NATIONAL
TREASURY

**REPUBLIC OF SOUTH AFRICA**

# EXPLANATORY MEMORANDUM

# ON THE

# TAXATION LAWS AMENDMENT BILL, 2013

**4 July 2013**

This Explanatory Memorandum provides background information and a guide on the amendments contained in the Draft Taxation Laws Amendment Bill, 2013.

**ANNEXURE B**

[W.P. –- '13]

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EXPLANATION OF MAIN AMENDMENTS

# 1. INCOME TAX: INDIVIDUALS, SAVINGS AND EMPLOYMENT

## 1.1. BURSARIES OR SCHOLARSHIPS TO EMPLOYEE RELATIVES

[Applicable provision: Section 10(1)(q)]

### I. Background

An income tax exemption exists for any "bona fide" bursary or scholarship that is granted by an employer to an employee or a relative of that employee. Different rules apply depending on whether the bursary or scholarship has been awarded to the employee or the relative.

For the exemption to apply in the case of employee bursaries or scholarships, the employee must undertake to reimburse the employer if the employee fails to complete his or her studies for reasons other than death, ill-health or injury. If a bursary or scholarship is awarded to a relative of the employee, the exemption will apply only if the employee's remuneration does not exceed R100 000 during the year of assessment and the amount of the bursary or scholarship does not exceed R10 000 (collectively referred to as "the monetary limits").

### II. Reasons for change

Government seeks to support and encourage the private sector in the provision of education and training. In particular, Government seeks to encourage employers to provide bursaries and scholarships to their employees and their relatives. However, the monetary limits associated with bursaries and scholarships granted to relatives have not kept pace with inflation and the ever increasing costs of education.

Moreover, these monetary limits assume a uniformity in education that does not exist. There are significant differences between the cost structure of basic education versus further education. Subsidies and other forms of financial support are also far more readily available for basic education, meaning that the income tax does not need to provide the same level of support as is required for further education.

### III. Proposal

It is proposed that the monetary limits be increased for bursaries and scholarships to relatives of qualifying employees:

1. The first monetary limit in respect of qualifying employees will be increased from R100 000 to R200 000.

2. The second monetary limit of R10 000 is to remain in respect of bursaries and scholarships in the case of qualifications up to and including NQF level 4 (also known as matric or grade 12) as set by the South African Qualifications Authority (SAQA). However, a separate monetary limit of R30 000 is to be introduced in respect of any further education.

**3. Effective date**

The proposed amendments are effective as from 1 March 2014 and will be applicable in respect of years of assessment commencing on or after that date.

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## 1.2. ALIGNMENT OF THE TAX TREATMENT OF INDIVIDUAL – BASED INSURANCE POLICIES

[Applicable provisions: Section 10(1)(gG) and new paragraph 12C of the Seventh Schedule, sections 10(1)(gL) and 23(r)]

**I. Background**

As a general matter, there are currently two forms of disability insurance plans that are offered to individuals – capital protection and income protection. The tax outcomes of each differ in terms of premiums and payouts. Disability policies are offered to salaried workers, employers and self-employed business-owners (including professionals).

In the case of capital protection plans, cover exists to protect individuals against the loss of the individual's income earning capacity (e.g. through loss of a limb or mental capacity). In plans of this kind, no deduction is available in respect of premiums paid, but there is no tax payable in respect of insurance policy pay-outs.

In the case of income protection plans, cover exists to protect individuals against the loss of future income (focusing on the negative income impact of the disability rather than the disability itself). In plans of this kind, premiums are deductible but tax fully applies on policy payouts.

**II. Reasons for change**

The distinction between disability capital protection and income protection is unfortnate. The net benefit of these plans is often economically the same with the terminology easily blurred to suit the client's tax needs. The unique tax treatment of disability plans aimed at income protection is also questionable when the overall tax treatment of individual insurance is considered. Both life and disability insurance essentially have the same objective – to protect the financial future of an individual and his or her family through insurance against an adverse personal event (death or disability).

The amount of cover chosen is designed ultimately for future "income" protection whether the payments come in the form of a lump sum for reinvestment (with reinvestment earnings providing the desired safety) or as an annuity. In the end, life and disability plans premiums are essentially expenses of a personal nature. Policy proceeds are mainly designed to protect personal lifestyles, not to fund business continuation. Even if some funds are ultimately applied for business continuation, policy proceeds for business should be deductible when applied – not the initial insurance premiums (being too remote from the trade itself with the premiums essentially acting as disguised "deductible" reserve for expenses that are often personal in nature).

### III. Proposal

It is proposed that life and disability premiums and pay-outs be treated in the same manner for tax purposes regardless of whether the policy is aimed at capital or income protection. The key aspect of these plans is the personal nature of the contingency involved, not the potential use of funds (a use which may or may not be deductible at a later date). Going forward, premiums paid by natural persons in respect of life, disability and severe illness policies will no longer be deductible per se if the policies are aimed at income protection. However, all pay-outs on life, disability and severe illness policies will be tax-free, irrespective of whether the payout takes the form of a lump sum or an annuity.

Some employers pay a premium in respect of an employer-provided insurance policy for the benefit of employees. The premiums will be deductible for the employer, as long as the premiums are taxed as a fringe benefit in the hands of employees. With the employee being taxed on the premium (with no subsequent deduction available), the policy pay-outs will be tax-free.

Lastly, the system will operate cleanly going forward. There will be no transitional period for current policy holders, meaning that premiums going forward will no longer be eligible for deduction even if the plans are pre-existing. On the other hand, all policy pay-outs will be tax-free even if the policy previously generated deductible premiums.

### IV. Effective date

The proposed amendments are effective as from 1 March 2014 and will be applicable in respect of expenditures incurred as well as receipts and accruals in respect of years of assessment commencing on or after that date.

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## 1.3. ROLLOVER TREATMENT FOR EXCESS DEDUCTIBLE DONATIONS

[Applicable provision: Sections 18A(1)

### I. Background

Government provides incentives to encourage donations by persons to certain organisations (e.g. public benefit organisations, government, quasi-government and biodiversity projects). These deductible donations are generally limited to 10 per cent of the taxable income of the donor for the year of assessment in which the donation occurs. The excess donation is permanently lost.

### II. Reasons for change

As a conceptual matter, the existence of deductions for donations operates as a rough form of earmarking, whereby taxpayers can effectively earmark income tax otherwise expended through the general process. Even though this form of earmarking is typically supported in modern tax systems, many tax systems have a ceiling so that this form of earmarking is limited. In the case of South Africa, the limitation is 10 per cent (as outlined above).

While Government remains committed to the 10 per cent limitation, concerns exist that the 10 per cent limitation has an unduly harsh impact in the case of large donations, especially if one or more large assets are involved. Government has recognised this concern by allowing for the spreading of expenditure over a 10 year period if land is effectively donated to Government for conservation purposes (i.e. for use as a national park or nature reserve). In other cases, taxpayers can arrange their affairs so as to spread large donations over multiple years. The question is whether taxpayers should be forced to restructure their donations in such a fashion merely to meet the vagaries of tax law.

**III. Proposal**

In order to mitigate the need for structuring donations, the hard cut-off aspect of the 10-per cent limitation will be removed. Donations in excess of 10 per cent will no longer be fully lost as a deductions. Instead, the excess will be rolled over and allowed as a deductible deduction in the subsequent year of assessment (subject to the 10 per cent rule). If any excess remains, the excess can be further rolled over again.

**Example:**

**Year 1:**

| | |
|---|---|
| Taxable income | R1million |
| Allowable donation as a deduction | R100 000 |
| Actual donations made | R150 000 |
| Deduction claimed | R100 000 |
| Amount rolled over | R50 000 |

**Year 2:**

| | |
|---|---|
| Taxable income | R1.5million |
| Allowable donation as a deduction | R150 000 |
| Actual donations made | R0 |
| Deduction claimed (incl. roll over) | R50 000 |
| Amount rolled over | R0 |

It should also be noted that the 10 per cent spreading rule for land declared as a national park or nature reserve will be eliminated as unnecessary in light of the new rollover rule. The declaration will be treated like any other donation.

**IV. Effective date**

In respect of donations, the proposed amendment is effective as from 1 March 2014 and will be applicable in respect of donations paid or transferred during years of assessment commencing on or after that date. In the case of land declared as a national park or nature reserve, the proposed amendment comes into operation on 1 March 2014 and applies in respect of a declaration made on or after that date.

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## 1.4. REVISED CONTRIBUTION INCENTIVES FOR RETIREMENT SAVINGS

[Applicable provisions: Sections 11(k) and 11(l), new paragraph 2(l) of the Seventh Schedule]

# I. Background

## *A. General*

Government has long encouraged South Africans to save for their retirement through tax incentives when making retirement contributions. In particular, the aim of these incentives is to encourage income-earners to save for their retirement so as to reduce their vulnerability in old age. There are currently three main forms of retirement funds: pension funds, provident funds and retirement annuity funds. Pension and provident funds are employer-formed funds, and retirement annuity funds are generally funded by separate individuals.

## *B. Employer (i.e. pension or provident) funds*

### 1. <u>Employer contributions</u>

As a matter of legislation, taxable employers may deduct contributions to a pension, provident or benefit fund, in an amount at least equal to 10 per cent of the “approved remuneration” of covered employees. In addition, SARS has the discretion to allow a greater percentage, and in practice, a 20 per cent threshold is accepted without specific SARS permission. Tax-exempt entities are not concerned with the deduction and do not view the above limits as any restraint to contributions. The value of the contribution will include amounts allocated in the fund towards risk benefits and administrative costs.

Unlike other 'in kind' benefits, employer contributions to pension and provident funds do not form part of the taxable income of employees. In short, employer contributions to a pension or provident fund do not lead to fringe benefit taxation for employees (regardless of whether the employer is a taxable or tax-exempt entity).

### 2. <u>Employee-member contributions</u>

In the main, member taxpayers may claim a tax deduction up to a maximum of 7.5 per cent of “retirement-funding employment” income in respect of contributions to a pension fund, commonly referred to as 'pensionable income'. However, provident fund members may not claim a tax deduction in respect of their own contributions (leaving only a 20 per cent employer contribution).

## *C. Individual (retirement annuity) funds*

Retirement annuity funds largely exist for separate individuals seeking to fund their own retirement. These individuals may be utilising these funds as a supplement to their employer-provided retirement savings or these funds may act as the chief form of retirement savings in the case of the self-employed, partners in a partnership (or joint venture), or a form of simplified fund on behalf of multiple persons associated with a small business.

Members making contributions to these funds are generally eligible to deduct amounts up to 15 per cent of 'non-retirement-funding-income', commonly referred to as 'non-pensionable income'. 'Non-pensionable income' in general amounts to the individual's total income less any 'pensionable income' and allowable deductions. Employers making contributions to these funds on behalf of an employee-member may also deduct these contributions, but these contributions are added to the employee-member’s income. This additional employee-member income may also be deductible (as part of the overall 15 per cent limit as if the employee contributed these sums directly).

## II. Reasons for change

The aim of the current retirement savings-regime is to encourage individuals to save towards achieving an adequate level of retirement income. However, the regime is fragmented, leading to differences in tax treatment and annuitisation requirements between funds. A consistent treatment is preferred where the same result follows irrespective of the method of funding. Furthermore, the various tax deduction limits in the current regime applicable to employers and individuals do not always produce an equitable result. The regime is unintentionally generous in the case of the employees of tax-exempt employers and high-income-earning individuals. It follows that the deduction limits should be revisited.

## III. Proposal

### *A. Member contributions*

Going forward, individual members making a contribution will receive a uniform deduction for these contributions regardless of the approved fund involved (i.e. regardless of whether the contribution is to a pension, provident or retirement annuity fund). Under this revised approach, deductible contributions will be subject to an annual percentage limit and a monetary limit.

1. **Percentage limit**: Deductions in respect of contributions made by the member will be allowed up to 27.5 per cent on the greater of "remuneration" or "taxable income" (excluding annuities and retirement lump sums). Potential reliance on taxable income means that self-employed individuals can make deductible contributions (or that formally employed individuals can make individual contributions based on amounts above remuneration if earning income from other sources).

