), the 14 per cent VAT charge becomes only a temporary charge. In these instances, the VAT vendor purchasing the property can claim input credits for the VAT paid. However, the VAT vendor must also charge VAT on resale (with the sales price increased for the value-added). One common set of role players in this area are developers.

###### *B. Change in use adjustment*

As indicated above, input credits for VAT vendors are based on the assumption that the acquisition is for the purposes of making wholly taxable supplies (thereby giving rise to a VAT charge on resale). Therefore, if a VAT vendor's principal intention is to sell fixed residential property but subsequently the vendor changes the use/application of the fixed residential property so that the property is to be used for non-taxable purposes (partly or wholly), the

vendor is obliged to make a change in use adjustment. In the case of residential fixed property developers, change in use adjustments commonly arises when these developers shift from a resale intention to a rental application.

## **II. Reasons for change**

Developers that develop residential fixed property (e.g. townhouse complexes) with the principal purpose or intention of supplying that fixed property for sale are sometimes forced to rent these properties due to weak selling market conditions. Current weakness in the property markets and the economic climate has exacerbated this difficulty. In this scenario, rental operations are designed to provide the developer with temporary cash inflows to cover the carrying cost associated with the extended holding of the property.

At a technical level, developers have a VAT change in use of a residential property when renting that property (even if only temporarily). This change in use creates a major problem for developers in economic distress because this change in use places the developer in the unenviable position of being forced to pay VAT on a deemed supply. This deemed supply is deemed made at open market value (at the change in use date). This VAT cost escalates if the developer is forced to rent multiple residential rental properties. All of these VAT charges undercut the cash-flow gains otherwise associated with temporary rentals and may even force certain developers into insolvency.

## **III. Proposal**

### *A. Short-term solution: Temporary residential rentals permitted*

The VAT rules concerning change in use adjustments for property developers that temporarily rent residential properties are problematic from a practical and a legal theory perspective. From a practical perspective, premature imposition of VAT upon developers because of forces outside their control seems questionable as an economic matter, especially if the charge can undermine their continued viability. From a legal theory perspective, a host of questions arise that strike at core concepts within the VAT as a whole (see “Theoretical issues raised” below). Proper resolution of these theoretical issues will undoubtedly require a thorough and time-consuming analysis.

In the meantime, legislative intervention is urgently required in order to ensure that the VAT system does not force certain VAT developers into insolvency. This urgency is highlighted by the ongoing economic global uncertainty impacting the local residential property market. To this end, it is proposed that temporary relief be granted to developers that rent residential fixed properties before intended sale. While not trying to solve the larger legal theoretical issues, developers will be given a maximum grace period of 36 months to rent fixed residential property before sale. This 36 month period commences when the fixed property is rented for the first time. If the vendor rents the residential fixed property beyond the permissible 36 month period, the deemed change-in-use charge will apply. This deemed charge will trigger a deemed supply at market value of the property as of the 36 month cut-off date.

In order to qualify for this relief, two requirements must be satisfied:

- the vendor at issue must be a “developer as defined” where a “developer” generally means a vendor who continuously or regularly construct, extend or substantially improves fixed property consisting of any dwelling or for the purpose of disposing of that fixed property
- and the developer must have the overriding purpose/intention of selling the property as soon as the opportunity arises.

**Example 1:**

**Facts:** Vendor (a property developer) buys a townhouse for R1 000 000 as stock in trade (i.e. for resale purposes). Vendor repairs the townhouse after a period of 6 months, Vendor cannot find a buyer for the townhouse and is forced to rent out the property to cover some of interest costs for the financing of the property. Vendor rents out the property for a 12 month period and is fully committed to selling the property when the opportunity arises.

**Result:** Vendor qualifies for relief in terms of the interim provisions as the intention to resell has not been abandoned.

**Example 2**

**Fact:** Vendor (a property developer) develops 20 units as part of a townhouse development. Vendor initially sells 15 of the units off plan. However, 12 months after completion of the development, Vendor struggles to find buyers for the remaining 5 units. Vendor opts to rent out the units to cover the interest costs of financing development (at the time of renting, the market value per unit is R2 million). Initially, Vendor does undertake this rental as a short term measure but thereafter decides that the rental option is ultimately preferred. Vendor, accordingly decides to ‘take the townhouses off market’ and use the property solely for rental (i.e. Vendor abandons the sell intention; the market value of a unit at a time when is R2,5 million).

**Result:** Vendor initially qualifies for the interim relief but loses this relief when the intention to sell the property changes. In this case, Vendor B is subjected to the normal rules governing the change in use adjustment and must account for VAT as of the date that the intention to sell has been abandoned.

*B. Theoretical issues raised*

The problem of vendors (i.e. developers) renting fixed property for exempt residential use is not unique to South Africa. When a vendor rents fixed property for an exempt use, three main

issues come into consideration: (i) purpose versus application; (ii) consumption versus recoupment; and (iii) rental charged as a proxy for consumption/recoupment. These issues are discussed briefly below.

(i) *Purpose versus application*

In New Zealand, a few court cases have addressed the situation where taxpayers have acquired residential fixed property for development and resale but subsequently (i.e. rents those properties temporarily due to circumstances outside their control). This unanticipated rental use has precipitated the question of what is the taxpayer's "principal purpose" and whether an adjustment is required.

In *CIR v Morris*, the New Zealand High Court held that the taxpayer's principal purpose of making taxable supplies continued despite the fact that apartments were simultaneously used for the separate purpose of making non-taxable supplies by way of residential accommodation. The Court did not consider the extent to which the apartments had been committed to a non-taxable use, but the Court instead referred this issue to the New Zealand Taxation Review Authority for consideration. Upon remittance, the Taxation Review Authority held that a change in use had occurred.

In *CIR v Carswell Investments Ltd*, the taxpayer was a property development company whose main activity was the acquisition of vacant sections onto which existing houses were located. The taxpayer rented out twenty properties as rental accommodation pending their sale. The New Zealand Commissioner and the taxpayer agreed that the principal purpose for which the properties were held was a taxable one (property development), but the New Zealand Commissioner considered that the renting of houses (which is exempt in terms of the New Zealand GST Act) triggered a change in use that required an adjustment. The taxpayer objected to this decision and the New Zealand Taxation Review Authority held that the taxpayer did not change the taxpayer's principal purpose of making taxable supplies. The New Zealand Commissioner appealed to the High Court, which sided with the New Zealand Commissioner.

South Africa's VAT seems to espouse the same approach taken in New Zealand (from a legislative standpoint). A reading of section 17(1) with the section 1 definition of 'input tax' within the VAT Act, specifies that input tax can only be deducted if the intention or purpose is to make taxable supplies. It is submitted that although the intention of the developer is to sell the unit, the developer changes the application or use of the unit. VAT, unlike the income tax, does not hinge solely on an 'intention' test; 'application' seems to be an interdependent but intervening variable. Stated differently, although intention is important for VAT purposes, intention goes hand-in-hand with application or use. As a result, a change in application brings about a supply by the vendor (refer to section 18(1) of the VAT Act).



(ii) *Consumption versus recoupment*

*Taxing consumption*

South Africa's approach to change in use adjustments is based on the principle that VAT needs to reflect the consumption of goods or services in a given period. The New Zealand change in use rules apply to industries where vendors make a mixture of taxable and exempt supplies (e.g. financial service providers and some property developers). The change in use rules ensure that private use is taxed. For example, assume a luxury yacht is acquired and initially used exclusively in a chartering business (primary purpose), but at a later stage also privately. Under these circumstances, this charge is subject to the GST change in use rules. This change in use ensures that parity of treatment exists with a similar yacht purchased and used exclusively for private purposes.

It is recognised that the intention of a developer to sell the fixed property that is now being rented for residential purposes does not change yet, it is an accepted fact that the developer has changed the use of that fixed property (although arguably only for an intermittent period). The corollary for this change is that current consumption must be taxed (thereby triggering a VAT event) in the hands of the vendor.

*Recoupment*

Also at issue is the debate of recoupment versus consumption. When a change in use occurs, should the effect be:

- (i) To recoup input tax previously claimed by the vendor (i.e. effectively, placing the vendor in the same position as if the vendor had originally incurred the input tax for a non-taxable purpose), or
- (ii) To tax current consumption in the hands of the vendor?

In New Zealand, the Court of Appeal in the *Lundy Family Trust* case considered the issue of how to treat adjustments previously made when assets are returned to an original taxable purpose. The New Zealand Court ruled that a vendor can deduct output tax adjustments previously declared. The New Zealand Court also seemed to suggest that output tax adjustments made in respect of the change in use must be capped to the amount of the original input tax deduction received by the vendor. This view seems to sanction the recoupment of previously deducted input tax when a change in use occurs.

Lastly, it is unclear whether the change in use adjustment (be it consumption or recoupment based) is temporary or permanent. A temporary charge seems to infer that the fixed property does not leave the VAT base and that the subsequent sale by the developer is subject to VAT. At variance is a permanent charge which infers that the

asset is 'burnt up' once the deemed charge is made by the vendor and that any subsequent sale is not subject to VAT.

*(iii) Rental income as a proxy for consumption/recoupment*

As stated above the predicament faced by property developers who temporarily rent out residential units, is fully recognised. It is also fully recognised that the current value of the change in use adjustment (i.e. deemed supply) is disproportionate to the exempt rental income received for lease of the property. Hence, there is a view that a claw-back of the monthly rental income can serve as a proxy:

- to tax private consumption in the hands of the developer on a monthly basis; or
- to recoup, on a monthly basis, a portion of input tax previously deducted by the developer.

It must, however, be borne in mind that this approach is tantamount to subjecting the rental income to VAT, which would lead to its own set of policy ramifications.

In view of the complexities above, a short-term solution to the problem faced by developers is established. Once all issues have been fully evaluated, a permanent solution will be has been undertaken to address the problem facing developers that temporarily rent residential fixed properties.

#### **IV. Effective date**

According to general principles, the proposed amendment will apply to all supplies of fixed property (i.e. change in use) made by fixed property developers on or after the date of promulgation of this Bill but before 1 January 2017.

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## **5.2. DELINKING VAT FROM TRANSFER DUTY**

[Clauses 129(1)(c) & 137(1)(b-d) and 138; Applicable Value-Added Tax Act provision: Section 1 "input tax" para. (b) proviso; section 16(3)(a)(ii)(aa); 16(3)(a)(ii)(bb)]

### **I. Background**

#### *A. Basic concepts*

The purchase of fixed property from a non-vendor is subject to transfer duty as opposed to VAT. If the purchaser is a vendor who acquires the property, the purchaser may receive notional input credits (e.g. these inputs are often available for developers who develop and on-sell fixed property or for vendors using fixed property for non-residential rental commercial use). These notional inputs arise because the fixed property purchased is viewed as second-hand goods.