2. **Monetary limit:** No member may deduct contributions in excess of an annual limit of R350 000. This limit ensures that wealthy individuals do not receive excessive deductions (*vis-à-vis* lower income individuals who do not have the means to contribute much to these funds).

Contributions in excess of the annual limits may be rolled over to future years where the amounts will again be deductible together with contributions made in that year, but subject to the limits applicable in that year. However, as per existing legislation, where any contributions have not been deducted as at retirement, the nominal value will be set off against any lump sum income prior to the tax calculation so as to avoid double taxation.

### *B. Employer contributions*

1. <u>Employer deduction</u>

Employer contributions to all approved retirement funds (South African) will be deductible against income under a specific deduction provision. The deduction will effectively be unlimited. Unlike the current position where employer contributions to benefit funds (friendly society and medical scheme) are included in the specific deduction provision, the general tax position will apply in future.

In certain cases (particularly in respect of defined benefit funds) employer contributions are allocable in the fund to both current and retired employees. The employer deduction will be available regardless of whether the fund allocates the contribution to a current or a retired employee. However, no fringe benefit will arise in the case of an employer contribution allocable by a retirement fund to a retired member of the fund.

2. Employee fringe benefit

In future, any contributions made by an employer to an approved South African retirement fund for the benefit of an employee-member will be taxed as a fringe benefit in the hands of the member. The value of the fringe benefit for tax purposes will depend on whether the contributions are made to a defined benefit fund or a defined contribution fund.

a. If the contributions are made to a defined contribution fund, the contribution allocable to the employee will be includible as a taxable fringe benefit for that employee as at the cash value of the contribution.
b. If the contributions are made to a defined benefit fund, the value of the fringe benefit will be determined through a special formula (see **VALUATION OF FRINGE BENEFIT FOR DEFINED BENEFIT PURPOSES**).

Any contributions made by an employer for the benefit of an employee-member will be deemed to have been made by the employee, thereby being potentially deductible. These amounts will fall within the percentage and monetary limits as outlined above.

**Example 1: Basic employer calculation**

***Facts:*** Employee A is a member of a provident fund. Employee A has a total cost to company (remuneration) of R300 000, which includes a basic salary of R180 000. Pursuant to the fund's rules, the employer contribution represents 20 per cent of Employee A’s basic salary, and Employee A’s contribution represents 5 per cent of Employee A's basic salary. In monetary terms, Employer makes a contribution of R36 000 (R3 000 per month) to the fund in the name of Employee A, whilst Employee A makes a contribution of R9 000 (R750 per month) to the fund.

***Result:*** Employee A will be taxed on the R36 000 employer contribution as a fringe benefit. However, for purposes of determining potential contributions deductions, Employee A will be deemed to have contributed the R36 000 to the provident fund, together with Employee A’s own contributions (R9 000), totalling R45 000. Therefore, Employee A will be entitled to a deduction of R45 000 against income earned. Neither the percentage limit (27.5 per cent of R300 000 = R82 500) or the monetary limit of R350 000 will limit the tax deduction.

**Example 2: Basic employer calculation with retirement annuity fund**

***Facts:*** Employee B is a member of a pension fund. Employee B has a total cost to company (remuneration) of R300 000, which includes a basic salary of R180 000. Employee B earns rental income from a property, resulting in taxable income of R250 000. The employer contribution represents 20 per cent of Employee B's basic salary, and Employee B's contribution represents 5 per cent of B's basic salary. In monetary terms, Employer makes a contribution of R36 000 to a South African approved pension fund in the name of Employee B, whilst Employee B makes a contribution of R9 000. Employee B also makes a further contribution of R51 000 (R4 250 per month) to a retirement annuity fund (in respect of which Employee B has provided proof to Employer).

***Result:*** Employee B will be taxed on the R36 000 employer contribution as a fringe benefit. However, for purposes of determining potential contributions deductions, Employee B will be deemed to have contributed the R36 000 to the pension fund, together with Employee B's own contributions to the pension fund totalling R45 000. Employee B's total retirement fund contributions are R96 000 (R45 000 + R51 000). The percentage limit (27.5 per cent of R300 000 = R82 500) will limit the tax deduction in respect of the contribution of R96 000 to R82 500. Therefore, B will be unable to deduct R13 500 in the current year of assessment. The R13 500 will be available for deduction in future years subject to the percentage and monetary limits applicable in those years.

**Example 3: Basic retirement annuity fund calculation**

***Facts:*** Individual C is self-employed and generates R400 000 from providing consulting services. Individual C makes contributions to a retirement annuity fund during the year of assessment of R120 000 (R10 000 per month).

***Result:*** The deductibility of Individual C's deduction will be based on the higher of "remuneration" or "taxable income". In this instance, the deduction is limited to R110 000 (27.5 per cent of R400 000). The R10 000 excess can be rolled over to a future year of assessment (subject to future percentage and monetary limits).

### IV. Effective date

The proposed amendments will be effective in respect of contributions made on or after 1 March 2015.

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## 1.5. VALUATION OF FRINGE BENEFIT FOR DEFINED BENEFIT PURPOSES

[Applicable provisions: New definitions of "defined contribution component of a fund", "defined benefit component of a fund", and "retirement-funding income" in paragraph 1 of the Seventh Schedule and new paragraph 12D of the Seventh Schedule]

## I. Background

Going forward, any contributions made by a employer to an approved South African retirement fund for the benefit of an employee will be taxable as a fringe benefit in the hands of the employee (excluding a retired employee) - **REVISED CONTRIBUTION INCENTIVES FOR RETIREMENT SAVINGS**. The value of the contribution will include amounts allocated in the fund towards risk benefits and administrative costs.

## II. Reasons for change

### *A. Defined contribution and defined benefit funds*

In the case of a defined contribution retirement fund, the contribution can be directly linked to the benefits that the member is entitled to upon withdrawal, retirement, or death. As a result, the employer contribution is an accurate measure of the value that the employee becomes entitled to through the fund.

However, defined benefit funds have an inherent element of cross-subsidisation across members where the value of actual contributions does not exactly match up with the benefits that a member receives. More specifically, the benefits of a defined benefit fund member upon retirement are mostly determined by the member's final salary at retirement, the years of service, and an accrual rate (which indicates how the pension benefits increase due to additional years of service). Therefore, the benefits are determined in relation to a formula, whereas the actual employee and employer contributions over years are based on the pensionable income in that year. It follows that there is no direct relationship between the value of the benefits that a member will receive on retirement and the contributions made.

To illustrate, two members receive the same pension benefits upon retirement if they have the same final salary and years of service. However, Member A received a large increase in salary just before retirement, whereas Member B received steady salary increases. It follows that the total actual contributions for previous years would have been lower for Member A than for Member B. Also, members with more years of service will also receive a larger value of pension benefits due to the increase arising from the accrual rate, implying that defined benefit funds are generally biased in favour of older members against younger members (except if the younger members are highly educated and skilled, allowing them to progress rapidly to a high income).

To summarise, the cross-subsidisation within defined benefit funds effectively ensures that the cash value of the employer contribution is not an accurate reflection of the benefit that the member receives. Therefore, a special valuation method is required to determine the value that a defined benefit fund member becomes entitled to through the fund on an employer contribution.

### *B. Fund-provided risk benefits*

Certain retirement funds provide their members with risk benefits, such as death and/or permanent disability cover. These risk benefits (commonly known as 'approved risk benefits') are akin to the structure of a defined benefit fund as a result of the risk sharing that flows from the pooling of the risks of the members. As a matter of policy, it is preferable that there is consistency in the tax treatment of approved and unapproved risk benefits.

## III. Proposal

### *A. Contributions to a defined contribution fund*

As from 1 March 2015, employer contributions to a retirement fund for the benefit of an employee will result in a fringe benefit for that employee (see **REVISED CONTRIBUTION INCENTIVES FOR RETIREMENT SAVINGS**). If the employer makes the contribution to a defined contribution fund, the value of the fringe benefit will be the cash equivalent of that part of the contribution that pertains to that employee.

### *B. Contributions to a defined benefit fund*

If an employer makes a contribution to a defined benefit fund for the benefit of an employee, the employer must determine the value of the fringe benefit for that employee through the application of a compulsory formula. The formula approximates the increase in value of the annuity and lump sum benefit of the member as a result of one additional year of service, based on the value that the member will be entitled to as a retirement benefit.

1. Conceptual methodology of the formula

The formula was created using the methodology:

a. A capital value is created which approximates the value of the pension benefits (present value of the annuity and the lump sum) of the member that would be received at retirement as if that calculation had been performed at the end of the current year.

b. Another capital value is created, with the same calculation, but assuming the calculation was performed at the beginning of the current year.

c. The difference between the two capital values represents the increase in the value of benefit within the fund (assuming no change in the definition of permeable income over the year and no change in the benefit design of the fund, the formula simplifies to the formula described.

d. The methodology assumes an average increase in salary.

2. The formula mechanics

a. Overview

The formula will result in a monthly fringe benefit by virtue of the pensionable income pertaining to a specific month (as opposed to being on an annual basis). The formula in the main relies on information that must be provided by the valuator of the retirement fund to the employer. It follows that the valuator will be required to provide the employer with the necessary information in a structured format and in a timeous manner.

The relevant information is:

i. **The value of the "annuity accrual rate" of the fund (A)**: The increase in the annuity benefit that the member will become entitled to upon retirement as a result of one additional year of service, expressed as a proportion of the member's “projected annuity income” at retirement.

ii. **The value of the "lump sum accrual rate" of the fund (L)**: The increase in the lump sum benefit that the member will become entitled to upon retirement as a result of one additional year of service, expressed as a proportion of the member's “projected lump sum income” at retirement.

iii. **The value of the "fund factor" for that fund (F)**: Different values will be provided through a Regulation issued by the Minister of Finance by way of notice in the Government Gazette. Some of the elements that may influence the value of the "fund factor" are:

- The promise of increases in pension benefits during retirement (such as whether their annuity income will increase by a percentage of inflation); and

- The age of retirement within the fund.

Also required in the formula is the "**retirement funding income**" per member (Y), commonly referred to as 'pensionable income'. In terms of the rules of a pension or provident fund, the employer determines its contribution towards the fund on the employee's pensionable income (being an itemised part of the employee's “remuneration”). Due to the uneven fluctuations of the items, retirement fund rules generally exclude items such as bonuses, variable fringe benefits, and overtime pay from pensionable income at the choice of the employer.

The formula to be applied by the employer to calculate the value of the fringe benefit for an employee in a particular month is:

**Y x ((A x F) + L) - defined benefit employee contribution for the month**

b. Reason for deducting the employee contribution for the month

The calculation of an employee's fringe benefit in respect of the employer contribution in the case of a defined contribution fund is done with reference to the employer's actual contribution. However, in the case of a defined benefit fund, the fringe benefit value is determined with reference to the entire increase in value, which is co-funded by the employer and the employee. Because the formula represents the entire increase in value, whether funded by the employer or the employee contribution, it is necessary to deduct the employee contribution in order to obtain an accurate value for the fringe benefit.

**Example: Application of the formula**

***Facts:*** The Employer's contribution towards the pension fund is based on Employee B's basic salary only, totalling R12 000 for the month ("retirement-funding income" or 'Y' in the formula). The employer contribution towards the defined benefit fund is R2 000 and the employee's contribution is R500. The valuator provides the employer with the following information:

i. The value of the "annuity accrual rate" of the fund (**A**): **1/55**

ii. The value of the "fund factor" for that fund (**F**): **10**

iii. The value of the "lump sum accrual rate" of the fund (**L**): **1/15**

***Result:***

Z = Y x (A x F + L) - employee contribution for the month
Z = R12 000 x (1/55 x 10 +1/15) - R500
Z = R2 481.82

*C. Hybrid funds*

A retirement fund can consist solely of defined benefit components or defined contribution components, or the fund can house a combination of these components. A defined contribution component within a retirement fund means that within that component, the member is entitled to a retirement benefit that is generally based on the contributions made to the fund plus any fund investment return thereon. However, for a defined benefit component, the member is entitled to a retirement benefit that is based on the member's final salary, years of service, and a fund-determined factor.

An employer that contributes to a retirement fund that contains both defined benefit and defined contribution components will rely on the valuator of the fund to provide the split per member, of employer and employee contributions pertaining to that member. Again the valuator will be required to provide the employer with the necessary information in a structured format and in a timeous manner.