The rationale for notional input credits when acquiring second-hand goods is primarily based on the need to eliminate double VAT charges on the same value-added. For instance, if a VAT vendor develops and sells fixed property, the selling vendor charges VAT on the sales price. If the fixed property is sold to a non-vendor, the VAT charge is an additional cost for the non-vendor. If the non-vendor further on-sells the same fixed property to a second VAT vendor, the second VAT vendor indirectly bears the cost of the VAT borne by the non-VAT vendor in respect of the initial purchase (and for VAT incurred in respect of improvements). Notional inputs for the second VAT vendor in respect of these second hand goods (i.e. fixed property) eliminate double VAT charges on the same value-added by providing notional input relief in the absence of actual inputs.

### *B. Anti-avoidance*

In the case of fixed property, notional input credits for VAT vendors are based on the lesser of: (i) the purchase price, or (ii) the open market value of the fixed property; both of which are limited to the transfer duty payable in respect of the purchase. The main rationale for these notional input ceilings is to undermine schemes that seek to artificially inflate notional input claims. These claims are possible because notional inputs are not matched by outputs when a VAT vendor acquires property from a non-Vendor. With the introduction of the transfer Duty limit, notional input credits are instead matched against transfer duty payable.

## **II. Reasons for change**

While the transfer duty ceiling for notional inputs in respect of second-hand fixed property prevents avoidance, the ceiling is arguably unfair. The ceiling generally means that the notional inputs allowed do not fully compensate the VAT vendor for most or all of the VAT probably paid by previous owners. Indeed, no notional input credits are allowed at all for the purchase of smaller residential properties because these smaller properties are free from transfer duty (due to the R600 000 threshold).

Admittedly, rules are needed to prevent avoidance schemes (see *Amor van Zyl Trust* case and ITC 1686). The question is whether the transfer duty ceiling is the best mechanism, especially since the transfer duty undermines the objective of notional input credits. In this vein, it should be noted that an open market value ceiling exists that equally eliminates the avoidance scheme of inflating prices for fixed properties (without undermining the objective of notional input credits).

## **III. Proposal**

It is proposed that the transfer duty ceiling be eliminated as superfluous. Amongst other limits, the open market value rule will remain intact to prevent the over-inflation of prices. Given the relative ease of valuing local residential properties, pricing manipulation for VAT purposes becomes an extremely risky proposition.

Instead, acquisition of fixed property from non-VAT vendors will be subject to largely the same rules applicable for the claiming of notional input tax credits in respect of other second-hand goods. Hence, fixed property notional input credits are deferred to the extent of actual payment (i.e. which excludes promissory notes and loan accounts). Notional inputs in

respect of fixed property acquisitions must be deferred further until the fixed property concerned is registered in the vendor's name.

**Example:**

**Facts:** Individual directly or indirectly holds all the shares of Property Company and Company X. Company X issues a R1 million promissory note to Property Company in exchange for fixed property. Property Company is a non-VAT vendor, and Company X is a vendor.

**Result:** Company X cannot claim any notional VAT inputs on the purchase in respect of the promissory note. Notional inputs are allowed only in respect of payment that reduces or discharges liabilities.

The payment rules effectively prevent purchasers from obtaining notional input credits in respect of seller financed property until payment. Taxpayers seeking to undermine this limitation through indirect seller finance schemes will most likely be in violation of the general anti-avoidance rule.

#### **IV. Effective date**

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

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### **5.3. DEFERRED CHARGE FOR UNPAID GROUP MEMBER DEBT**

[Clause 140; Applicable Value-Added Tax Act provision: sections 22(1) 22(3); 22(3A); and 22(6)(a)]

#### **I. Background**

Special anti-avoidance rules apply in the case of debt created pursuant to an unwritten agreement. In this scenario, indebted vendors registered on the VAT invoice basis must return VAT inputs previously claimed to the extent these indebted vendors have not paid for previously received supplies within a 12-month period. This required charge-back applies to the unpaid consideration (i.e. the amount outstanding).

The required pay-back provision aims to create neutrality for the fiscus once the creditor is taken into account. The creditor can generally claim VAT inputs in respect of VAT previously paid at any time that the creditor writes off the debt (to reverse the prior output). In terms of the debtor, the charge-back provision is based on the commercial assumption that the creditor will typically write off unwritten debt after 12 months. In effect, the charge-back provision is designed to ensure that the corresponding debtor doesn't delay payment past this 12-month period.

#### **II. Reasons for change**

In practice, group companies often do not have written agreements with one another for each VAT transaction processed via loan accounts (because written agreements in this context are too cumbersome). Intra-group loan accounts are typically reflected solely as mere accounting journal entries. Group members often operate internal loan accounts for commercial reasons without clearing these accounts for many years (in effect, these loan accounts act as a form of interest-free financing for related group company members). Therefore, the current 12-month pay-back provision is unrealistic in a group context, between wholly-owned members within a group of companies.

### **III. Proposal**

In view of the above, it is proposed that the pay-back provision should not apply within wholly-owned members of a group of companies. However, this exclusion from the 12-month rule comes at a price – the creditor providing the supply to the indebted group member cannot claim a deduction for a bad debt written off.

The net effect of the amendment is to provide relief for unwritten intra-group debt without placing the fiscus at risk. The extension of the pay-back provision and the write-off last as long as the debtor and creditor are within the same wholly-owned group.

### **IV. Effective date**

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

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## **5.4. SYNCHRONISING VAT AND CUSTOMS RELIEF FOR TEMPORARY IMPORTS**

[Clause 143(1)(b)Applicable Value-Added Tax Act provision: Item No. 470.03/00.00/02.00 in Schedule 1 of the VAT Act]

### **I. Background**

VAT is generally payable when goods are imported into South Africa. However, through the use of a Schedule Item Number (i.e. Item No. 470.03/00.00/01 of Schedule 1 to the VAT Act), VAT exempts goods that are temporarily imported for manufacturing, processing, finishing, equipping or packing of goods as long as the goods are destined exclusively for export. A corresponding Schedule Item Number also exists in the Customs and Excise Act, whereby dutiable goods are allowed to enjoy a full duty rebate (i.e. Rebate Item No. 470.03/00.00/01.00 in Part 3 of Schedule 4 to the Customs and Excise Act). For practical purposes, SARS Customs officials administer the VAT exemption solely through reliance on the corresponding Customs and Excise Schedule Item Number.

### **II. Reasons for change**

The current VAT exemption for temporary imports is facing operational barriers in the case of duty-free imported goods. This operational difficulty exists because SARS effectively relies on the Customs and Excise Item Schedule to apply the VAT exemption. SARS Customs uses this Schedule Item Number only to clear goods that are dutiable. However, the lack of

coverage for duty-free goods causes operational difficulties for Customs officials who are controlling the exemption determination. To date, this issue has mainly impacted platinum and gold imported temporarily into South Africa for the purposes of beneficiation. The net result has been to undermine South Africa's role as a regional beneficiation stakeholder.

### **III. Proposal**

In order to remedy this anomaly, it is proposed that the current wording of the applicable Schedule Item Number in the Customs and Excise Act (Rebate item 470.03 (Tariff Heading 00.00) of Part 3 to Schedule 4) be amended to additionally include duty free goods. Correspondingly, the VAT Act (Item No. 470.03/00.00/02.00 of Schedule 1) will be amended to mirror the applicable Schedule Item Number in the Customs and Excise Act. The proposed amendments will ensure that SARS Customs officials can apply the VAT temporary exemption equally for both duty-free and dutiable goods.

### **IV. Effective date**

According to general principles, the proposed amendments will apply to all goods imported on or after the date of promulgation of this Bill.

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## **5.5. INTRA-WAREHOUSE TRANSFERS**

[Clause 135; Applicable Value-Added Tax Act provision: Section 13(2A)]

### **I. Background**

The import and entry of goods into a bonded storage warehouse does not give rise to VAT or customs duty consequences. Goods may also be sold or otherwise disposed of while in the storage warehouse, subject to the permission of the customs authority. If a sale or disposal of this nature occurs, the seller and the buyer are required to complete a declaration evidencing the transfer of ownership. This transfer of ownership will not trigger a liability for import VAT as long as the goods remain in the storage warehouse and have not been entered for home consumption. The liability for import VAT will only be triggered after transfer if the buyer removes the goods from the storage warehouse for entry into home consumption. The buyer is required to complete a customs declaration when this entry for home consumption occurs.

### **II. Reasons for change**

If a buyer removes goods from a bond storage warehouse after a transfer of ownership in the warehouse, a risk to the fiscus exists that the buyer may utilise the value for customs duty purposes (i.e. the value of the goods when first entered into the storage warehouse) as the VAT import value. The buyer will often rely on this value because this value will be lower than the intra-warehouse sale value. Reliance on this lower value is misplaced because the intra-warehouse sale is the best indicator of true arm's length value.

### **III. Proposal**

The valuation of goods entered for home consumption will be changed to reflect intra-warehouse sales before entry. In particular, if a VAT vendor acquires goods located in a

bonded warehouse before entry, the value of the goods upon entry for home consumption will instead be deemed to equal the value of the goods taken into account when the VAT vendor acquired the goods (i.e. the intra-warehouse sales value. The import value will be ignored.

#### **IV. Effective date**

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

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### **5.6. MINIMUM VAT EXEMPTION FOR IMPORTED SERVICES**

[Clause 136; Applicable Value-Added Tax Act provision: section 14(5)]

#### **I. Background**

VAT is payable on the importation of goods and services into South Africa. However, the VAT Act provides for a minimum threshold exemption in respect of certain imported goods. For example, books, newspapers and journals imported by post are exempt if the value does not exceed R100. No similar exemption exists with regard to imported services.

#### **II. Reasons for change**

The absence of a minimum threshold with regard to imported services means that VAT is payable on importation no matter how insignificant the consideration. This lack of a threshold creates a compliance burden for the importer and an enforcement burden for SARS even though nominal revenue is at stake. Furthermore, the existence of a threshold for goods with the absence of a threshold for services effectively results in an imported hard copy publication being exempt under R100 while the same on-line publication is fully subject to import VAT.

#### **III. Proposal**

In view of the above, the introduction of a minimum threshold exemption of R100 for the importation of services will be added. This threshold for imported services matches the threshold exemption for imported goods.

#### **IV. Effective date**

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

### **5.7. INPUT CREDITS IN RESPECT OF DISCOUNT VOUCHERS**

[Clause 137 (1)(e-f); Applicable Value-Added Tax Act provision: Sections 16(3)(i)]

## I. Background

Manufacturers or producers may issue tokens, vouchers or stamps as part of their normal business activities in order to promote the marketing of their products. The holder of the token, voucher or stamp is entitled (upon redemption thereof) to a discount of the price of goods purchased. The redemption by the holder of the token, voucher or stamp can be undertaken directly from the manufacturer/producer or from an agent of the manufacturer/producer (typically a retailer) vendor.

In the later case, the manufacturer/producer reimburses the agent (retailer) for the discount allowed. In terms of the valuation rules, the monetary value of the token, voucher or stamp is deemed to include the VAT when the manufacturer/producer provides reimbursement.

**Example:**

**Facts:** Book Publisher issues R28 worth of vouchers for the promotion of certain books in its catalogue. Individual M redeems a R28 voucher for the purchase of a book priced at R228 at Book Store (an agent of book publisher). Book Publisher reimburses Book Store the R28 discount allowed.

**Result:** Book Publisher claims a deduction of 14/114 of R28 (i.e. R3.44). The total consideration for the supply made by Book Store is R228 (with the R28 voucher including VAT at 14 per cent).

## II. Reasons for change

Deemed inclusion of the VAT for tokens, vouchers or stamps can be problematic. When the holder of a token, voucher or stamp redeems these items in respect of a supply subject to the zero rate of tax then unintended consequences may arise. This is best illustrated by way of example.

**Example:**

**Facts:** Manufacturer specialises in the manufacture of certain foodstuffs. Manufacturer issues R8 vouchers for the promotion of all of its foodstuffs. Individual N redeems two R8 vouchers at a supermarket store for the purchase of eggs and pilchards (two zero rated items). B subsequently reimburses the supermarket store for the discount allowed on the supply.

**Result:** Manufacturer claims a deduction of 14/114 of R16 (i.e. R1.96) reimbursed to the supermarket store. This result follows even though no VAT arose in relation to the underlying purchase.

## III. Proposal

It is proposed that the anomaly referred to above be removed because the VAT rules were not designed to cater for tokens, vouchers or stamps being redeemed in respect of zero rated



supplies. The proposal will result in the vendor issuer of a token, voucher or stamp only being allowed to claim an input deduction if the underlying supply is taxable at the standard rate.

#### **IV. Effective date**

According to general principles, the proposed amendment will apply to all tokens, vouchers, or stamps redeemed in respect of goods supplied on or after the date of promulgation of this Bill.

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### **5.8. CLARIFICATION OF ZERO RATING FOR MINING RIGHT CONVERSIONS**

[Clause 134; Applicable Value-Added Tax Act provision: Sections 11(1) (n)]

#### **I. Background**

In 2002, the Mineral and Petroleum Resources Development Act (MPRDA) was introduced, which required holders of old order mineral rights to convert their rights into new order rights after approval by the Department of Mineral Resources. New order mineral production rights cannot last for more than 30 years, but holders can obtain approvals for renewal. Various acts, including the VAT Act, provide relief so that conversions and renewals do not give rise to unfair tax charges when parties remain economically neutral. More specifically in the case of VAT, conversions and renewals are zero-rated for VAT purposes.

#### **II. Reasons for change**

The current VAT zero-rating for mineral right conversions and renewals is problematic. Some taxpayers are claiming that the transfer of mineral rights to third parties (outside the conversion or renewal process) fall within the zero-rating even though this extension of the zero rating was never intended. The zero rating was merely intended to protect mineral rights holders from being subject to VAT solely because regulation requires an alteration of rights while those rights remain in the same hands.

Moreover, the need for a zero rating in the case of mining right renewals to avoid adverse VAT consequence is technically questionable. MPRDA changes in mineral rights for renewals should instead be viewed as akin to a change in land zoning rights, which is merely viewed as a non-event (non-supply) in line with common law without specific legislative relief. However, this treatment of renewals as a non-supply may create additional distortions (such as wrongly increasing turnover when allocating inputs under the turnover method).

#### **III. Proposal**

The zero rating provision for conversions (where no ownership of the rights changes hands) will be amended to reflect that only the supply of the old order right or OP26 right that is made pursuant to the conversion will be zero rated (i.e. the supply of the old right must be made to government pursuant to the conversion). Further, it is accordingly proposed that the zero rating for mineral right renewals be deleted as superfluous.

#### **IV. Effective date**

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

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## **6. OTHER TAXES**

### **6.1. TRANSFER DUTY: RELIEF FOR ENTITIES**

[Key transfer duty provisions: Sections 2 and 9 of the Transfer Duty]

#### **I. Background**

The Transfer Duty has two different sets of rates. Natural persons acquiring property are subject to a zero, five or eight per cent charge depending on the value of the immovable property acquired. On the other hand, legal entities (companies and trusts) acquiring immovable property are subject to an eight per cent charge regardless of value.

#### **II. Reasons for change**

Many years ago, the higher transfer duty rate for companies and trusts could be justified. At one time, a company (or trust) could be used to avoid the transfer duty by holding immovable property indirectly on behalf of natural persons. Under this scenario, the company share or trust interests could seemingly be sold free of transfer duty even if the legal entity held immovable property as the entity's sole asset. The only transfer duty that could be applied was on the initial acquisition by the legal entity.

With the anti-avoidance amendments of 2002, the acquisition of immovable property by companies or trusts now triggers transfer duty as if the immovable property were acquired directly. The enactment of capital gains tax adds further layers of tax. With these changes, the higher transfer duty for legal entities is no longer necessary because the overall tax burden on the appreciation of immovable property within companies or trusts is at least as high as immovable property directly held by natural persons.

More importantly, non-tax reasons often exist for using legal entities to hold immovable property. For instance, many investors prefer to hold rental properties in the form of a company to obtain the benefit of limited liability protection. This limited liability protection protects investors from excessive losses. The use of multiple companies can also be used so that the separate properties can be protected against the risks of one another. The current flat 8 per cent charge on immovable property by companies and trusts creates a cost that makes these commercial uses prohibitive.

#### **III. Proposal**

The flat transfer duty rate for legal entities will be removed. All persons (natural and legal) will henceforth be subject to the same graduated rates. Because the differences in transfer

duty rates will no longer exist, tax-free “asset-for-shares” (e.g. formations) will now be permitted. It should be noted that the anti-avoidance rules for property legal entities will remain in order to ensure that legal entities do not hold property mainly for tax motivated reasons.

#### **IV. Effective date**

The proposed rate adjustment will be effective for immovable property acquired (or interest or restriction in any property renounced) on or after 23 February 2011. Assets-for-share relief will be permitted from 1 January 2012.

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## **6.2. SECURITIES TRANSFER TAX: TEMPORARY ADJUSTMENT TO THE BROKER - MEMBER EXEMPTION**

[Key security transfer tax provision: Section 8(1)(q)]

### **I. Background**

Taxpayers purchasing (or otherwise acquiring) listed and unlisted shares are generally subject to the Securities Transfer Tax. This indirect tax applies at a rate of 0.25 per cent in respect of the share value acquired. This tax (like other taxes) contains a number of exemptions. Among these exemptions, an exemption exists for members purchasing listed shares for their “account and benefit.” In practice, a “member” is a broker with a permit to operate directly on the JSE. A broker can act in capacity as principal or as an agent on behalf of others.

The exemption for brokers-member dates back many years to predecessor versions of the Securities Transfer Tax. The purpose of the exemption is to ensure liquidity on the JSE. As a general matter, the 0.25 per cent gross purchase charge should not unduly impact the liquidity of the market due to the low nature of the percentage involved. However, problems may arise when broker-members operate as market-makers that enhance JSE share liquidity. This market making typically involves short-term trades with profit spreads as low as 0.1-to-0.25 per cent. The current broker-member exemption accordingly exists in order to ensure that the Securities Transfer Tax does not disrupt these short-term trades.

### **II. Reasons for change**

Share and share-based products have become increasingly sophisticated since the broker-member exemption was introduced many years ago. It has now come to Government’s attention that the broker-member exemption is being used in circumstances outside the initial intention.

More specifically, it appears that certain financial institutions have engaged in many transactions with broker-members acting as “principal”. In the most prominent circumstances, these financial institutions are operating as market makers for derivatives. More specifically, the institutions at issue offer derivatives to a client while maintaining a perfectly hedged position with a broker (that is often “connected” in terms of ownership). The

broker-member would simultaneously hold the underlying shares in the capacity as principal to offset the derivative offered to the institution. The nature of the back-to-back relationship would typically remove all the risks and rewards associated with the position in respect of the broker-member. In exchange for the broker-member's participation, brokers in these circumstances would typically receive consideration equivalent to that of a service fee offered to an agent.

At issue is whether these broker-members are acting for their own benefit within the meaning of the Securities Transfer Tax. In particular, the concept of "account and benefit" was intended to ensure that the broker had a beneficial interest in the share acquired (i.e. bore the risks and rewards). Review of the law would accordingly suggest that these transactions should at least be viewed as "problematic."

### **III. Proposal**

#### *A. Technical versus policy considerations*

Application of the broker member exemption raises two types of issues – one at a technical level and one at a policy level.

- At a technical level, Government maintains its view that the broker-member must be operating as the "beneficial owner" of the acquired share to obtain the exemption. Formal treatment as "principal" for JSE purposes is not sufficient by itself to satisfy the standard of beneficial ownership. Were beneficial ownership of this nature to be accepted, any taxpayer could simply undermine the Securities Transfer Tax by using a broker-member as an intermediary (acting in the nominal capacity as "principal").
- On the other hand, the policy issues are not so straight-forward. Many of the transactions at issue appear to operate as a form of market-making not envisioned by the initial legislation. As outlined above, many of the shares at issue are being used to facilitate market-making in derivatives (and seemingly lack a primary tax motivation). Sudden imposition of the Securities Transfer Tax in these circumstances could accordingly disrupt the derivatives market, thereby reducing liquidity.

#### *B. Temporary legislation*

In view of the above, a two-fold solution is proposed. In order not to disrupt the market, it is proposed that the broker-member exemption be expanded to cover all broker-member activities wherein the broker-member is acting in the capacity as principal. This exemption would allow the parties involved to carry on as before without further tax risk. On the other hand, the expanded exemption will apply only from 1 January 2011 (roughly when the matter was first raised with Government at a policy level). SARS remains free to enforce the law in respect of acquisitions occurring prior to this date. This proper enforcement should not adversely impact the market because of the expanded broker-member exemption will apply going forward (at least for a year).

Moreover, the expanded exemption will only last for a temporary period – i.e. until the close of 2012. This interim period will be used to further investigate whether the transactions at issue provide meaningful value in terms of liquidity and whether the expanded exemption can be maintained without imposing an undue risk to the tax base. Also at issue is the question of competitiveness of the JSE as opposed to the London Stock Exchange. At this stage, it is understood that share acquisitions on the London Stock Exchange are subject to a 0.5 per cent charge, but this foreign charge contains more exemptions (i.e. the South African Securities Transfer Tax carries a lower overall rate but with a broader base).