Once the employer has the employer contribution split per employee, the value of the fringe benefit in respect of the defined contribution component will be the cash equivalent of that part of the employer contribution. The formula will apply to the defined benefit component of the fund and will approximate a benefit increase only in respect of that component of the fund. In order to determine the entire fringe benefit resulting from the employer contribution to the hybrid fund, the employer will aggregate the cash value of the defined contribution component and the result of the formula as applied to the defined benefit component.

**Example: Hybrid fund**
***Facts:*** Employer contributes R25 000 for the benefit of Employee A to a hybrid pension fund. Employee A contributes R5 000. The valuator supplies the employer with the following information split:

| Contribution | Defined benefit component | Defined contribution component |
|---|---|---|
| **Employer** | R10 000 | R15 000 |
| **Employee A** | - | R5 000 |

The valuator also supplies the employer with the necessary information to calculate the fringe benefit in respect of the employer contribution that pertains to the defined benefit component of the fund.

***Result:***

| |
|---|
| Value of fringe benefit<br>= The contribution in respect of the defined contribution component + the result of the application of the formula to the defined benefit component<br>= R15 000 + the result of the formula |

*D. Approved risk benefits*

Ordinarily, approved risk benefits would be treated the same as a defined benefit component of a fund, and would have been subject to the formula. However, unapproved employer-provided death and disability benefits (although subject to the same risk sharing effect) are taxed as at the cash value of the premium paid by the employer for the benefit of the employee. Therefore, the tax treatment of unapproved risk benefits is in line with cash value concept applied to a defined contribution component of a fund.

In order to ensure the uniformity of the tax treatment, approved risk benefits will be regarded as a defined contribution component. The result will be that the fringe benefit that results from an employer contribution (approved) or an employer premium (unapproved) will be taxed the same irrespective of whether the risk benefits are employer-, or fund-provided.

**Example - Risk benefits**
***Facts:*** Employer contributes R25 000 for the benefit of Employee A to a defined benefit fund that provides approved risk benefits to its members. Employee A contributes R5 000. The valuator supplies the employer with the following information split:

| **Contribution** | **Defined benefit component** | **Defined contribution component** |
|---|---|---|
| Employer | R23 000 | R2 000 |
| Employee A | R5 000 | - |

Note that the approved risk benefits are treated as a defined contribution component. The valuator also supplies the employer with the necessary information to calculate the fringe benefit in respect of employer contribution that pertains to the defined benefit component of the fund.

***Result:***

| |
|---|
| Value of fringe benefit<br>= The contribution is respect of the defined contribution component + the result of the application of the formula to the defined benefit component<br>= R2 000 + the result of the formula |

**IV. Effective date**

The proposed amendments will be effective in respect of contributions made on or after 1 March 2015.

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## 1.6. PROVIDENT FUND POST-RETIREMENT ANNUITY ALIGNMENT

[Applicable provisions: The definitions of "pension fund", "provident fund", "retirement annuity fund", "pension preservation fund", and "provident preservation fund" in section 1, and paragraph 6(1)(a) of the Second Schedule]

**I. Background**

*A. Overview*

There are three basic types of retirement funds in the South African retirement system: Pension funds, provident funds, and retirement annuity funds. Retirement funds accept contributions for the benefit of (and from) members with the purpose of establishing and growing a member's retirement interest (i.e. savings). For individuals that change employers, there are preservation funds that hold retirement savings until retirement (see paragraph F. Preservation funds below).

*B. Contributions to retirement funds*

Employer contributions to pension funds and provident funds are tax deductible up to certain limits. Further, while member contributions to pension funds or retirement annuity funds are tax deductible (subject to limits), no tax deduction is available for member contributions to provident funds.

*C. Payouts from retirement funds*

If a contribution to a retirement fund is tax deductible, the payout is taxable. If a contribution is non-deductible, the payout is tax-free. Growth is never taxed in a retirement or preservation fund and is therefore always taxable upon payout.

Payouts from a retirement fund can be in the form of a lump sum or an annuity. A lump sum will be taxable according to the retirement tax tables while an annuity will be taxable according to the recipient's marginal tax rate.

### *D. Annuitisation*

Pension and retirement annuity fund members are bound by a mandatory annuitisation requirement that requires the members to annuitise a part of their fund interests upon retirement (but not before). However, provident fund members are not required to annuitise any portion of fund savings. As a result, provident fund members typically receive their retirement interests as a lump sum upon retirement.

As a general matter, mandatory annuitisation for pension and retirement annuity funds requires that at least two-thirds of a member's total retirement interest be paid in the form of an annuity (including a living annuity) upon retirement. These members will always be entitled to receive at least one-third of their total retirement interests in the form of a lump sum upon retirement.

It should be noted that where a member exits any retirement fund prior to retirement, there is no mandatory annuitisation required. Members in this situation may choose to preserve their fund interests or to receive their entire interests in the form of a lump sum.

### *E. De minimis exception*

The de minimis exception overrides the mandatory two-thirds annuitisation requirement. If the total value of a fund interest at retirement does not exceed R75 000, the exception permits the member to receive the entire retirement interest in the form of a lump sum. This exception is based on the premise that an annuity of less than R75 000 is not cost effective in terms of commission and administrative fees. This exception applies separately in respect of each membership interest in a retirement fund.

### *F. Preservation funds*

Preservation funds exist to allow individuals to preserve their retirement savings when changing employers. Therefore, pension preservation and provident preservation funds cannot accept contributions from members; these funds can only accept transfers from (employer-provided) pension and provident funds.

Members of a pension preservation fund have the same mandatory annuitisation requirement upon retirement as pension fund members (e.g. the same two-thirds versus one-third calculation). Similarly, members of provident preservation funds (as with provident fund members) are allowed to receive their entire retirement interest in the form of a lump sum upon retirement.

### *G. Fund-to-fund transfers*

In general, no tax is levied on the transfer of retirement savings from one fund to another. However, due to the lack of annuitisation requirements in provident and provident preservation funds, transfers of retirement savings to those funds are taxed if the transfer is from a retirement or preservation fund where annuitisation is mandatory. This measure ensures that retirement savings in funds that require mandatory annuitisation remain segregated from funds without mandatory annuitisation.

## II. Reasons for change

A strong link exists between insufficient retirement income for retired members of provident funds and the lump sum payouts made by provident funds at retirement. In short, the absence of mandatory annuitisation in provident funds means that many retirees spend their retirement assets too quickly and face the risk of outliving their retirement savings. In view of these concerns, it is Government's policy to encourage a secure post-retirement income in the form of mandatory annuitisation. Therefore, provident funds and provident preservation funds must be aligned to other retirement and preservation funds.

The proposals made in respect of **REVISED CONTRIBUTION INCENTIVES FOR RETIREMENT SAVINGS** will result in provident fund members being able to claim a deduction in respect of contributions (their own and employer contributions). Pension, provident, and retirement annuity fund members will henceforth enjoy the same tax deduction in respect of contribution. Therefore, uniformity in contribution means that members of pension, provident and retirement annuity funds should be treated the same upon retirement payout (i.e. should be subject to the same two-thirds annuitisation requirements).

## III. Proposal

### *A. Basic annuitisation rule*

It is proposed that the same mandatory annuitisation requirements currently applicable to pension and retirement annuity funds be applied to provident funds as from 1 March 2015. More specifically, as from 1 March 2015, any person retiring from a provident fund or provident preservation fund cannot receive a lump sum upon retirement of more than one-third of their retirement interests. In other words, a mandatory compulsory annuity will now be required for the remaining two-thirds of their retirement interests (pre-retirement interests remains free from any mandatory compulsory annuitisation).

### *B. Protection of historic vested rights within a provident fund*

1. **General protective measures:** In an effort to protect historic vested rights, measures will be introduced to segregate historic rights from new rights. These measures will require a certain amount of administrative intervention to succeed:

    a. Balances in provident funds as at 1 March 2015 (and any subsequent growth thereon) need not be annuitised.

    b. If a provident fund member is older than 55 years of age as at 1 March 2015, the mandatory annuitisation requirements will not apply to contributions made (and any growth thereon) if the member remains in the same provident fund until retirement.

2. **Administrative requirements:** Provident funds must maintain separate accounts in respect of a member under the age of 55 as at 1 March 2015 in order to separate pre-1 March 2015 contributions (and any growth thereon) from post-1 March 2015 contributions (and related growth). This segregation is required in order to determine

what part of the member's retirement interest is subject to the mandatory annuitisation requirements versus those interests remaining under the prior dispensation. Separate accounts generally need not be maintained by a provident fund in respect of members of age 55 as at 1 March 2015 (no annuitisation required) and those that join a provident fund on or after 1 March 2015 (full annuitisation required).

**Example 1: Provident fund member older than age 55 on 1 March 2015**

***Facts:*** Member T of the United Provident Fund is aged 56 years old on 1 March 2015, at which time Member T's fund interest is R400 000. Member T continues to contribute to the provident fund and retires at age 64. On that day, Member T's retirement interest is R750 000.

***Result:*** Member T will be able to take the entire amount as a lump sum at retirement (as under pre-existing law). The provident fund need not keep split accounts for Member T.

**Example 2: Provident fund member younger than age 55 on 1 March 2015**

***Facts:*** Member W of Open Provident Fund is 54 years old on 1 March 2015, at which time Member W's fund interest is R450 000 with this amount increasing by R150 000 by the year 2020. Member W also continues to pay R200 000 in contributions to the fund after 1 March 2015 until 2020 with related growth amounting to R50 000. The final retirement interest in 2020 is R850 000.

***Fund administration:*** Open Provident Fund must maintain two separate accounts for Member W. One account in respect of the pre-1 March 2015 contributions and any growth thereon (R450 000 + R150 000); and another account in respect of the post-1 March 2015 contributions and related growth (R200 000 + R50 000)

***Result:*** The pre-1 March 2015 contributions plus any growth thereon (R450 000 + R150 000 = R600 000) can be freely withdrawn as a lump sum. The remaining R250 000 is subject to mandatory annuitisation. Member W may only take one-third of the R250 000 as a lump sum, while the remaining two-thirds is subject to annuitisation.

*C. Fund-to-fund transfers*

1. **General protective measure:** The protection of provident fund vested rights will apply_in respect of contributions made to a provident fund prior to a 1 March 2015 (and any growth thereon). This protection will apply irrespective of whether the retirement interest remains in the provident fund or whether the retirement interest is transferred to another retirement or preservation fund. Stated differently, a member of a retirement or preservation fund need not annuitise any contributions made to a provident fund prior to 1 March 2015 (together with any growth on those contributions).

2. **Administrative requirements:** If a provident fund member wants to transfer the member's retirement interest to another retirement or preservation fund, the provident fund must be in a position to inform the transferee fund of the split of the fund interest between the value that remains subject to annuitisation and the value that continues to enjoy vested right protection. Stated differently, the provident fund must provide the split between the pre-1 March 2015 contributions (and related growth) *vis-à-vis* the post-1 March 2015 contributions (and related growth) for this split to recognised by the transferee fund. All other funds inheriting these split accounts must similarly retain this split for record-keeping purposes.

**Example**: **Provident fund member transfers to new fund**
***Facts:***

- Person S, a member of Investment Provident Fund, is 29 years old on 1 March 2015, at which time the fund interest is R1 000 000.
- Person S continues to contribute to the provident fund. Six years later, Person S resigns. At this point, the R1 000 000 has grown to R2 000 000.
- The new contributions that Person S made to the Investment Provident Fund (and the growth on thereon) amounts to R500 000.
- Person S transfers this R2 500 000 balance to a preservation fund. When Person S turns 70, Person S resigns from the preservation fund with a retirement interest of R10 000 000.
- The pre-1 March account of R2 000 000 grew to R8 500 000, and the subsequent amount of R500 000 grew to R1 500 000.

***Administration:***
Investment Provident Fund

- Investment Provident Fund must maintain an account for Person S in respect of the fund interest of R1 000 000 as at 1 March 2015 and any growth thereon (R1 000 000). Investment Provident Fund must also maintain a separate account for any contributions made after 1 March 2015 and any growth thereon (totaling R500 000).
- When Person S transfers these amounts to the preservation fund, Investment Provident Fund must provide the preservation fund with a split of fund interests with one account falling within annuitisation (R500 000) and the other enjoying vested right protection (R2 000 000).