#### **IV. Effective date**

The proposed amendments will be effective for transactions entered into on or after 1 January 2011 until the close of 31 December 2012.



**NATIONAL  
TREASURY**

**REPUBLIC OF SOUTH AFRICA**  

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**CLAUSE BY CLAUSE EXPLANATION**  
**TO THE**  
**DRAFT EXPLANATORY MEMORANDUM**  
**(TLAB) 2011**

**[27 JANUARY 2011]**



## CLAUSE 1

Transfer Duty: Amendment of section 1

Paragraph (a): The amendment updates the title to a Government office.

Paragraphs (b) to (e): The amendment deletes references to repealed legislative acts from the “property” definition and cross-references thereto.

## CLAUSE 2

Transfer Duty: Amendment of section 2

See notes on **RATES AND THRESHOLDS** and **TRANSFER DUTY: RELIEF FOR ENTITIES**

## CLAUSE 3

Transfer Duty: Amendment of section 3A

Paragraph (a): See notes on **ISLAMIC FINANCE: EXTENSION OF MURABAHA**

Paragraph (b): **ISLAMIC FINANCE: PROPOSED SUKUK**

## CLAUSE 4

Transfer Duty: Amendment of section 5

Paragraph (a): Deletion of an obsolete cross-reference (see paragraphs (b) to (e) in Clause 1).

Paragraphs (b) and (c): The amendment updates the title to a Government office.

## CLAUSE 5

Transfer Duty: Amendment of section 9

See notes on **TRANSFER DUTY: RELIEF FOR ENTITIES**

## CLAUSE 6

Income Tax: Fixing of rates of normal tax and amendment of certain amounts for purpose of Act 58 of 1962

See notes on **RATES AND THRESHOLDS**

## CLAUSE 7

Income Tax: Amendment of section 1

Paragraph (a): The proposed amendment modifies the connected person definition for group ownership and company ownership so as to take into account voting rights (in addition to the current focus on “equity shares”). Voting rights are an important part of a meaningful ownership interest that connects various persons.

Paragraph (b): See notes on **DIVIDENDS TAX: CONTRIBUTED TAX CAPITAL ADJUSTMENTS**. In addition, the proposed amendment clarifies how the reduction of contributed tax capital reduction is applied in the case of new company residents versus pre-existing company residents.

Paragraphs (c) to (g): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (h): The amendments seek to clarify the definition of ‘equity share’ by reverting to pre-existing language.

Paragraph (i): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (j): The amendment deletes the word “stock” because modern usage of the term “stock” suggests shares as opposed to debt.

Paragraph (k): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (l): The term entity is added to the foreign partnership definition because certain foreign conduits are technically entities (e.g. limited liability companies).

Paragraph (m): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraphs (n) and (o): The proposed change clarifies the inter-relationship of gross income in respect of voluntary awards received/accrued in respect of services rendered and restraint of trade compensation.

Paragraph (p): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: TAXATION OF PROCEEDS PAYOUT**

Paragraph (q): The proposed change clarifies the inter-relationship of gross income in respect of legitimate lump sum amounts taken into account under the retirement/withdrawal tables versus artificial amounts.

Paragraphs (r) to (t): The proposed change clarifies the inter-relationship of gross income in respect of lease premiums, amounts received/accrued in respect of asset dispositions.



**Paragraph (u): See notes on DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

Paragraph (v): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: TAXATION OF PROCEEDS PAYOUT**

Paragraph (w): The proposed amendment adjusts the language for consistency of style.

Paragraph (x): See notes on **INCENTIVE: HEADQUARTER COMPANY ADJUSTMENTS**

Paragraph (y): The amendment seeks to amend the definition of "living annuity" to allow the beneficiary upon the death of the annuitant to continue with the annuity, commute the annuity in full for a lump sum, or exercise a combination of the previous options.

Paragraph (z): The amendment adjusts the language contained in the definition of "pension fund" to technically allow for employers to subsequently join that fund. As a practical matter, subsequent entry of membership regularly occurs in the case of umbrella funds.

Paragraph (zA): The amendment corrects the reference to the Pension Funds Act, 1956.

Paragraphs (zB) and (zC): The basic philosophy for permitted transfers between retirement savings funds is to permit the transfer of less restrictive funds to equal or more restrictive funds. The amendment accordingly permits pension preservation funds to be additionally transferred from provident and provident preservation funds (as opposed to transfers solely from pension and pension preservation funds).

Paragraph (zD): The proposed amendment to the definition of "pension preservation fund" aligns the concept of "unclaimed benefit" in the Income Tax Act with the definition of the concept now found in the Pension Funds Act.

Paragraph (zE): The amendment corrects an erroneous cross-reference.

Paragraph (zF): The proposed amendment to the definition of "pension preservation fund" aligns the concept of "unclaimed benefit" in the Income Tax Act with the definition of the concept now found in the Pension Funds Act.

Paragraph (zG): The amendment corrects an erroneous cross reference.

Paragraph (zH): The basic philosophy for permitted transfers between retirement savings funds is to permit the transfer of less restrictive funds to equal or more restrictive funds. The amendment accordingly permits pension preservation funds to be additionally transferred from provident and provident preservation funds (as opposed to transfers solely from pension and pension preservation funds).

Paragraph (zI): The amendment corrects an erroneous cross-reference.

Paragraph (zJ): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (zK): The amendment seeks to prevent amounts taxed as a “severance benefit” from being included and taxed as normal income. An amount taxed as a “severance benefit” is taxed as a lump sum benefit under the retirement tax table.

Paragraph (zL): Stemming from amendments made in 2010, the term “share capital” will be replaced by the term “share” because the term “share capital” is anachronistic given the new Companies Act.

Paragraph (zM): The proposed amendment deletes a duplicated word.

Paragraph (zN): The amendment adds the definition of “share” to clarify that the term “share” includes “similar” equity interests (mainly to better account for a variety of foreign ownership interests).

Paragraph (zO): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

## **CLAUSE 8**

Income Tax: Amendment of section 5

The amendment corrects the date when the cross-reference to section 7A(4A) is deleted. More specifically, the effective date of the deletion will be moved from 1 January 2010 to 1 March 2011 (consistent with the date when severance payments are added to the lump sum formula contained in the 2<sup>nd</sup> Schedule).

## **CLAUSE 9**

Income Tax: Amendment of section 6

Paragraph (a): The amendment seeks to add “severance benefit” to the amounts which are excluded from being taxed according to the normal tax rates for natural persons. An amount taxed as a “severance benefit” is taxed as a lump sum benefit under the retirement tax table.

Paragraphs (b) to (d): See notes on **RETIREMENT: THIRD REBATE FOR OLDER PERSONS**

Paragraph (e): The rules relating to the transitional phase-out of SITE will apply solely to taxpayers whose full remuneration falls within SITE (not just the amounts attributable to “net remuneration”). These transitional rules relate to all taxes under the Income Tax Act (not just the normal tax).

## **CLAUSE 10**

Income Tax: Insertion of section 6A

See notes on **MEDICAL SCHEMES CREDIT**

#### CLAUSE 11

Income Tax: Amendment of section 6 $quat$

Paragraphs (a) to (d): See notes on **TIMING OF FOREIGN TAX REBATES**; See also notes on **UNIFICATION OF THE SOURCE RULES**

Paragraphs (e) and (f): See notes on **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

Paragraph (g): See notes on **TIMING OF FOREIGN TAX REBATES**

#### CLAUSE 12

Income Tax: Insertion of section 6 $quin$

See notes on **SPECIAL FOREIGN TAX CREDIT FOR MANAGEMENT FEES**

#### CLAUSE 13

Income Tax: Amendment of section 6 $quin$

See notes on **SPECIAL FOREIGN TAX CREDIT FOR MANAGEMENT FEES**

#### CLAUSE 14

Income Tax: Insertion of section 6 $sex$

See notes on **ANTI-AVOIDANCE: DIVIDEND CESSIONS**

#### CLAUSE 15

Income Tax: Amendment of section 7

Paragraph (a): The amendment revises legal language in line with proper technical usage.

Paragraphs (b) and (c): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### CLAUSE 16

Income Tax: Amendment of section 8

Paragraph (a): The amendment increases the maximum amount on which actual expenses in respect of wear and tear (and finance charges) may be claimed against a travel allowance. As a result of this amendment, the maximum amount is now R480 000. This amendment aligns the maximum cost of a vehicle with the maximum value of a vehicle according to the rate per kilometer table fixed by the Minister of Finance on 25 February 2011 by notice in the Gazette.

Paragraph (b): The amendment re-inserts references omitted erroneously.

#### **CLAUSE 17**

Income Tax: Amendment of section 8A

Paragraph (a): The amendment corrects a spelling error.

Paragraph (b): The amendment deletes the word “stock” because modern usage of the term “stock” suggests shares as opposed to debt.

#### **CLAUSE 18**

Income Tax: Amendment of section 8B

See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 19**

Income Tax: Amendment of section 8C

See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 20**

Income Tax: Amendment of section 8E

See notes on **ANTI-AVOIDANCE: INDEPENDENTLY SECURED OR THIRD-PARTY BACKED SHARES**

#### **CLAUSE 21**

Income Tax: Insertion of section 8EA

See notes on **ANTI-AVOIDANCE: INDEPENDENTLY SECURED OR THIRD-PARTY BACKED SHARES**

## **CLAUSE 22**

Income Tax: Substitution of section 9

See notes on **UNIFICATION OF THE SOURCE RULES**

## **CLAUSE 23**

Income Tax: Amendment of section 9A

A controlled foreign company does not technically have a “year of assessment” or “income” - only South African residents holding participating rights in that controlled foreign company have these items. The proposed changes accordingly adjust the language to reflect technically correct terms associated with a controlled foreign company – i.e. a “foreign tax year” and “net income”.

## **CLAUSE 24**

Income Tax: Amendment of section 9C

Paragraphs (a) to (c): The term “equity share” is now technically delinked from section 41 for ease of use. However, like the section 41 definition, the term “equity share” includes participatory interests in a portfolio of collective investment scheme (meaning that the disposal of these interests after three years triggers a capital gain/loss as under current law).

Paragraph (d): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (e): See notes on **INCENTIVE: VENTURE CAPITAL COMPANY REVISIONS**

Paragraph (f): As discussed above, the term “equity share” is now technically delinked from section 41 for ease of use.

Paragraph (g): The amendment merely clarifies the existing intention. The first-in-first-out timing rule should be applied only to identical shares in the same company.

## **CLAUSE 25**

Income Tax: Amendment of section 9D

Paragraphs (a) to (c): See notes on **OFFSHORE CELL COMPANIES**

Paragraph (d): See notes on **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

Paragraph (e): See notes on **TRANSFER PRICING: SECONDARY ADJUSTMENTS**

Paragraph (f): A controlled foreign company does not technically have a “year of assessment” - only South African residents holding participating rights in that controlled foreign company have these items. The proposed changes accordingly adjust the language to reflect technically correct term associated with a controlled foreign company – i.e. a “foreign tax year”.

Paragraphs (g) and (h): See notes on **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

Paragraph (i): See notes on **DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

Paragraphs (j) to (l): See notes on **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

Paragraph (m): The proposed amendment rectifies an anomaly in respect of the current election. Taxpayers mainly seek to use the election when the foreign income is subject to a high level of tax, but the high tax exception indirectly prohibits use of the election in these circumstances. The election will accordingly be allowed to override the high-tax exception. It should be noted that this change is only temporary. The election will be removed in 2012 as part of the overall controlled foreign company reforms (see paragraph (n)).

Paragraph (n): See notes on **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

#### **CLAUSE 26**

Income Tax: Insertion of section 9H

See notes on **SINGLE CHARGE FOR COMPANY EMIGRATION**

#### **CLAUSE 27**

Income Tax: Insertion of section 9I

See notes on **INCENTIVE: HEADQUARTER COMPANY ADJUSTMENTS**

#### **CLAUSE 28**

Income Tax: Amendment of section 10

Paragraph (a): The amendment now covers entities formed pursuant to the old and new companies act legislation.

Paragraph (b) and (c): See notes on **RATES AND THRESHOLDS**

Paragraph (d): The current wording refers to a share block company "established in terms of" the Share Blocks Control Act. However, the Share Blocks Control Act does not technically address the establishment of share block companies (only defining them). Therefore, it is proposed that the wording be adjusted to read "as defined in" the Share Blocks Control Act, 1980.

Paragraph (e): The amendment now covers entities formed under the old and new companies act legislation.

Paragraph (f): The proposed amendment deletes the cross-reference to the former exemption contained in section 10(1)(x) because that exemption was deleted in 2010.

Paragraph (g): See notes on **ROAD ACCIDENT FUND PAYOUTS**

Paragraph (h): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: TAXATION OF PROCEEDS PAYOUT**

Paragraph (i): See notes on **ANTI-AVOIDANCE: ACQUISITION DEBT ARISING FROM REORGANISATION ROLLOVERS**

Paragraphs (j) and (k): See notes on **RATES AND THRESHOLDS**

Paragraph (l): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (m): Automatic ordinary revenue treatment for taxpayers disposing of "trading stock" shares in a buyback is inconsistent with the new dividend definition, which treats specific buybacks as dividends. This dividend treatment should equally apply regardless of whether the shares are held as trading stock or capital. This automatic ordinary treatment is also unnecessary as an anti-avoidance mechanism given the addition of the minimum holding period rules for the dividend exemption (see notes on **ANTI-AVOIDANCE: DIVIDEND STRIPPING ADJUSTMENTS**).

Paragraph (n): See notes on **DIVIDENDS FROM EMPLOYEE SHARE-BASED TRUSTS**

Paragraph (o): See notes on **ANTI-AVOIDANCE: DIVIDEND CESSIONS** (in relation to (ee)) and **ANTI-AVOIDANCE: DIVIDENDS IN RESPECT OF BORROWED SHARES** (in relation to (ff) and (gg)).

Paragraph (p): See notes on **DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

Paragraph (q): The amendment corrects punctuation.

Paragraph (r): See notes on **EMPLOYEE COMPENSATION FUND ENTITIES**

Paragraph (s): See notes on **INCENTIVE: FILM PRODUCTION REVISIONS**

## CLAUSE 29

Income Tax: Insertion of section 10B

See notes on **DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

## CLAUSE 30

Income Tax: Amendment of section 11

Paragraph (a): The proposed amendment deletes paragraph (bA) as obsolete in light of the business start-up deduction rules contained in section 11A. The latter also allow for the deduction of pre-start-up interest expenses.

Paragraph (b): The proposed amendment deletes paragraph (hA) as obsolete in light of the revised company/trust mining rehabilitation rules contained in section 37A.

Paragraph (c): The amendment seeks to add “severance benefit” to amounts which a taxpayer may not take into account when calculating the permissible deduction for retirement annuity fund contributions. An amount taxed as a “severance benefit” is taxed as a lump sum benefit under the retirement tax table.

Paragraph (d): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: EMPLOYER CONTRIBUTIONS AS A TAXABLE FRINGE BENEFIT**

## CLAUSE 31

Income Tax: Repeal of section 11C

Taxpayers cannot deduct interest incurred for domestic shares due to the exemption of domestic dividends from normal tax (even though dividends trigger a separate 10 per cent charge under both the Secondary Tax on Companies and under the proposed withholding tax). The proposed amendments essentially place foreign dividends on par with domestic dividends, being subject to an overall maximum effective tax rate of 10 per cent. It is accordingly proposed that deductions be similarly disallowed in respect of expenditures incurred to acquire foreign shares.

## CLAUSE 32

Income Tax: Substitution of section 11D

See notes on **INCENTIVE: RESEARCH AND DEVELOPMENT REVISIONS**

## CLAUSE 33

Income Tax: Amendment of section 12C



Paragraphs (a) to (c): See notes on **INCENTIVE: RESEARCH AND DEVELOPMENT REVISIONS**

Paragraph (d): The proposed amendment makes provision for foundations and supporting structures on which a plant is mounted (or to which it is fixed) to be deemed part of that plant and to be eligible for the same deductions as the plant. This situation is set out in Practice Note 16, dated 12 March 1993. SARS has embarked on a process of repealing all practice notes. It is now proposed that this position instead be codified in the Income Tax Act. A similar provision already exists in paragraph (iiA) of the proviso to section 11(e).

#### **CLAUSE 34**

Income Tax: Amendment of section 12E

Paragraph (a): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (b): The definition of "small business corporation" in subsection (4) (a) refers to certain close corporations, co-operatives or companies. However, the definition of "personal service" in subsection (4) (d) only relates to a company or close corporation. The proposed amendment broadens the definition to include co-operatives in the definition of "personal service" to align the definition with the "small business corporation" definition.

#### **CLAUSE 35**

Income Tax: Amendment of section 12G

The proposed amendments contain grammatical and punctuation changes.

#### **CLAUSE 36**

Income Tax: Amendment of section 12H

The additional allowance for learnerships is extended by another five years.

#### **CLAUSE 37**

Income Tax: Amendment of section 12I

Paragraphs (a) to (d): See notes on **INCENTIVE: INDUSTRIAL POLICY PROJECT REVISION**

Paragraph (e): The amendment contains grammatical change.

#### **CLAUSE 38**

Income Tax: Amendment of section 12J

See notes on **INCENTIVE: VENTURE CAPITAL COMPANY REVISIONS**

#### **CLAUSE 39**

Income Tax: Insertion of section 12O

See notes on **INCENTIVE: FILM PRODUCTION REVISIONS**

#### **CLAUSE 40**

Income Tax: Amendment of section 13

See notes on **INCENTIVE: RESEARCH AND DEVELOPMENT REVISIONS**

#### **CLAUSE 41**

Income Tax: Amendment of section 13*quat*

Paragraph (a): The depreciation allowance for urban development zones can generally be used either by developers or first-purchasers (the first party purchasing the property from the developer). The first-purchaser cannot claim the depreciation allowance if already claimed by the developer. At issue is another requirement that prevents the developer from claiming the depreciation allowance if the property is used for anything other than sale. This same requirement also prevents the purchaser from claiming the allowance even if the allowance was never claimed by the developer.

With the advent of the global economic downturn, certain developers are temporarily renting their properties to maintain cash-flow due to a lack of sales. This temporary rental of property unfortunately prevents both the developer and first-purchaser from claiming the depreciation allowance. This result appears to be overly punitive. It is proposed that the developer be allowed to undertake temporary rentals for up to three years without jeopardizing the depreciation allowance. It should be noted that this relief roughly matches the three-year relief for temporarily rentals by developers registered for VAT (see note on **TEMPORARY RELIEF FOR THE RENTAL OF RESIDENTIAL PROPERTY BY DEVELOPERS**)

Paragraph (b): Consistent with other aspects of the urban development zone depreciation allowance, the allowance applies to purchases of the entire building or part of the building.

#### **CLAUSE 42**

Income Tax: Amendment of section 14

The proposed amendment eliminates a cross-reference to a deleted provision.

#### **CLAUSE 43**

Income Tax: Amendment of section 18

Paragraphs (a) and (b): See notes on **MEDICAL SCHEME CREDITS**

Paragraph (c): See notes on **RATES AND THRESHOLDS**

Paragraphs (d) and (e): See notes on **MEDICAL SCHEME CREDITS**

Paragraph (f): The proviso to subsection (4) relates to payment of tax in terms of section 5(1A), which has been deleted. The proviso is accordingly deleted as obsolete.

Paragraph (g): See notes on **MEDICAL SCHEME CREDITS**

#### **CLAUSE 44**

Income Tax: Amendment of section 18A

See notes on **DIVIDENDS TAX: COLLECTIVE INVESTMENT SCHEME ADJUSTMENTS (AND ISLAMIC FINANCE RELIEF)**

#### **CLAUSE 45**

Income Tax: Amendment of section 22

See notes on **DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

#### **CLAUSE 46**

Income Tax: Substitution of section 22B

See notes on **ANTI-AVOIDANCE: DIVIDEND STRIPPING ADJUSTMENTS**

#### **CLAUSE 47**

Income Tax: Amendment of section 23

Paragraphs (a) and (b): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: EMPLOYER CONTRIBUTIONS AS A TAXABLE FRINGE BENEFIT**

Paragraph (c): Taxpayers cannot deduct interest incurred for domestic shares due to the exemption of domestic dividends from normal tax (even though dividends trigger a separate 10 per cent charge under both the Secondary Tax on Companies and under the proposed withholding tax). The proposed amendments essentially place foreign dividends on par with domestic dividends, being subject to an overall maximum effective tax rate of 10 per cent. It is accordingly proposed that deductions be similarly disallowed in respect of expenditures incurred to acquire foreign shares.