Preservation fund
The preservation fund must keep separate accounts for Person S. One account must exist in respect of the fund interest of R2 000 000 that continues to enjoy vested right protection and any growth thereon (R6 500 000). A separate account is required for the R500 000 that remains subject to annuitisation and any growth thereon (R1 000 000).

***Result*:** The pre-1 March 2015 contributions plus growth thereon (i.e. R8 500 000) will remain free from annuitisation. The newer amounts (of R1 500 000) will become subject to the new dispensation. Member W may only take one-third of the R1 500 000 as a lump sum while the remainder is subject to annuitisation.

*D. De minimis exception*

As a further measure to accommodate provident fund members and ensure a comfortable transition, the current threshold for the *de minimis* exception (R75 000) will be doubled to R150 000 for all retirement funds. As a result, every member may receive their entire retirement interest in the form of a lump sum as long as the portion of the member's retirement interest that is possibly subject to mandatory annuitisation (i.e. the two-thirds amount) does not exceed R150 000.

**Example 4: *De minimis* exception**
***Facts:*** Member T of Consolidated Provident Fund retires at 60 years of age. Member T was 48 years old on 1 March 2015, at which time Member T's fund interest was R450 000, which increases to R600 000 upon Member T's retirement. Prior to retirement, Member T contributed R80 000 to Consolidated Provident Fund after 1 March 2015 with growth of R40 000. The final retirement interest was R720 000.

***Result:*** The pre-1 March 2015 amount plus growth (i.e. R600 000) thereon is free from annuitisation. The remaining (R120 000) amount is potentially subject to mandatory annuitisation but for the *de minimis* threshold (R150 000). Member T can accordingly receive the entire R720 000 in the form of a lump sum.

*E. Free portability between retirement funds*

Due to the alignment of the mandatory annuitisation requirements between all retirement and preservation funds, a more flexible system of free portability can now be allowed. The transfer of retirement savings to provident and provident preservation funds from other funds (to the extent that a transfer is allowed) will henceforth be free from tax in all instances (e.g. pension funds can now be transferred to provident funds).

**IV. Effective date**

The proposed amendments will be effective as from 1 March 2015.

## 1.7. EMPLOYER PROVIDED ACCOMODATION - LOW-COST HOUSING

[Applicable provision: Paragraph 5 of the Seventh Schedule and new definition of "remuneration factor" in section 1]

**I. Background**

*A. Overview*

As a general matter, tax is levied on transfers of value from an employer to an employee, whether in cash or in kind. Therefore, when employers provide an employee with benefits (such as cheap or free services) or sell an asset to an employee at less than market value, the employee is subject to tax on the fringe benefit provided. More specifically, if an employee acquires an asset at less than the market value from an employer, the employee is subject to tax on the difference between the market value and any amount paid by the employee in respect of the asset acquired.

*B. Employer-provided housing*

It is not uncommon in South Africa for employers operating in remote areas to provide housing to their employees. In particular, it is customary for employers to provide housing in industries that predominantly require employees to be away from their ordinary place of residence. This provision of housing can operate as an offering of rental housing or through the outright transfer of housing.

In certain cases, employer-provided housing (i.e. accommodation) is formally required in order for the employer to conduct business. For instance, in the case of mining, employer-provided accommodation is part of the employer's responsibilities in terms of the Broad-Based Socio-Economic Empowerment Charter for the South African Mining and Minerals Industry (the "Mining Charter").

*C. The South African context*

In industries where employer-provided housing is customary, employers often sell this housing to employees at less than market value (typically at cost or even below). Financing of this employer-provided housing may take the form of an employer-guaranteed bank loan, a direct employer-provided loan or a deferred salary plan directly with the employer. Under current law, below market housing (even at cost) is taxed as a fringe benefit for the employees involved.

## II. Reasons for change

Government is supportive of employers that provide low-income employees with affordable accommodation, thereby empowering their employees through home ownership. However, the potential tax levied on the fringe benefit resulting from this below-market value transfer effectively hinders the viability of these schemes. Because Government wants to encourage employer-assisted housing as part of Government's anti-poverty objectives, these tax barriers must be addressed.

## III. Proposal

*A. Overview*

Low-income employees will not be taxed, taking into account certain requirements, when acquiring low-income housing from their employers at a discount (i.e. at a price below market value). The detailed aspects of these requirements will be discussed below.

*B. Employee salary limitations*

The aim of this requirement is to restrict the incentive to employees within certain socio-economic levels. Employees falling within this incentive must not earn more than R200 000 in salary (i.e. remuneration) during the year of assessment immediately preceding the year of assessment in which the acquisition took place. For this purpose, remuneration includes fringe benefits, bonuses, over-time, etc. A special rule will apply to gross-up the remuneration if the employee was not in the employment of the employer for the entire preceding year of assessment.

*C. Property value limitations*

The cost of the immovable property that is acquired by the employee, may not exceed R350 000 for the employer. The R350 000 applies irrespective of whether the employer acquired the property or developed the property. The R350 000 limit is based on information from employers in industries that customarily provide housing to employees (mining and other companies operating in less accessible locations).

**Example**
***Facts:*** The employer sells immovable property (cost of R350 000 to the employer) to Employee A for R 250 000. Employee A's remuneration as at the end of previous year of assessment was R180 000.

***Result:*** Employee A will have a zero value fringe benefit in respect of the difference between the cost and the consideration paid (R100 000).

**IV. Effective date**

The proposed amendments are effective as from 1 March 2014 and will be applicable in the acquisition of property by an employee from an employer on or after that date.

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## 1.8. SHARE SCHEMES INCOME RECOGNITION

[Applicable provisions: Section 10(1)(k)(dd) and new section 11(t)]

**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). These triggering events are designed to be delayed so that the appreciation associated with these schemes is fully taxed. This delay also has the added benefit of taxing persons when cash or readily-sellable shares are available to pay the tax.

*B. Dividends derived from restricted share incentive schemes*

In addition, rules exist to prevent taxpayers from converting high-taxed salary into low (or no) taxed dividends. Under these rules, dividends from restricted employee share schemes are taxable as ordinary revenue unless the dividend falls into one of three exceptions:

1. The share involved constitutes an equity share that lacks hybrid equity share features (without regard to the three-year carve-back);

2. The dividend itself constitutes an equity instrument; or

3. The dividend arises from a trust solely containing equity shares that lack hybrid equity share features (without regard to the three-year carve-back).

In effect, dividends from restricted share incentive schemes will be respected if the underlying shares have pure equity features (e.g. stem from ordinary shares as opposed to preference shares). This distinction is based on the notion that preference shares can be used by high-end salaried employees to convert salary into low-taxed dividends; whereas, pure equity shares are primarily used as a legitimate form of compensation for rank-and-file employees, including broad-based empowerment schemes. This distinction has its origin in a former avoidance technique used by high-executive schemes that was based on restricted liquidating preference shares (i.e. preference shares whose sole value stemmed from a fixed interest-like dividend yield).

**II. Reasons for change.**

It has come to Government's attention that the equity versus non-equity share distinction in respect of restricted employee shares is unfortunate. Many share schemes hold pure equity shares, whereby the sole intent of the scheme is to generate dividends for employees without the employees ever obtaining direct control of the shares. The dividend yield in these instances effectively operates as disguised low-taxed salary for employees (that is not deductible by employers).

**III. Proposal**

Dividends from (restricted and unrestricted) employee shares and share schemes essentially operate as salary regardless of whether the underlying shares have equity or non-equity features. In essence, these shares are economically akin to unissued treasury shares with the associated dividends operating like salary. Under this revised approach **–**

1. The recipient of the dividend (typically an employee, but it may also be an employee share trust) from the equity instrument (as defined in section 8C(7)) will be taxed on the dividend as ordinary income (without any Dividends Tax) unless the equity instrument has vested (as contemplated in section 8C(3)); and

2. The company declaring the dividend in respect of the equity instrument will be entitled to an income tax deduction equal to the amount of the inclusion.

This matching ordinary revenue/deduction approach restores vertical equity in this arena. In the case of upper-income employees, the deduction for the company declaring the dividend will effectively offset a 28 per cent rate of tax while ordinary revenue in the hands of the upper-income employee will probably be subject to a 40 per cent rate of tax. In the case of lower-income employees, the same 28 per cent deduction offset applies for the company to be matched against an employee marginal rate of 18 or 25 per cent. Taxpayers will further avoid the potential 15 per cent imposition of Dividends Tax.

The new regime will effect restricted equity instruments acquired within section 8C (i.e. an employee) context without regard to whether the underlying shares have a pure equity or preference-like yield. The only exception to this revised rule is a dividend involving the distribution of equity instruments of the company employer (e.g. shares of the employer) because this form of yield is non-deductible under the common law (e.g. Labat).

**IV. Effective date**

The proposed amendments are effective as from 1 March 2014 and will be applicable in respect of dividends declared on or after that date.

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## 1.9. REMOVAL OF DIVIDEND CHARACTER OVERLAP

[Applicable provisions: Paragraph (k) of the "gross income" in section 1 and section 10(1)(k)(i)]

**I. Background**

*A. Gross income list*

The starting point for the normal tax calculation within the income tax is the "gross income" definition. As a starting point, gross income means "the total amount, in cash or otherwise, received or accrued to or in favour of" a person from all sources if that person is a resident (or from South African sources if that person is a non-resident) unless the amount is of a capital nature. The definition then lists amounts to be included without limiting the scope of the definition. These named amounts are fairly extensive, including amounts in respect of services, as consideration for restraints of trade and "by way of a dividend or a foreign dividend", amongst others.

*B. Dividends*

As stated above dividends (and "foreign dividends") are specifically included as gross income as a named item. The term "dividend" is fully defined in the Act with dividends being exempt from normal tax (but for certain exceptions). Dividends are instead typically subject to the Dividends Tax, subject to exceptions including an exemption for dividend amounts constituting income under the normal tax.

## II. Reasons for change

Because the gross income definition contains many forms of income, these various forms of income potentially overlap. One area of ongoing concern is the potential overlap of dividends with other forms of income. This overlap is important because dividends (unlike most other forms of gross income) are often exempt from normal tax.

One common area of concern is the arguable overlap of dividends with gross income from services. If a taxpayer provides services in exchange for amounts, these amounts could conceivable include amounts derived from dividends. In these circumstances, it is often technically argued that the service provider has directly received dividend income when, in fact, the cause of the amount received or accrued is due to the services rendered. The nature of where the amount is derived being irrelevant but for the esoteric argument that the definition of gross income fails to prioritise the nature of gross income when the amounts involved conceivably fall within two or more gross income categories. No reason exists to allow this policy conflict to continue.

## III. Proposal

If an amount can be characterised as both a "dividend" (or a foreign dividend) and another form of named income under the gross income definition, the amount will be treated as falling within the other named category. This prioritization will eliminate the possibility that certain forms of income will incorrectly be characterized as dividend. For instance, if a person receives amounts for services rendered and these amounts stem from dividends transferred in exchange, the amounts at issue will be viewed as service income (and not dividends). It will also be clarified that dividends will only enjoy the exemption from normal tax if included as dividends with the gross income definition.

## IV. Effective date

The proposed amendment applies in respect of amounts received or accrued on or after 1 January 2014.

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# 2. INCOME TAX: BUSINESS (GENERAL)

## 2.1. ANTI-HYBRID DEBT INSTRUMENT RE-CHARACTERISATION RULES

[Applicable provisions: Section 8F and new section 8FA]

## I. Background

### *A. Overview*

In the area of corporate financing, there are three basic sources of finance – equity, debt and retained profits. For commercial purposes, debt and equity are the key sources of external finance. As a general matter, debt is redeemable with a yield based on the time value-of-money (e.g. interest), and payment obligations exist without regard to the performance of the debtor company (i.e. payments are required without regard to profits or cash available). On the other hand, equity is typically non-redeemable with the yield (i.e. dividends) depending on the performance of the company (i.e. profits), and payment obligations are discretionary or can be deferred without giving rise to legal claims.

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

### *B Hybrid Instruments*

Current law contains anti-avoidance rules that deal with hybrid debt instruments (i.e. debt instruments with equity features) as well as hybrid equity instruments (equity instruments with debt features). In the case of hybrid debt instruments, the anti-avoidance rules deny a deduction in respect of any amount paid or payable in terms of the hybrid debt instrument. However, the instrument otherwise remains a debt instrument for all other purposes of the Income Tax Act (including interest treatment for amounts received by the payee).

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

## II. Reasons for change

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

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

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

## III. Proposal

### *A. Overview*

In order to reduce the scope for the creation of equity that is artificially disguised as debt, a two-fold regime is proposed for domestic company issuers. One set of rules focuses on features relating to the nature of the instrument itself (i.e. the corpus); the second set of rules focuses on the nature of the yield. In making these rules, it is understood that the features distinguishing debt from equity are varied and are often contextual. Nonetheless, the proposal takes aim at domestic companies that issue stated debt instruments so as to artificially generate interest deductions if clear-cut equity features exist when viewed in isolation.

In term of the anti-avoidance rules relating to the instrument (i.e. the corpus), the proposal focuses on debt-labeled instruments that (i)have features indicating that redemption is unlikely within a reasonable period; (ii) have features that enable a conversion into shares or (iii) have a yield based on the solvency of the issuer. These features will be tested on a continuous basis (i.e. not once off at the date of issue but at any time thereafter).

In terms of the anti-avoidance rules focusing on yield, the debt yield must be based on time value of money (e.g. a rate of interest) – not other factors. Lack of payment due to company insolvency is also a problem. If the focus relates to the debt instrument itself, any amount of interest in respect of the instrument will be treated as a dividend *in specie* declared and paid by the issuer. The dividend *in specie* will be deemed to be declared and paid on the last day of the year of assessment of the issuer. In addition, a deduction of the interest will be denied. Similarly, the interest will also be treated as a dividend *in specie* accrued to the holder on the last day of assessment of the issuer. If the focus relates solely to the yield, the yield at issue will also be treated as a dividend *in specie*.

Lastly, the proposed regime will contain some exceptions to simplify administration and ensure that South Africa is not left in an uncompetitive situation. These exceptions include exceptions for certain forms of regulatory capital issued by regulated intermediaries.

*B. Instrument focused recharacterisation*

1. <u>Features</u>

A key feature of debt is the holder’s ability to redeem the capital amount loaned within a reasonable period. Instruments without this key feature operate more like equity (i.e. shares), and the yield on these instruments will accordingly be treated as equity yields (i.e. dividends *in specie)*. In order to avoid this deemed *in specie* dividend treatment, the debt instrument (i.e. the corpus) must be fully redeemable within 30 years from the date of issue (taking into account the terms of the instrument itself or any side arrangement). However, this treatment will not apply to financial instruments payable on demand. Where the issuer has a right to convert or exchange that instrument to or for another financial instrument (other than a share) the latter instrument will be treated as the former instrument for the purposes of determining the cumulative 30 years redemption period.

The recharacterisation rules also target certain mechanisms commonly used to avoid required redemption. Hence, conditions allowing for the issuer to repay the debt in the form of shares (i.e. of the issuer or group member) will also cause a recharacterisation (i.e. the repayment must generally come in the form of cash). Moreover, the obligation to repay will be disregarded if conditional upon the solvency of the debtor (i.e. the market value of the issuer’s assets being less than its liabilities). Like the 30-year redemption rule, these anti-avoidance rules take into account not only the instrument itself, but side arrangements as well.

As stated above, the test for whether a debt is commercially real or artificial must be tested continuously – not merely from the date of issue or modification. If the conditions of the debt change, the debt becomes subject to the avoidance rules at the time of the change (and not before).

2. Impact of recharacterisation

Debt instruments falling under the reclassification rules will remain within the debt paradigm. Only the interest in relation to the instrument will be treated as a dividend *in specie* in the hands of the payor as well as the payee. As a result, the payor will be denied the deduction for the stated interest. The stated interest will be treated as a dividend *in specie* (potentially subject to the Dividends Tax depending on circumstances), and the interest incurral rules (e.g. section 24J) will no longer be relevant to the existence of the instrument.

*C. Yield focused recharacterisation*

In some circumstances, the debt/equity recharacterisation will focus on the yield of the instrument without looking to the whole. Under these rules, the recharacterisation will similarly deem the particular yield at issue to be a dividend *in specie* in the hands of both the payor and the payee without converting the instrument as a whole (or even without converting other yields that lack equity features). In order to breach this standard, the yield at issue (taking into account all agreements) must have one of the following features:

a. The yield must not be determined with reference to time-value-of-money principles or a specified rate of interest (e.g. instead being based on company profits); or

b. The timing of payment must not be subject to the solvency (i.e. the market value of the assets being less than its liabilities) of the issuer of the instrument.

As a result, the payor will no longer obtain any deduction for the stated interest. The stated interest will be treated as a dividend *in specie* (potentially subject to the Dividends Tax depending on circumstances), and the interest incurral rules (e.g. section 24J) will no longer be relevant to the existence of the instrument. The instrument itself will retain its debt characterisation and other payments will have to be tested separately for debt/equity recharacterisation.

*D. Exemptions from reclassification*

The anti-hybrid rules will be subject to certain exemptions as a matter of policy. In particular, exemptions will exist for small business companies as well as certain regulated debt issued by banks and insurers.

1. <u>Relief for small businesses</u>

Small business companies (see section 12E) will not be subject to the hybrid recharacterisation rules. In most cases, the differences between debt and equity have little overall impact on the fiscus.

2. <u>Relief for regulated bank capital</u>

Banks often issue various forms of capital, including Tier I (straight equity) and Tier II (debt with equity features) capital. Increased pressure is being placed on the banks to increase these forms of capital via the international banking Basel standards. While it is understood that certain forms of Tier II capital will probably be in violation of the hybrid recharacterisation rules, these rules will be waived for Tier I and Tier II capital issued by banks and controlling companies in relation to those banks so as not to place further pressure on the cost of banking capital given the global regulatory uncertainties in this regard. This exclusion will also apply to Tier I and II capital issued to connected persons in relation to banks to the extent that such capital does not exceed 5 per cent of the Tier I and II capital issued by that bank, respectively. It is also understood that tax systems of other countries similarly exempt these forms of debt from potential recharacterisation on similar policy grounds.

3. <u>Relief for regulated insurer capital</u>

Short-term and long-term insurers are required to maintain a sound financial condition by maintaining adequate levels of assets to cover their regulated liability and capital requirements. As a safeguard mechanism, the redemption of certain classes of debt instruments issued by short-term and long-term insurers are subject to approval by the Registrar of short term and long term insurance (respectively). These forms of debt operate roughly similar to Tier I and Tier II debt and will accordingly be exempt from the hybrid debt reclassification rules.

4. <u>Wholly owned Pension and Provident Fund subsidiaries</u>

It is also understood that there are certain owned subsidiaries of pension and provident funds (“funds”) that issue linked units to the funds. Profits distributed by these subsidiaries often have a dividend element (for example, 1 per cent as a dividend and 99 per cent as interest). Interest payments in respect of these linked units (the debenture part) will therefore be potentially reclassified in these rules. As a consequence, the subsidiary will not be able to claim a deduction in respect of the yield paid to the funds in respect of these instruments.

Interest paid in respect of the above-mentioned instruments issued by wholly owned pension fund subsidiaries will be excluded from the application of the reclassification rules. However, this exclusion will only apply if the fund acquired the shares before 01 January 2013 and the instrument was also issued before that date.

## IV. Effective date

The proposed hybrid instrument recharacterisation rules will come into effective in the case of amounts incurred or accrued on or after 1 January 2014.

## 2.2. ANCILLARY COMPONENTS OF PIPELINES

[Applicable provision: Section 12D(1)("affected asset" definition)]

### I. Background

In 2000, special depreciation allowances were added to encourage and support significant capital investments within the energy generation and the electronic communications sectors. This coverage included pipelines used for the transport of natural oil and the refined by-products, water used for generating electricity as well as cables for the transmission of electricity or electronic communications (plus railway lines). The depreciation allowance applies at a rate of 10 per cent for natural and refined by-products. The depreciation allowance for the other assets mentioned is 5 per cent.

### II. Reasons for change

Oil pipeline networks are specifically engineered and built to include communication cables made out of optical fibre. These cables are used for the transmission of electronic communications relating to pipeline operations. While the pipelines themselves are eligible for depreciation allowances, ancillary communication and other equipment associated with the pipeline transmission appear to fall outside these allowances. No reason exists for this deviation.

### III. Proposal

It is proposed that the allowance in respect of pipelines used in the transportation of natural oil should be extended to include ancillary equipment (e.g. the communication cables) forming part of the pipelines and transmission lines. This change is consistent with the initial proposal – to provide a depreciation allowance for all assets at issue and all related equipment and structures.

### IV. Effective dates

The amendment will come into effective for years of assessment commencing on or after 1 January 2014.

## 2.3. CROSS-ISSUE OF SHARES

[Applicable provision: Sections 24B and 40CA]

### I. Background

If a company issues its own shares in exchange for the issue of shares by another company, both companies will be deemed not to have incurred any expenditure in respect of their respective acquisitions (i.e. both companies will have a zero tax cost in the shares received). However, if a company issues shares as consideration for other assets, the company is generally treated as having incurred expenditure equal to the market value of the shares (measured at their post-transaction value). The difference in both scenarios stems from the fact that the first scenario is tax-free for both parties; whereas, the issue of shares as consideration for other assets typically gives rise to tax (being a disposal of assets by the party receiving the shares).

The zero tax cost rule is fairly broad, covering direct and indirect transfers as well as cross-issues involving connected persons. However, an exception is available from the zero tax cost rule for the cross-issue of shares if preference shares are issued for ordinary shares. This exception exists in recognition of many black economic empowerment financing arrangements. In a typical self-financing arrangement, an operating company issues ordinary shares itself in exchange for the issue of preference shares by the black economic empowerment company. The dividends from the ordinary shares serve as a basis for the dividend payments from the preference shares.

## II. Reasons for change

### *A. Unintended reach of the zero tax cost rule*

The zero tax cost rule has broader coverage than initially intended, especially because the zero tax cost rule covers both direct or indirect interests as well as exchanges between connected persons. For instance, if a taxpayer transfers assets to a company in exchange for shares, the zero tax cost rule appears to apply if that company subsequently transfers those same assets to a subsidiary in exchange for subsidiary shares. In addition, the zero tax cost rule continues to have an adverse impact on black economic empowerment transactions. While the operating company is free from the zero tax cost rule in respect of preference shares received to fund the transaction, the black economic empowerment company is fully subject to a zero tax cost in respect of the ordinary shares held in the operating company.

### *B. Recent case law*

In the recent decision of the Supreme Court of Appeal in *C: SARS v Labat Africa Ltd (669/10) [2011] ZASCA 157,* the Supreme Court had to determine whether the issuing of shares by a company as consideration for the acquisition of a trademark amounts to "expenditure actually incurred" by the issuing company. Because the term "expenditure" is not defined in the Income Tax Act, the Court observed that the term's ordinary meaning had to be attributed. In this regard, the ordinary meaning of the term "expenditure" encompasses the action of spending funds, disbursement or consumption and hence, requires a diminution of the assets by the person who expends. The Court held that the issue of shares does not give rise to any diminution in the assets of the issuing company and that the shares issued as consideration for the acquisition of the trademark accordingly do not amount to "expenditure",

The Supreme Court decision removes the necessity of having a non-expenditure rule within the Income Tax Act because this rule now exists via judicial precedent. This finality did not exist when the zero tax cost cross-issue rule was initially legislated.

## III. Proposal

The rules against cross-issues will be eliminated due to the adverse impact that the zero tax cost rule has in respect of commercially driven transactions involving the issue of shares for assets.

Companies that issue shares for assets will generally obtain a market value tax cost in those assets (unless rollover treatment applies under the reorganisation rules).

However, it should be note that the Labat Africa Ltd decision will continue to apply in all other contexts. For instance, if shares are issued in exchange for services, the issue of shares will not be deductible by the issuing company.

**IV. Effective dates**

The repeal of section 24B will come into effect in the case shares issued on or after 1 January 2014.