#### **CLAUSE 48**

Income Tax: Amendment of section 23B

Paragraph (a): See notes on **INCENTIVE: RESEARCH AND DEVELOPMENT REVISIONS**

Paragraph (b): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: KEYPERSON RISK PLANS**

#### **CLAUSE 49**

Income Tax: Insertion of section 23K

See notes on **ANTI-AVOIDANCE: ACQUISITION DEBT ARISING FROM REORGANISATION ROLLOVERS**

#### **CLAUSE 50**

Income Tax: Amendment of section 23K

See notes on **ANTI-AVOIDANCE: ACQUISITION DEBT ARISING FROM REORGANISATION ROLLOVERS**

#### **CLAUSE 51**

Income Tax: Repeal of section 24F

See notes on **INCENTIVE: FILM PRODUCTION REVISIONS**

#### **CLAUSE 52**

Income Tax: Amendment of section 24I

See notes on **FOREIGN CURRENCY: FOREIGN SHARE ACQUISITION HEDGES**

### **CLAUSE 53**

Income Tax: Amendment of section 24J

Paragraphs (a) and (b): See notes on **ANTI-AVOIDANCE: DEBT WITHOUT SET MATURITY DATES**

Paragraph (c): The amendment deletes the word “stock” because modern usage of the term “stock” suggests shares as opposed to debt.

Paragraph (d): See notes on **ANTI-AVOIDANCE: DEBT WITHOUT SET MATURITY DATES**

### **CLAUSE 54**

Income Tax: Amendment of section 24JA

See notes on **ISLAMIC FINANCE: ADJUSTMENTS TO THE 2010 LEGISLATION** and see notes on **ISLAMIC FINANCE: PROPOSED SUKUK**

### **CLAUSE 55**

Income Tax: Amendment of section 25BA

See notes on **DIVIDENDS TAX: COLLECTIVE INVESTMENT SCHEME ADJUSTMENTS (AND ISLAMIC FINANCE RELIEF)**

### **CLAUSE 56**

Income Tax: Amendment of section 30B

The amendment clarifies the implicit notion that the general rule of subsection (2) is subject to the additional conditions of subsections (3) and (4).

### **CLAUSE 57**

Income Tax: Substitution of section 31

The amendment simplifies section 31. See notes on **TRANSFER PRICING: SECONDARY ADJUSTMENTS**

### **CLAUSE 58**

Income Tax: Amendment of section 35

See notes on **UNIFICATION OF THE SOURCE RULES**

**CLAUSE 59**

Income Tax: Amendment of section 35A

The amendment corrects a grammatical error.

**CLAUSE 60**

Income Tax: Amendment of section 36

See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

**CLAUSE 61**

Income Tax: Amendment of section 37J

Paragraph (a): See notes on **UNIFICATION OF THE SOURCE RULES**

Paragraph (b): The exclusion for controlled foreign companies is moved from section 37J(2) to section 37K; see also notes on **CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS**

**CLAUSE 62**

Income Tax: Insertion of section 37JA

See notes on **CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS**

**CLAUSE 63**

Income Tax: Amendment of section 37K

Paragraph (a): See notes on **CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS**

Paragraph (b): The terms are adjusted in accordance with the explicit definition of “foreign resident” contained in section 37I.

Paragraph (c) to (e): The exclusion for controlled foreign companies is moved from section 37J(2) to section 37K.

#### **CLAUSE 64**

Income Tax: Amendment of section 37L

See notes on **CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS**

#### **CLAUSE 65**

Income Tax: Substitution of section 37M

See notes on **CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS**

#### **CLAUSE 66**

Income Tax: Insertion of section 37N

See notes on **CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS**

#### **CLAUSE 67**

Income Tax: Amendment of section 41

Paragraphs (a) and (b): See notes on **INCENTIVE: HEADQUARTER COMPANY ADJUSTMENTS**

Paragraph (c): The amendment deletes an obsolete reference.

Paragraphs (d) and (e): The amendment updates the company legislation references from coverage of the 1973 Companies Act to coverage of the 2008 Companies Act.

Paragraphs (f) and (g): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 68**

Income Tax: Amendment of section 42

Paragraph (a) to (c) : See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

Paragraph (d) : See notes on **DIVIDENDS TAX: CONTRIBUTED TAX CAPITAL ADJUSTMENTS**

Paragraph (e): Although assets received by a company in a section 42 “asset-for-share transaction” generally have a carryover base cost, a fair market value tax cost applies in the case of listed shares transferred (and in the case of collective investment scheme interests transferred). It is now proposed that this fair market deviation must be reflected when determining contributed tax capital (because contributed tax capital derived from an “asset-for-share transaction” mirrors the tax cost of the shares received in a section 42 transfer).

Paragraph (f): See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

Paragraph (g): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (h): Because most taxpayers prefer to fall within rollover treatment, taxpayers falling within the conditions of “asset-for-share transactions” receive the benefit of rollover treatment unless the parties agree otherwise. However, transferring parties falling completely outside of South African taxing jurisdiction generally prefer to avoid rollover treatment because the assets transferred effectively receive a market value tax cost without any upfront taxation (regardless of the reorganisation rollover rules). It was accordingly intended that asset transfers from parties wholly outside South African taxing jurisdiction be excluded from rollover treatment. The exclusion, however, failed to account for potential taxation under the controlled foreign company regime. It is accordingly proposed that the exclusion from rollover treatment apply only where transferor lacks: (i) taxable income (or assessed loss), and (ii) section 9D net income.

## **CLAUSE 69**

Income Tax: Amendment of section 44

Paragraph (a): See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

Paragraph (b): Under current law, target shareholders fall within amalgamation rollover treatment only if these shareholders have a qualifying interest (often requiring a 20 per cent minimum equity stake). The qualifying interest requirement operates separately from other aspects of the amalgamation rollover rules. The net result may mean that rollover treatment applies at the entity level but not the shareholder level. This split treatment gives rise to technical anomalies and can be unfair to minority shareholders who may be “involuntary” participants. The qualifying interest requirement for the target shareholders will accordingly be dropped.

Paragraph (c): See notes on **ANTI-AVOIDANCE: ACQUISITION DEBT ARISING FROM REORGANISATION ROLLOVERS**

Paragraphs (d) and (e): See the discussion in respect of paragraph (b) above.

Paragraphs (f) and (g): See notes on **DIVIDENDS TAX: REORGANISATION MITIGATION**



Paragraph (g) to (h): In order for “amalgamation transaction” rollover treatment to apply, the amalgamated company must be liquidated within a set period. Failure to satisfy this deadline triggers gain. A proviso is added to ensure that any tax resulting from this failure to liquidate will be recoverable from the resultant company. This liability for the resultant company in an amalgamation matches the liability for holding company transferees in a “failed” rollover liquidation.

Paragraph (i): The amendment updates the references to collective investment schemes in accordance with recent changes to the section 1 definitions.

Paragraph (j): The amendment updates a cross-reference.

Paragraph (k): See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

## CLAUSE 70

Income Tax: Amendment of section 45

Paragraph (a): See notes on **ANTI-AVOIDANCE: INTRA-GROUP ROLLOVER CONSIDERATION**

Paragraph (b): The amendment deletes a superfluous word.

Paragraph (c): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

## CLAUSE 71

Income Tax: Amendment of section 46

Paragraph (a) and (b): See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

Paragraph (c): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES** and **DIVIDENDS TAX: REORGANISATION MITIGATION**

Paragraph (d): See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

Paragraph (e): In 2009, the “election-out” mechanism from rollover treatment in the case of most reorganisations was changed to a written agreement among the parties to avoid confusion about whether a need existed to submit this election to SARS. Yet, the “election-out” mechanism has inadvertently remained in the case of unbundlings. This mechanism will accordingly be changed to a written agreement mechanism consistent with the other reorganisation provisions.

## CLAUSE 72

Income Tax: Amendment of section 47

Paragraphs (a) to (e): See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

Paragraph (f) and (g): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (h) and (i): See notes on **CONTROLLED FOREIGN COMPANY (CFC) RESTRUCTURING**

#### **CLAUSE 73**

Income Tax: Substitution of section 57

- 6.3. See notes on DIVIDENDS TAX: REMOVAL OF THE VALUE-EXTRACTION TAX (VET) and see notes on DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 74**

Income Tax: Amendment of section 64C

Paragraphs (a) and (b): The amendment updates the company legislation references from coverage of the 1973 Companies Act to coverage of the 2008 Companies Act.

Paragraph (c): The proposed amendment eliminates the potential overlap between actual and deemed dividends when applying the Secondary Tax on Companies. More specifically, a deemed dividend cannot arise if an actual dividend exists.

Paragraph (d): An exemption from deemed dividend treatment exists in the case of loans to trusts so that these trusts can acquire shares for the benefit of employees. However, in practical terms, this exemption is slightly too narrow. The exemption will accordingly be expanded to cover 7<sup>th</sup> schedule associated institutions (not just the company or a controlling company).

#### **CLAUSE 75**

Income Tax: Amendment of section 64D

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

#### **CLAUSE 76**

Income Tax: Amendment of section 64E

Paragraph (a): See notes on **DIVIDENDS TAX: ACCRUAL VERSUS CASH ACCOUNTING**

Paragraph (b): See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

Paragraph (c): See notes on **DIVIDENDS TAX: REMOVAL OF THE VALUE EXTRACTION TAX (VET)**

#### **CLAUSE 77**

Income Tax: Insertion of section 64EA

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

#### **CLAUSE 78**

Income Tax: Amendment of section 64F

Paragraph (a) and (b): See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

Paragraph (c): The exemptions dealing with residential property distributions under paragraph 51A of the 8<sup>th</sup> Schedule have been moved to section 64FA (specifically dealing with distributions *in specie*).

#### **CLAUSE 79**

Income Tax: Insertion of section 64FA

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

#### **CLAUSE 80**

Income Tax: Amendment of section 64G

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

#### **CLAUSE 81**

Income Tax: Amendment of section 64H

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

## CLAUSE 82

Income Tax: Substitution of section 64I

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

## CLAUSE 83

Income Tax: Amendment of section 64J

The proposed technical changes in wording stem from changes in the dividend definition and in the trigger for the Dividends Tax (from accrual to payment). These changes clarify the transitional effective date between the Secondary Tax on Companies to the Dividends Tax.

## CLAUSE 84

Income Tax: Amendment of section 64K

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS** and **DIVIDENDS TAX: COLLECTIVE INVESTMENT SCHEME ADJUSTMENTS (AND ISLAMIC FINANCE RELIEF)**

## CLAUSE 85

Income Tax: Repeal of Part IX

See notes on **DIVIDENDS TAX: REMOVAL OF THE VALUE-EXTRACTION TAX**

## CLAUSE 86

Income Tax: Amendment of section 68

The amendment revises legal language in line with proper technical usage.

## CLAUSE 87

Income Tax: Amendment of section 80T

The term “arrangement” for purposes of reportable arrangements is being changed in line with the term “arrangement” as used for impermissible avoidance arrangements (i.e. section 80L)).

#### **CLAUSE 88**

Income Tax: Amendment of section 101

The proposed amendment updates the reference to collective investment schemes in line with recent changes to the section 1 definition.

#### **CLAUSE 89**

Income Tax: Amendment of section 103

See notes on **ANTI-AVOIDANCE: DIVIDEND CESSIONS**

#### **CLAUSE 90**

Income Tax: Amendment of paragraph 2C of the Second Schedule

The amendment corrects the reference to the Pension Funds Act, 1956

#### **CLAUSE 91**

Income Tax: Amendment of paragraph 4 of the Second Schedule

The amendment clarifies that the general timing rules are subject to paragraphs 3 and 3A dealing with the death of members, former members and the death of successor members.

#### **CLAUSE 92**

Income Tax: Amendment of paragraph 6 of the Second Schedule.

The basic philosophy for permitted transfers between retirement savings funds is to permit the transfer of less restrictive funds to equal or more restrictive funds. The amendment accordingly permits all fund transfers to retirement annuity funds (the most restrictive type of retirement fund).

#### **CLAUSE 93**

Income Tax: Amendment of paragraph 1 of the Fourth Schedule

Paragraph (a): The proposed amendment improves the technical linkage to the entities described in section 10(1)(e) as initially intended.

Paragraph (b): The amendment improves the technical linkage to the language of Seventh Schedule as initially intended.

#### **CLAUSE 94**

Income Tax: Amendment of paragraph 2 of the Fourth Schedule

Paragraph (a): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: EMPLOYER CONTRIBUTIONS AS A TAXABLE FRINGE BENEFIT**

Paragraphs (a) and (b): See notes on **MEDICAL SCHEME CREDITS**

#### **CLAUSE 95**

Income Tax: Amendment of paragraph 9 of the Fourth Schedule

See notes on **MEDICAL SCHEME CREDITS**

#### **CLAUSE 96**

Income Tax: Amendment of paragraph 18 of the Fourth Schedule

See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 97**

Income Tax: Amendment of paragraph 3 of the Sixth Schedule

See notes on **SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF**

#### **CLAUSE 98**

Income Tax: Amendment of paragraph 6 of the Sixth Schedule

See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 99**

Income Tax: Amendment of paragraph 8 of the Sixth Schedule

See notes on **SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF**

## **CLAUSE 100**

Income Tax: Amendment of paragraph 10 of the Sixth Schedule

See notes on **SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF**

## **CLAUSE 101**

Income Tax: Amendment of paragraph 1 of the Seventh Schedule

Paragraph (a): The amendment deletes a superfluous word.

Paragraph (b); See notes on **UNIFICATION OF THE SOURCE RULES**

Paragraph (c): The amendment intends to add amounts taxed as a “severance benefit” to the definition of “taxable benefit”. An amount taxed as a “severance benefit” is taxed as a lump sum benefit under the retirement tax table.

## **CLAUSE 102**

Income Tax: Amendment of paragraph 2 of the Seventh Schedule

Paragraph (a): Subparagraph (a) relates to the right of an employee to private use of assets as an employee fringe benefit. The value of this use is determined in accordance with paragraphs 6 and 7. The proposed amendment deletes the references to specific subparagraphs because these paragraphs need to be read in their entirety.

Paragraph (b) and (c): See notes on **EMPLOYER-OWNED INSURANCE POLICIES: EMPLOYER CONTRIBUTIONS AS A TAXABLE FRINGE BENEFIT**

## **CLAUSE 103**

Income Tax: Amendment of paragraph 7 of the Seventh Schedule

See notes on **JUDICIAL LONG DISTANCE COMMUTING**

## **CLAUSE 104**

Income Tax: Amendment of paragraph 9 of the Seventh Schedule

See notes on **RATES AND THRESHOLDS**

## **CLAUSE 105**

Income Tax: Amendment of paragraph 12A of the Seventh Schedule

See notes on **MEDICAL SCHEME CREDITS**

#### **CLAUSE 106**

Income Tax: Insertion of paragraph 12C in the Seventh Schedule

See notes on **EMPLOYER-OWNED INSURANCE POLICIES: EMPLOYER CONTRIBUTIONS AS A TAXABLE FRINGE BENEFIT**

#### **CLAUSE 107**

Income Tax: Amendment of paragraph 5 of the Eighth Schedule

See notes on **RATES AND THRESHOLDS**

#### **CLAUSE 108**

Income Tax: Amendment of paragraph 12 of the Eighth Schedule

See notes on **SINGLE CHARGE FOR COMPANY EMIGRATION**

#### **CLAUSE 109**

Income Tax: Amendment of paragraph 19 of the Eighth Schedule

See notes on **ANTI-AVOIDANCE: DIVIDEND STRIPPING ADJUSTMENTS**

#### **CLAUSE 110**

Income Tax: Amendment of paragraph 20 of the Eighth Schedule

See notes on **DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

#### **CLAUSE 111**

Income Tax: Amendment of paragraph 43 of the Eighth Schedule

See notes on **FOREIGN CURRENCY: REPEAL OF CAPITAL GAIN RULES**

#### **CLAUSE 112**

Income Tax: Substitution of paragraph 43A of the Eighth Schedule



Paragraph (a) to (c): See notes on **ANTI-AVOIDANCE: DIVIDEND STRIPPING ADJUSTMENTS**

### **CLAUSE 113**

Income Tax: Amendment of paragraph 51A of the Eighth Schedule

Paragraph (a): The proposed amendment updates a heading.

Paragraphs (b) and (c): The technical language relating to the potential transferees of residential property entities creates unnecessary anomalies. The law is clarified to state that these transferees must be connected persons to the liquidating entity (i.e. company or trust), and those connected persons mainly used the residential property for domestic (i.e. non-business) purposes. These persons typically involve the founding family member, the spouse or the dependents who use the property for personal use.

Paragraph (d): As under current law, taxpayers holding residential property in a company or trust must terminate the company or trust as a condition for relief. The proposed amendment adjusts the rules for terminating trusts to be more flexible in line with the rule for companies. Under the revised rule, trusts must take steps to terminate within six months (without the legislation describing the actual specifics).

Paragraph (e): The amendment corrects an erroneous cross-reference.

Paragraph (f): In line with the rest of the subparagraph, the reference should be to a “company” as opposed to a “trust”.

Paragraph (g): The company or trust limitation applies to transferors, not transferees. The “company or trust” language is accordingly dropped.

Paragraph (h): As under current law, companies or trust shareholders holding residential property entities must be terminated as a condition for relief (like the required termination of the residential property entity). The proposed amendment adjusts the rules for terminating trust shareholders to be more flexible in line with the rule for company shareholders. Under the revised rule, trust shareholders must take steps to terminate within six months (without the legislation describing the actual specifics).

Paragraph (i): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

### **CLAUSE 114**

Income Tax: Amendment of paragraph 55 of the Eighth Schedule

See notes on **EMPLOYER-OWNED INSURANCE POLICIES: TAXATION OF PROCEEDS PAYOUT**

### **CLAUSE 115**

Income Tax: Amendment of paragraph 57 of the Eighth Schedule

See notes on **RATES AND THRESHOLDS**

#### **CLAUSE 116**

Income Tax: Amendment of paragraph 64B of the Eighth Schedule

Paragraph (a): See notes on **INCENTIVE: HEADQUARTER COMPANY ADJUSTMENTS**

Paragraph (b): See notes on **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

Paragraphs (c) to (e): See notes on **INCENTIVE: HEADQUARTER COMPANY ADJUSTMENTS**

Paragraphs (f) and (g): See notes on **DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

Paragraph (h): See notes on **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

Paragraph (i): See notes on **DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS**

Paragraph (j): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES** and **REFORM OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME**

#### **CLAUSE 117**

Income Tax: Amendment of paragraph 74 of the Eighth Schedule

Paragraph (a): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (b): See notes on **DIVIDENDS TAX: ACCRUAL VERSUS CASH ACCOUNTING**

Paragraph (c) and (d): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 118**

Income Tax: Amendment of paragraph 75 of the Eighth Schedule

See notes on **DIVIDENDS TAX: IN SPECIE DIVIDENDS**

#### **CLAUSE 119**

Income Tax: Amendment of paragraph 76 of the Eighth Schedule

Paragraph (a): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (b): See notes on **DIVIDENDS TAX: REVISED TREATMENT OF CAPITAL DISTRIBUTIONS** and **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

Paragraph (c): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**. The term "paid" in reference to expenditure is also deleted as obsolete in respect of the Eighth Schedule.

#### **CLAUSE 120**

Income Tax: Amendment of paragraph 76A of the Eighth Schedule

See notes on **DIVIDENDS TAX: REVISED TREATMENT OF CAPITAL DISTRIBUTIONS** and **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 121**

Income Tax: Insertion of paragraph 76B of the Eighth Schedule

See notes on **DIVIDENDS TAX: REVISED TREATMENT OF CAPITAL DISTRIBUTIONS**

#### **CLAUSE 122**

Income Tax: Amendment of paragraph 77 of the Eighth Schedule

See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 123**

Income Tax: Amendment of paragraph 78 of the Eighth Schedule

Paragraph (a): The proposed amendment restores the capital gains rules for share distributions. Shares received via a distribution generally have a base cost of nil because share distributions generally fall outside the dividend definition. To the extent a share distribution qualifies as a dividend (under prior, current or proposed law), the shares are deemed to have a base cost equal to the amount recognised as a dividend.

Paragraph (b): See notes on **DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES**

#### **CLAUSE 124**

Income Tax: Repeal of Part XIII of the Eighth Schedule

See notes on **FOREIGN CURRENCY: REPEAL OF CAPITAL GAIN RULES**

#### **CLAUSE 125**

Income Tax: Amendment of paragraph 8 of the Tenth Schedule

In 2010, the oil and gas right definition applicable to Tenth Schedule oil and gas relief was modified for technical deficiencies. These modifications are now being made to the definition required for fiscal stability under the same Schedule.

#### **CLAUSE 126**

Custom & Excise: Amendment of section 47B

The air passenger tax on international flights to destinations in non-member countries (i.e. countries that are not member states of the South African Customs Union) will be increased from R150 to R190 as from the date of 1 October 2011. It should be noted that the air passenger tax on flights to destinations in member states will also be increased from R80 to R100 from 1 October 2011 (this latter change will be published by notice in the Government Gazette).

#### **CLAUSE 127**

Custom & Excise: Amendment of Schedule 1

This clause provides for the amendment of the rates of duty on alcoholic and tobacco products in Schedule No. 1 with two sets of effective dates:

- Appendix II to this Bill arises from the Budget Review proposals tabled by the Minister of Finance on 23 February 2011. Subject to section 58(1) of the Customs and Excise Act, 1964, Appendix is deemed to have come into operation on 23 February 2011.
- Appendix III of this Bill applies from 1 March 2011.

#### **CLAUSE 128**

Custom & Excise: Continuation of amendments of Schedules

This clause provides for the continuation, withdrawal or insertion of amendments in the Schedules to the Customs and Excise Act made during the period from 1 August 2010 until the close of 31 July 2011.