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## 2.4. REMOVAL OF DIVIDEND EXEMPTION FOR DIVIDENDS APPLIED AGAINST DEDUCTIBLE FINANCIAL PAYMENTS

[Applicable provisions: New proviso (hh) to section 10(1)(k)(i)]

**I. Background**

Dividends paid by resident companies are generally exempt from income tax but subject to the Dividends Tax at a rate of 15 per cent. However, there are certain specific exemptions to the Dividends Tax (e.g. dividends paid to South African company shareholders).

Current law contains several anti-avoidance rules that are intended to deny the exemption for company shareholders if there are artificial shifts of exempt dividend income or to prevent mismatches (i.e. deductible amounts derived from exempt dividend income). One rule designed to prevent mismatches involves otherwise exempt dividends arising from share lending arrangements if the dividends are applied to pay offsetting manufactured dividends in respect of short-sale obligations.

**II. Reasons for change**

The current rules cover only one form of financial arrangement where dividends are applied against deductible offsetting payments. For instance, a financial intermediary company may hold shares as an offset against the issue of share derivatives (e.g. stock futures, contracts-for-difference and total return swaps. In these instances, the financial intermediary company receives exempt dividends in respect of the shares with the dividend proceeds applied to offset deductible payments in respect of the share derivative. The net result is a tax mismatch for the financial intermediary company – receipt or accrual of an exempt dividend with the dividend amount applied to cover a deductible payment owed in respect of a share derivative.

**III. Proposal**

In order to counter mismatches from various dividend/derivative mismatches, dividends received or accrued by a company will no longer be exempt if used as an offset against a deductible payment. More specifically, this provision will operate in similar fashion to the current rule preventing dividend mismatches involving share lending schemes. The exemption for dividends received or accrued by a company will be denied if the company incurs obligations to pay dividends where those obligations are determined wholly or partly with reference to dividends received or accrued.

**IV. Effective date**

The proposed amendments to will come into effect on 1 January 2014 and will apply in respect of amounts received or accrued during any year of assessment commencing on or after that date.

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## 2.5. DEDUCTIBLE DONATIONS OF APPRECIATED IMMOVABLE PROPERTY

[Applicable provisions: Sections 18A and 37C(5)]

**I. Background**

*A. Special dispensation for deductible donations*

A special dispensation for donations exists that allows donations to be deductible against the donor’s income when made to certain organisations engaged in public benefit activities. This dispensation also applies in respect of donations made to Government and certain quasi-Governmental institutions. In this regard, a donation may be made in the form of cash or property (both of which are generally subject to the annual 10 per cent ceiling).

If a donation is made in cash, the cash donation will generally be deductible in the hands of the donor to the extent that the donation does not exceed 10 per cent of the donor’s taxable income. Property donations follow a similar paradigm, except for the determination of the deductible amount. Donations of trading stock are fully deductible to the extent of the cost price thereof. For property other than trading stock, the amount of the donation is limited to the lower of cost to the donor or the fair market value of that asset on the date on which the donation is made. Donations within the special dispensation are not subject to the capital gains on the difference between market value and cost (despite the fact that the donation is technically a disposal).

The purpose of the deductible “lower of cost or market value” rule is two-fold. Firstly, taxpayers should not obtain a deduction for pre-tax amounts (i.e. untaxed gains). If taxpayers seek to obtain a deduction for the appreciation, taxpayers should sell the property and recognise the capital gain, followed by a cash contribution. Secondly, concerns exist that taxpayers may overvalue property in order to artificially enhance the deduction.

*B. Incentive for environmental conservation participants*

Government has created various mechanisms to promote biodiversity conservation, including the use of fiscal incentives to promote land donations for protected environments, national parks and nature reserves. More specifically, if land is declared to be a national park or nature reserve with an endorsement on the title deed for at least 99 years, the lower of the cost or the market value of the land is treated as a tax deductible donation.

However, unlike regular deductible donations, the value of the deduction is spread over 10 years at 10 per cent per annum. The purpose of this 10 per cent spreading is to reduce the adverse impact of the overall 10 per cent ceiling relating to deductible donations.

## II. Reasons for change

Oftentimes, landowners own and use their land for many years before considering the possibility of making a donation of that land. Many landowners seeking to make a 99-year private endorsement for the promotion of a national park or nature reserve have owned the land for a considerable amount of time or it has been passed on through family generations. In these instances, the fair market value of the land is considerably larger than the cost. Failure to account for the appreciation differential in the deductible determination essentially eliminates most of the potential tax benefit for making a donation or a 99-year private endorsement for land conservation.

## III. Proposal

In order to enhance the incentive for deductible donations on 99-year endorsements for land conservation, donations of appreciated immovable property (that qualify as capital assets) will be allowed to exceed cost. Under the revised rule, the deductible amount above cost will equal the lower of market or municipal value. The municipal value limit will prevent the existence of excessive deductions caused by artificial valuations.

In addition, the revised rule will indirectly take into account the capital gain charge and recoupment that should have arisen had a deemed disposal occurred upon donation. This implicit accounting of the implied capital gain charge and recoupmet ensures some level of parity between a “sale of property for cash followed by a deductible donation of that cash” and a “direct deductible donation”. With this adjustment, the deductible amount will be reduced by the taxable capital gain inclusion and recoupments that would have been taken into account for taxable income.

**Example**

***Facts:*** Mr. X owns farmland with a base cost of R250 000. In 2013, Mr X undertakes a 99-year endorsement of the farm land in terms of the Department of Environmental Affairs’ biodiversity stewardship programme. At the time of the donation, the farm land has a municipal value of R3 million and a market value of R3.4 million. Mr X has a taxable income of R1 million for the 2013 year of assessment.

***Result:*** Mr X can potentially deduct the R250 000 base cost as well as a portion of the R2 750 000 municipal value exceeding base cost. Because Mr. X is a natural person, this latter amount equals R1 834 250 (R2 750 000 multiplied by 66.7 per cent). The total potential deduction accordingly equals R2 084 250 (R250 000 plus R 1 834 250). This amount is limited to R100 000 during the current year due to the 10 per cent deductible donation ceiling. The excess R1 984 250 can be carried forward to future years (due to the newly proposed carryover).

## IV. Effective date

The proposed amendments will be effective as from 1 March 2014 and will be applicable in respect of amounts paid or transferred during years of assessment commencing on or after that date.

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## 2.6. DEDUCTIBLE INTEREST LIMITATION IN RESPECT OF ACQUISITION INDEBTEDNESS

[Applicable provisions: New provisions Section 23N and Section 23O of the Income Tax Act 9 after section 23K]

### I. Background

*A. Deductibility of interest in the case of company acquisitions*

Interest expenses incurred in respect of debt used to finance the acquisition of business assets are generally deductible because business assets are intended to produce income. Interest on debt used to acquire shares is generally not deductible because shares produce only exempt dividend income.

Despite the above, interest deductions associated with share acquisitions can be achieved indirectly through the use of the section 45 rollover provisions (or to a much lesser extent, the section 47 rollover provisions). This objective is generally achieved when: (i) an acquiring company purchases all of the shares of a target company using temporary debt-financing, (ii) followed by a tax-deferred sale of assets by the target company to a newly formed subsidiary of the acquiring company that is funded via long-term debt. In these circumstances, the interest on the long-term debt is deductible by the newly formed subsidiary on the assumption that the debt is directly linked to income producing assets of the former target company.

A special deduction (under section 24O) is also available for interest incurred if that interest is associated with debt used to acquire controlling share interests in an operating company. Interest deductions are allowed in this circumstance because this form of acquisition is comparable to indirect share acquisitions.

*B. Discretionary limitations*

Potentially high levels of debt are often used to fund company acquisitions with excessive debt often anchored on the expectation of inflated future profits. In order to prevent this misuse of acquisition debt, interest deductions associated with this debt are currently subject to discretionary limits as determined by SARS. These limits are designed to target potential base erosion caused by excessive debt (and to prevent the interest deduction from becoming a facilitator of unwarranted risk). The level of debt allowed essentially focuses on the question of acceptable versus unacceptable tax leakage.

### II. Reasons for change

As discussed above, the use of excessive debt for funding company acquisitions represents a significant risk to the tax system with taxable profits for the target company often wiped out for many years into the future. While the current discretionary system contains this risk, this discretionary system was never intended to be permanent. Taxpayers seeking debt-financing when attempting to acquire control of companies cannot be expected to obtain pre-approval in respect of every transaction. The purpose of the discretionary system was merely to obtain more information so as to create an informed objective set of permanent rules. The time has now come to set those rules.

## III. Proposal

### *A. Overview*

As discussed above, interest deductions associated with acquisition debt will now be contained through an objective set of rules as opposed to the current discretionary system. This interest limitation will apply to all debt used to fund indirect share acquisitions (i.e. facilitated through the use of sections 45 or 47) and direct share acquisitions (facilitated through the use of section 24O). The nature of these rules are roughly akin to the debt limitation rules associated with interest paid to exempt persons where the debtor and creditor are part of a controlling relationship (see **DEDUCTIBLE INTEREST LIMITATION IN RESPECT OF LOANS BETWEEN EXEMPT PERSONS AND DOMESTIC COMPANIES**).

### *B. Deductible interest limitation*

1. Ceiling formula

The aggregate deductions for interest paid or incurred in respect of acquisition debt will become subject to an annual limitation pursuant to a defined formula. More specifically, the aggregate deductions for these amounts will be limited to the sum of:

a. the interest received or accrued to the extent that it exceeds interest incurred (other than interest expenditure related to indirect and direct share acquisition transactions); and

b. in the case of a reorganisation transaction contemplated under sections 45 and 47, 40 per cent of adjusted taxable income of the acquiring company or

c. in the case of an acquisition transaction contemplated under section 240, the higher of 40 per cent of the adjusted taxable income of the acquired company in the year of assessment in which the acquisition takes place or in the year of assessment the interest is incurred (after the year of acquisition).

For this purpose, adjusted taxable income is the taxable income (as determined in terms of the Act) with certain exclusions and inclusion. In determining the adjusted taxable income all interest received or accrued and the the net income of a CFC should be excluded. However, all interest incurred, capital allowances as well as 75 per cent of the rental income of the acquirer. This calculation should also exclude all currency gains or losses. This formula is increased for rentals because financial institutions are generally more willing to provide funding if immovable property is involved.

2. Dual years

The formula for the ceiling is to be determined against two years with the adjusted taxable income in the year of the acquisition setting the minimum base. The purpose of this minimum base is to provide parties undertaking a company acquisition with the certainty that they can rely on an initial base calculation when negotiating sales terms. More specifically, the limitation will equal 40 per cent of –

The higher of:

a. the adjusted taxable income (as discussed above); or

b. the adjusted taxable income (as discussed above) during the year of assessment in which the interest expenditure is incurred.

3. Lost excess

Interest in excess of the formula limitation will be permanently lost after 5 years of assessment following the year of acquisition. The purpose of the regime is to prevent the use of excessive debt mainly to achieve tax savings so that the tax savings becomes a core element of making the deal viable. In essence, Government does not want the fiscus to be at stake without being present at the negotiating table. In view of the fact that excess interest deductions are permanently lost, the limitation will last for only five years assessment after the year of assessment in which the acquisition occurs.

4. Indirect versus direct acquisitions

In the case of indirect acquisitions (i.e. acquisitions utilising sections 45 and 47), the interest limitation will be determined with reference to the taxable income of the acquiring company. In the case of a section 24O acquisition, the interest limitation will apply in a similar fashion with the deductible interest of the acquiring company being limited to 40 per cent of the taxable income of the target company. The 40 per cent taxable income limitation will be further adjusted in accordance with the percentage stake being acquired if the acquirer is not acquiring all of the shares of the target company. For instance, if the acquirer acquires 80 per cent of the shares of target company, the limit will be 80 per cent of 40 per cent of the target company's taxable income.

*C. Special rules*

1. Upward adjustments for periods of high interest rates

The 40 per cent deduction limitation is based on the assumption of relatively low national interest rates. Therefore, the limitation will be increased should national interest rates eventually increase beyond a certain level. In particular, the 40 per cent threshold will increase for all taxpayers if the national repo interest rate exceeds 10 per cent. This higher limitation will be calculated as follows:

(40 per cent) "multiplied by" the repo rate/10

2. Denial of interest deductions for intra-group acquisitions between historic group members

Concerns have long-existed that the reorganisation rules are being linked to interest deductions so as to undermine the long-term taxable income of a pre-existing group. While the need for intra-group restructurings of historic group members is understood, it is highly questionable whether the restructuring of historic group members needs an injection of debt to be realigned. It is accordingly proposed that the interest deduction to facilitate the acquisition of a target company by an acquiring company be wholly denied if both companies were part of the same (section 1) group of companies within 18 months of the last 36 month period.

3. Acquisitions implemented under the section 23K pre-approval regime

Direct and indirect company acquisitions that are currently subject to section 23K will remain subject to conditions upon which approval was granted. However, interest incurred in respect of debt issued or used to redeem, settle or replace debt that was subject to the section 23K regime will be subject to the new acquisition indebtedness ceilings to the extent that such redemption, settlement or replacement occurs on or after 1 July 2013.

**Example 1: Interest rate adjustment**

***Facts:***
During its 2013 year of assessment, company X acquires the assets of company Y by way of a section 45 intra-group transaction. To fund the acquisition, company X issued a R8 million note at an interest rate of 10% per annum.

During the 2014 year of assessment the average repo rate (determined with reference to the monthly average repo rates during that year of assessment) was 11%. The taxable income of company X after taking in account all the adjustment is R1 million.

***Results:***

| | |
|---|---|
| Interest subject to limitation | = R800 000 |
| Interest allowable per limit | = [(40% x (11/10)) x Taxable Income |
| | = 44% x (1 million) |
| | = R440 000 |

As a result, R440 000 of the R800 000 interest incurred will be deductible in the 2014 year of assessment. The balance of R360 000 will be wholly denied for a deduction.

**Example 2: Determination of taxable EBITDA and effect of adjustments**

***Facts:***
During its 2013 year of assessment, company X acquires the assets of company Y by way of a section 45 intra-group transaction. To fund the acquisition, company X issued a R8 million note at an interest rate of 10% per annum. During the 2013 year of assessment, company X incurred expenditure and accrued income for the following:

Interest income: R400 000

Rental income: R100 000
Interest expenditure: R80 000

The taxable income of company X (before rental income, interest and capital allowances) amounted to R1 million ("Taxable EBITDA").

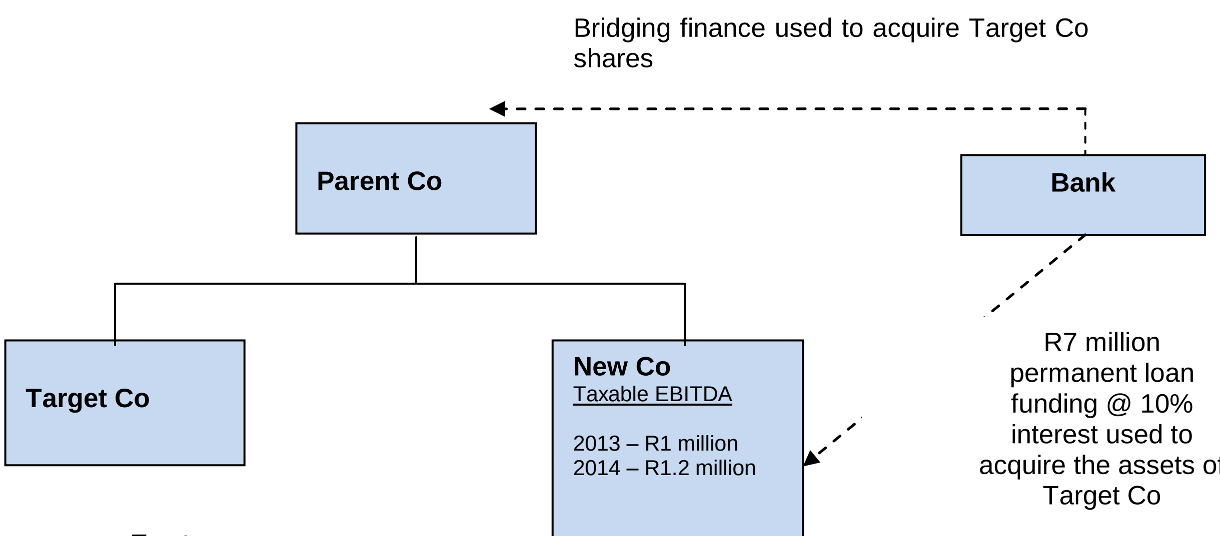
***Result:***
**<u>40% taxable EBITDA (for the 2013 year of assessment):</u>**
Interest subject to limitation = R800 000
Interest allowable per limit = [40% x (Taxable Income + 1.75(Gross Rental Income)]
= 40% x (1 million + 175 000)
= R470 000

**<u>Overall interest limitation:</u>**

Overall interest limitation = R470 000 + R400 000 – R80 000
= R790 000

As such, only R790 000of the R800 000 interest incurred by company X on the acquisition debt will be deductible. The balance of R10 000 will not be deductible.

**Example 3: Basic section 45 acquisition with acquisition year EBITDA comparison**




***Facts:***

- New Co is established by Parent Co to acquire the assets of Target Co in 2013. The interest deductions allowable for New Co during the 2013 and 2014 years of assessment will be as follows:

***Results:***
**<u>40% taxable EBITDA (for the 2013 year of assessment):</u>**

Interest subject to limitation = R700 000
Interest allowable per limit = [40% of R1 million taxable EBITDA]

= R400 000

- New Co's interest deduction for the 2014 year of assessment in respect of the acquisition debt will be limited to R400 000.
- As such, the balance of R300 000 will not be deductible.
- Note: Ignore the interest incurred from the bridging finance as negligible.

**<u>40% taxable EBITDA (for the 2014 year of assessment):</u>**

The limitation for the 2014 year of assessment will be based on the higher of the 2013 overall interest limit and the 2014 overall interest limit.

<u>2013 limit:</u>

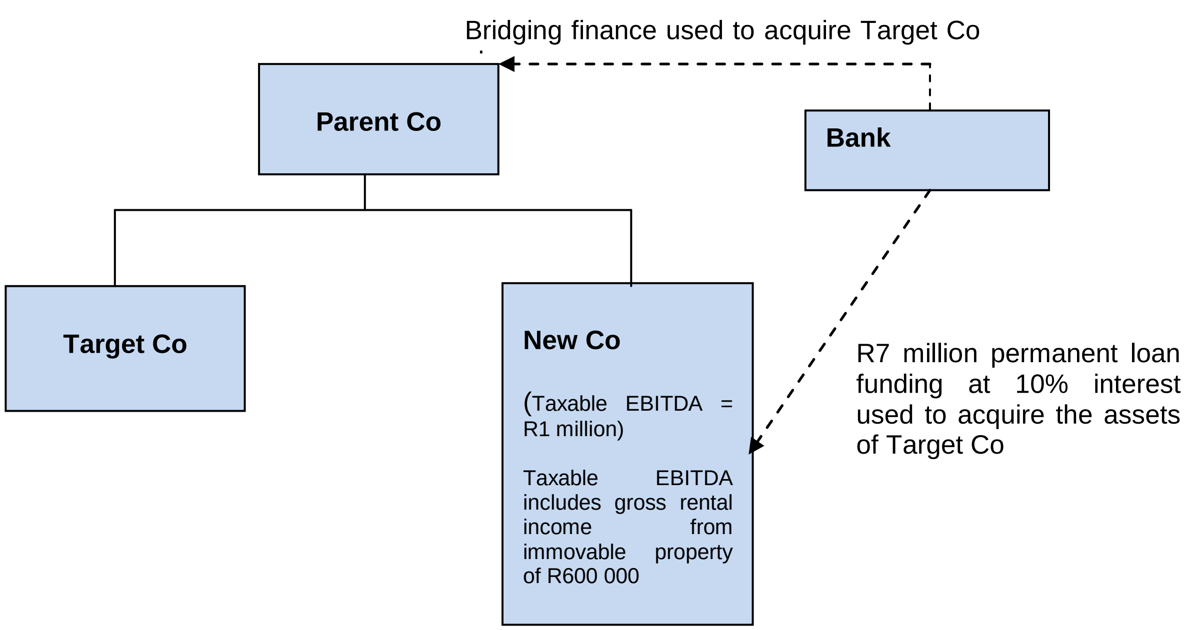
As determined above, the 2013 overall interest limit on acquisition debt was R400 000.

<u>2014 limit:</u>

Interest allowable per limit = [40% of R1.2 million taxable EBITDA]
= R480 000

- As the 2014 overall interest limit is higher, New Co's interest deduction for the 2014 year of assessment in respect of the acquisition debt will be limited to R480 000.
- As such, the balance of R220 000 of the R700 000 interest incurred in 2014 will not be deductible.
- Note: Ignore the interest incurred from the bridging finance as negligible.

**Example 4: Section 45 acquisition of assets generating rental income**



***Facts:***
The facts are the same as those in EXAMPLE 1, except that New Co has gross rental income of R600 000 in the year during which the acquisition took place (i.e. 2013).

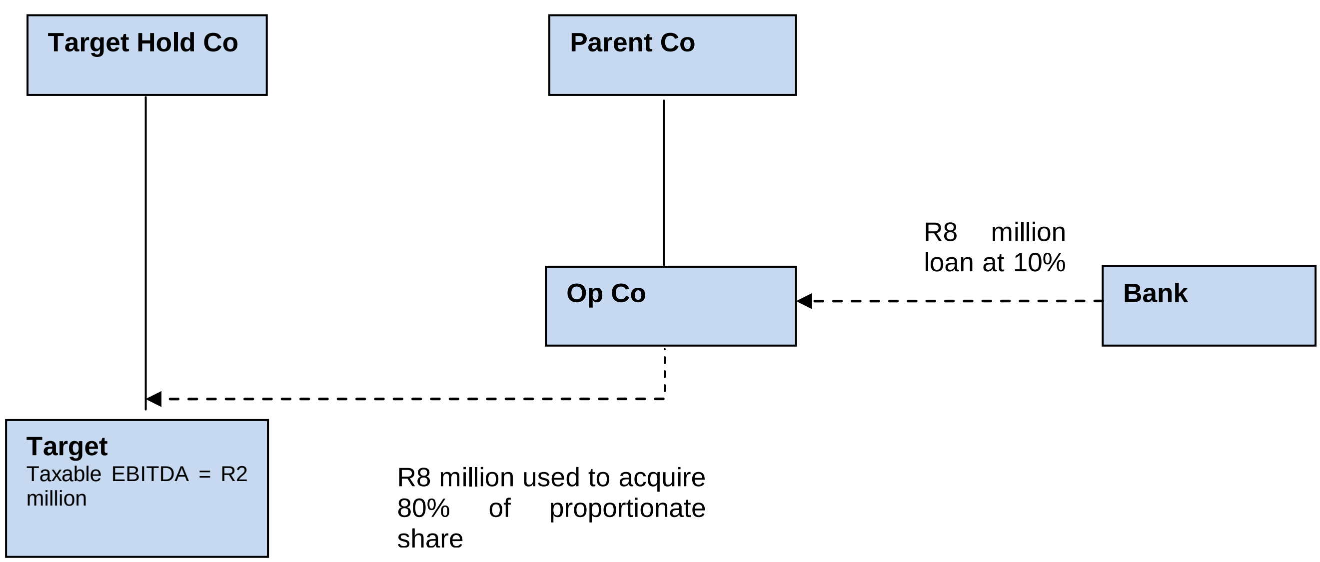
***Results:***

**<u>40% taxable EBITDA (for the 2013 year of assessment):</u>**

Interest subject to limitation = R700 000
Interest allowable per limit = [40% x (Taxable Income + 1.75(Gross Rental Income)]
= 40% x (1 million + 1050 000)
= R820 000

- New Co's interest deduction in respect of the acquisition debt will be limited to R820 000
- As such, the interest will be deductible in full.
- Note: Ignore the interest incurred from the bridging finance as negligible.

**Example 5: Section 24O acquisition of partial interest**




***Result:***
Interest subject to limitation =R800 000
Interest allowable per limit = 40% of (R2 million taxable Income of target company x 80%)
= R640 000

- OpCo's interest deduction in respect of the acquisition debt will be limited to R640 000 and the balance of R160 000 will not be deductible.