#### **CLAUSE 129**

Value-Added Tax: Amendment of section 1

Paragraph (a): See notes on **EMPLOYEE COMPENSATION FUND ENTITIES**

Paragraph (b): See notes on **ISLAMIC FINANCE: PROPOSED SUKUK**

Paragraph (c): See notes on **DELINKING VAT FROM TRANSFER DUTY**

#### **CLAUSE 130**

Value-Added Tax: Amendment of section 2

Paragraph (a): The amendment updates the references to financial accounting addressing financial instruments.

Paragraph (b): The amendment deletes the reference to “superannuation scheme” and replaces that definition with the current retirement savings definitions within section 1 of the Income Tax.

#### **CLAUSE 131**

Value-Added Tax: Amendment of section 8

See notes on **SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF**

#### **CLAUSE 132**

Value-Added Tax: Amendment of section 8A

See notes on **ISLAMIC FINANCE: ADJUSTMENTS TO THE 2010 LEGISLATION**

#### **CLAUSE 133**

Value-Added Tax: Amendment of section 10

Paragraph (a): See notes on **SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF**

Paragraph (b): See notes on **TEMPORARY RELIEF FOR THE RENTAL OF RESIDENTIAL PROPERTY BY DEVELOPERS**

#### **CLAUSE 134**

Value-Added Tax: Amendment of section 11

See notes on **CLARIFICATION OF ZERO RATING FOR MINING RIGHT CONVERSIONS**

#### **CLAUSE 135**

Value-Added Tax: Amendment of section 13

See notes on **INTRA-WAREHOUSE TRANSFERS**

#### **CLAUSE 136**

Value-Added Tax: Amendment of section 14

See notes on **MINIMUM VAT EXEMPTION FOR IMPORTED SERVICES**

#### **CLAUSE 137**

Value-Added Tax: Amendment of section 16

Paragraph (a): The amendment corrects punctuation and clarifies that the supply refers to the supply of both goods and services.

Paragraphs (b) to (d): See notes on **DELINKING VAT FROM TRANSFER DUTY**

Paragraphs (e) and (f): See notes on **INPUT CREDITS IN RESPECT OF DISCOUNT VOUCHERS**

#### **CLAUSE 138**

Value-Added Tax: Amendment of section 18

See notes on **DELINKING VAT FROM TRANSFER DUTY**

#### **CLAUSE 139**

Value-Added Tax: Insertion of section 18B

**6.4.** See notes on **TEMPORARY RELIEF FOR THE RENTAL OF RESIDENTIAL PROPERTY BY DEVELOPERS**

#### **CLAUSE 140**

Value-Added Tax: Amendment of section 22

See notes on **DEFERRED CHARGE FOR UNPAID GROUP MEMBER DEBT**

#### **CLAUSE 141**

Value-Added Tax: Amendment of section 23

See notes on **SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF**

#### **CLAUSE 142**

Value-Added Tax: Amendment of section 58

See notes on **TEMPORARY RELIEF FOR THE RENTAL OF RESIDENTIAL PROPERTY BY DEVELOPERS**

#### **CLAUSE 143**

Value-Added Tax: Amendment to Schedule 1

See notes on **SYNCHRONISING VAT AND CUSTOMS RELIEF FOR TEMPORARY IMPORTS**

#### **CLAUSE 144**

Unemployment Insurance Contributions: Amendment to Section 4

The proposed amendment excludes various government officials (including members of Parliament, the National assembly, municipal council and Council of Traditional Leaders) from being required to make unemployment insurance contributions. These parties are excluded because these persons do not receive corresponding Unemployment Insurance Fund benefits.

#### **CLAUSE 145**

Securities Transfer Tax: Amendment to Section 1

Dividend cessions will no longer be subject to the Securities Transfer Tax in view of the fact that dividend cessions will now be treated as ordinary revenue for purposes of the Income Tax Act. In essence, dividend cessions are viewed as an income right totally independent of the underlying shares.

#### **CLAUSE 146**

Securities Transfer Tax: Amendment to Section 4

Dividend cessions are being removed from the ambit of the Securities Transfer because these cessions are now treated as ordinary revenue for Income Tax purposes (i.e. no longer viewed as part of the security).

#### **CLAUSE 147**

Securities Transfer Tax: Amendment to Section 5

Dividend cessions are being removed from the ambit of the Securities Transfer because these cessions are now treated as ordinary revenue for Income Tax purposes (i.e. no longer viewed as part of the security).

#### **CLAUSE 148**

Securities Transfer Tax: Amendment to Section 8

Paragraph (a): The national restructuring of regional electricity distributors will no longer proceed as planned. Therefore, the exemption of the securities transfer tax to facilitate that restructuring is no longer necessary.

Paragraph (b): See notes on **SECURITIES TRANSFER TAX: TEMPORARY ADJUSTMENT TO THE BROKER-MEMBER EXEMPTION**

#### **CLAUSE 149**

Securities Transfer Tax: Substitution of section 8A

See notes on **ISLAMIC FINANCE: ADJUSTMENTS TO THE 2010 LEGISLATION**

#### **CLAUSE 150**

Royalty Act: Amendment to 8A of the Mineral and Petroleum Resources Royalty Act

This amendment corrects the heading relating to rollover relief in respect of the transfer of mineral resources between extractors.

#### **CLAUSE 151**



Royalty Act: Amendment to section 10 of the Mineral and Petroleum Resources Royalty Act

Members of an unincorporated body of persons may elect that the unincorporated body are deemed to be a person for the period the election. This election is essential for the unincorporated body to register for the royalty. The proposed amendment improves the literal ties to the word in the election contained in section 4 of the Mineral and Petroleum Resources Royalty (Administration) Act.

#### **CLAUSE 152**

Royalty Act: Amendment of section 15 to the Mineral and Petroleum Resources Royalty Act

This amendment allows an oil and gas company to utilise the average exchange rate when translating amounts received or accrued, or expenditures or losses incurred, in a foreign currency. This rule matches the translation rules relating to oil and gas companies as contained in the Income Tax.

#### **CLAUSE 153**

Royalty Act: Amendment of Schedule 2 to the Mineral and Petroleum Resources Royalty Act

This amendment correctly reflects the first saleable point for vanadium.

#### **CLAUSE 154**

Amendment of section 4 of Act 60 of 2008

The proposed amendment rectifies incorrect effective dates relating to the definition of "dividend".

#### **CLAUSE 155**

Revenue Laws Amendment Act, 2008: Amendment of section 14 of Act 60 of 2008

The proposed amendment postpones the effective date of section 9E (deals with passive holding companies) to 1 April 2013.

#### **CLAUSE 156**

Taxation Laws Amendment Act, 2009: Repeal of section 55 of Act 17 of 2009

The proposed amendment repeals an amendment to section 102 of the Income Tax Act, 1962, on the basis that the amendment to section 102 is no longer necessary in light of subsequent changes to the dividends tax withholding rules.

#### **CLAUSE 157**

Taxation Laws Amendment Act, 2009: Amendment of section 69 of Act 17 of 2009

See notes on **ANTI-AVOIDANCE: DIVIDEND STRIPPING ADJUSTMENTS**

#### **CLAUSE 158**

Taxation Laws Amendment Act, 2009: Repeal of section 79 of Act 17 of 2009

See notes on **DIVIDENDS TAX: REVISED TREATMENT OF CAPITAL DISTRIBUTIONS**

#### **CLAUSE 159**

Taxation Laws Amendment Act, 2010: Amendment of section 6 of Act 7 of 2010

The proposed amendment rectifies an incorrect effective date relating to the “foreign partnership” definition.

#### **CLAUSE 160**

Taxation Laws Amendment Act, 2010: Amendment of section 18 of Act 7 of 2010

Paragraph (a): Repeals the 2010 amendments in respect of employer-owned insurance policies. See the notes on **EMPLOYER-OWNED INSURANCE POLICIES: CESSION OF COMPENSATION AND PURE RISK POLICIES**

Paragraph (b) and (c): The proposed amendment inserts a missing effective date relating to the Companies Act, 2008.

#### **CLAUSE 161**

Taxation Laws Amendment Act, 2010: Amendment of section 19 of Act 7 of 2010

Repeals the 2010 amendments in respect of employer-owned insurance policies. See the notes on **EMPLOYER-OWNED INSURANCE POLICIES: EMPLOYER CONTRIBUTIONS AS A TAXABLE FRINGE BENEFIT** and **EMPLOYER-OWNED INSURANCE POLICIES: KEYPERSON RISK PLANS**.

#### **CLAUSE 162**

Taxation Laws Amendment Act, 2010: Repeal of section 41 of Act 7 of 2010

Repeals the 2010 amendments in respect of employer-owned insurance policies. See the notes on **EMPLOYER-OWNED INSURANCE POLICIES: CESSION OF COMPENSATION AND PURE RISK POLICIES**

#### **CLAUSE 163**

Taxation Laws Amendment Act, 2010: Repeal of section 42 of Act 7 of 2010

Repeals the 2010 amendments in respect of employer-owned insurance policies. See the notes on **EMPLOYER-OWNED INSURANCE POLICIES: KEYPERSON RISK PLANS**.

#### **CLAUSE 164**

Taxation Laws Amendment Act, 2010: Amendment of section 46 of Act 7 of 2010

The proposed amendment rectifies an incorrect effective date relating to the “foreign partnership” definition.

#### **CLAUSE 165**

Taxation Laws Amendment Act, 2010: Repeal of section 56 of Act 7 of 2010

See notes on **TRANSFER PRICING: SECONDARY ADJUSTMENTS**

#### **CLAUSE 166**

Taxation Laws Amendment Act, 2010: Amendment of section 137 of Act 7 of 2010

The proposed amendment is consequential to the change to the first saleable point for vanadium (see Clause 159).

#### **CLAUSE 167**

Taxation Laws: Amendment of section 138 of the Taxation Laws Amendment Act, 2010

The proposed amendment rectifies incorrect effective dates relating to the definition of “dividend”.

### **CLAUSE 168**

Taxation Laws: Amendment of section 145 of the Taxation Laws Amendment Act, 2010

The proposed amendment rectifies incorrect effective dates relating to the definition of “dividend”.

### **CLAUSE 169**

Two special zero-ratings for the Value-added Tax are added in respect of goods and services supplied by Cricket South Africa. The first zero-rating relates to the International Cricket Council Championship Trophy South African (2009) event. The second zero-rating relates to the Champions League Twenty20 (2010) event.

### **CLAUSE 170**

Short title and commencement

This clause contains the default effective date of amendments to the Income tax Act, 1962

### **APPENDIX I**

See notes on **RATES AND THRESHOLDS**