**IV. Effective date**

The proposed acquisition indebtedness ceilings will come into effect on 1 July 2013 and will apply in respect of acquisition transactions and refinancing arrangements entered into on or after that date. The section 23K approval regime will be limited to acquisition transactions before that date and will be wholly repealed in respect of interest incurred for years of assessment commencing on or after 1 January 2019.

## 2.7. DEFERRAL OF INCURRED EXPENDITURE BETWEEN TAXABLE PAYORS AND EXEMPT PAYEES

[Applicable provision: Section 23M]

**I. Background**

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

**II. Reasons for change**

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

This potential room for mismatch provides certain taxpayers with the opportunity to accelerate deductions without actually being forced to make payment until a much later date (if ever). The net effect is a deduction on the one side without roughly simultaneous income on the other, even though no cash ever moves.

**III. Proposal**

It is proposed that deductions for expenditures owed to persons that are exempt from South African tax (i.e. from normal tax and withholding taxes) be subject to temporary suspension if a controlling relationship exists between the payor and the exempt payee. A controlling relationship exists if either the payor or the payee:

1. Directly or indirectly holds more than 70 per cent of the equity shares or voting rights of the other person, taking into account persons that are connected to the payor or the payee (as the case may be); or

2. Is a person who is a connected person in relation to a person described in 1 above.

If these circumstances exist, the payor will be treated as having incurred the expenditure in respect of which the deduction is sought only upon actual payment. This anti-avoidance rule will not apply to any expenditure incurred in respect of the acquisition of trading stock (because trading stock triggers automatic subsequent income for the payor at issue).

**Example:**

***Facts****:* Foreign Parent owns all the shares of South African Subsidiary and Foreign Subsidiary. Foreign Parent and Foreign Subsidiary do not have any operations or activities within South Africa. In 2015, Foreign Subsidiary advances a three-year R10 million loan to South African Subsidiary. Interest on the loan is charged at JIBOR + 2% per annum. Interest is cumulative and payable only at the end of the loan-term of three years (together with the capital amount). South African withholding tax on interest will potentially apply at 15 per cent when the interest is paid or payable, but a tax treaty reduces the tax to zero. The interest is paid in 2018.

***Result:*** Under section 24J, interest is normally deductible during each of the three years as the interest is compounding. However, under this proposal, the deductions arising from the interest incurred by South African Subsidiary are suspended until the tax on the interest is withheld by the South African Subsidiary (i.e. in the case, on the date that the amount is paid).

**IV. Effective Date**

The proposed amendment will be effective for expenditures incurred on or after 1 July 2013.

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## 2.8. DEDUCTIBLE INTEREST LIMITATION IN RESPECT OF LOANS BETWEEN EXEMPT PERSONS AND DOMESTIC COMPANIES

[Applicable provisions: New provision under section 23P]

**I. Background**

*A. Initial Framework*

Interest is generally deductible if arising from trade, incurred in the production of income and not of a capital nature. This deduction applies even if the creditor is wholly exempt in respect of the interest received or accrued. Notable parties eligible to receive exempt interest are pensions and foreign persons. In the case of a foreign person, interest from South African sources is generally exempt unless that foreign person has a South African permanent establishment. This exemption is roughly matched within the South African tax treaty network, which often exempts foreign residents from taxation in respect of South African sourced interest unless that interest is attributable to a South African permanent establishment. The purpose of this cross-border exemption is to attract foreign debt capital to the domestic market.

*B. Anti-avoidance*

While debt capital is an important tool for investment, debt capital can also create opportunities for base erosion. Deductible interest paid to foreign (and other exempt) persons represents a risk to the fiscus because of the deduction/exemption mismatch. This mismatch leads certain parties to over-leverage because of the overall tax benefits. In view of these concerns, the tax system contains anti-avoidance measures to prevent this deliberate and excessive mismatch. At the end of the day, a balance is required between attracting debt capital and the protection of the tax base against base erosion.

In order to strike this balance, the Income Tax Act seeks to control excessive debt through one of two means. Historically, a 3:1 debt equity limit has applied to cross-border debt. This limit operated as an adjunct to transfer pricing. In addition, a 15 per cent withholding tax has been enacted that will generally apply to cross-border interest.

## II. Reasons for change

The current methods to limit excessive interest owed to exempt persons are largely incomplete. The 3:1 debt equity rule had to be changed in favour of a more facts and circumstances approach so as to satisfy international transfer pricing standards. The 3:1 debt limit also allowed for debt levels that are far too great with the prior rule arguably encouraging debt limits to the 3:1 level. As for cross-border interest withholding, the proposed charge is frequently reduced to zero under most South African tax treaties.

Excessive interest deductions pose a recurring risk if the creditor and debtor form part of the same economic unit. The terms of the funding instrument are often irrelevant because both parties can freely change the terms to serve the overall interest of the group. As a result, the debt label for these instruments is often driven by tax and other regulatory factors; whereas, loan capital frequently represents equity capital to be repaid only once the debtor is profitable.

## III. Proposal

*A. Overview*

It is proposed that the aggregate deductions for interest on all debt owed to persons be subject to an overall ceiling if a controlling relationship exists between the debtor and the other person (i.e. the creditor).

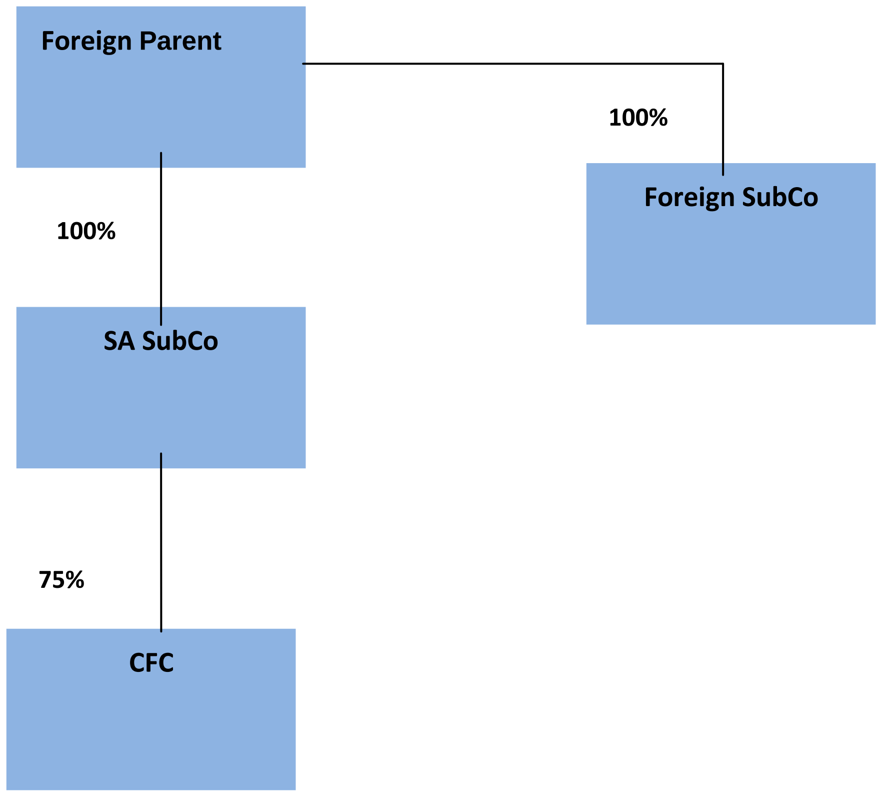
*B. Controlling relationships*

As stated above, the proposed interest limitation will apply only if either the debtor or creditor controls the other. More specifically, control exists if either the creditor or the debtor:

1. Directly or indirectly holds more than 70 per cent of the equity shares or voting rights of the other person, taking into account persons that are connected to the creditor or the debtor (as the case may be); or

2. Is a person who is connected to a more than 70 per cent person described in 1).

**Example**




***Facts:*** Foreign Parent owns all the equity shares in SA SubCo and Foreign SubCo. SA SubCo owns 75 per cent of the equity shares in CFC. What is the impact of this rule on any loans provided to SA SubCo by (i) Foreign Parent, Foreign SubCo, or (iii) CFC?

***Result****:* The interest limitation rule will apply in respect of any loans from:

(i) Foreign Parent (i.e. owns more than 70 per cent of the equity shares in SA SubCo;

(ii) Foreign SubCo (i.e. a connected person in relation to Foreign Parent); and

(iii) CFC (i.e. SA SubCo directly more than 70 per cent of the equity shares in CFC).

This rule will also apply to debt owed to persons who are not in a controlling relationship if:

- that person obtained the funding of the debt from a person with a controlling relationship in relation to the debtor; or
- the debt is guaranteed by a person with a controlling relationship in relation to the debtor.

*C. Deductible interest limitation*

1. <u>Formula calculation</u>

The aggregate deductions for interest paid or incurred in respect of debt owed to exempt persons with a controlling relationship will become subject to an annual limitation pursuant to a defined formula. More specifically, the aggregate deductions for these amounts will be limited to the taxable income of:

a. The total interest received or accrued to the debtor (excluding any interest subject to the limitation in terms of this proposal); and

b. 40 per cent of adjusted taxable income, reduced by

c. Interest incurred in respect to debts owed to persons other than creditors described in paragraph (b) of the proposal.

For this purpose, adjusted taxable income is the taxable income of the debtor less all interest received or accrued, and section 9D controlled foreign company net income with the addition of interest incurred, all capital allowances and 75 per cent of the debtor's rental income. This adjusted taxable income must be determined without regards to any exchange differences (determined in terms of section 24I)

Interest expense in excess of the limitation will not be deductible in the current year. The excess will be carried forward into the following year (while retaining its tainted character). The carry-forward period may not exceed 10 years with the excess being reduced on a first-in first-out basis.

**Example**

***Facts***: Foreign Parent owns all the shares in Foreign SubCo and 74 per cent of the shares in SA SubCo. In 2013, Foreign SubCo provides a loan of R 7,5 million and charges interest at 10 per cent. SA SubCo has interest income of R300 000 from loans provided to unconnected persons and has interest expenses of R190 000 on loans provided by unconnected person. The overall deductible allowances of SA SubCo in 2013 is R400 000. The taxable EBITDA of SA SubCo in 2013 is R2, 9 million.

***Result:*** The interest limitation rule will apply because the loan is provided by a connected person in relation to Foreign Parent (i.e. person who owns more than 50 per cent of the equity shares of SA SubCo. The interest limitation will be as follows:

Interest subject to limitation = R750 000

Interest limitation = Interest income – interest expenditure (not subject to limitation) + (40% x R1.5 million)
=R300 000 – R190 000 + R600 000
= R710 000

As a result, only R710 000 of the R750 000 interest incurred in the 2013 year of assessment will be deductible. The balance of R40 000 will carried forward.

*D. Special rules*

3. Upward adjustments for periods of high interest rates

The 40 per cent deduction limitation is based on the assumption of relatively low national interest rates. Therefore, the limitation will be increased should national interest rates eventually increase beyond a certain level. In particular, the 40 per cent threshold will increase for all taxpayers if the national repo interest rate exceeds 10 per cent. This higher limitation will be calculated as follows:

(40 per cent) "multiplied by" the repo rate/10

**Example**

***Facts****:* The facts in example 1 apply, however a variable rate of interest is charged on the funding from Foreign SubCo. During the 2014 year of assessment, the average repo rate increased to 12% (determined with reference to the monthly average rate during that year of assessment). The interest incurred by SA SubCo in 2014 amounted to R990 000

***Result****:* The interest limitation rule will apply because the loan is provided by a connected person in relation to Foreign Parent (i.e. person who owns more than 50 per cent of the equity shares of SA SubCo. The interest limitation will be as follows:

The interest limitation for the 2014 year of assessment will be as follows:

Interest subject to limitation = R990 000
Interest limitation = Interest income – interest expenditure (not subject to limitation) + [(40% x (12/10))x R1.5 million)]
= R300 000 – R190 000 + (48% xR1.5 million)
= R830 000

As a result, only R830 000 of the R990 000 interest incurred in the 2014 year of assessment will be deductible. The balance of R160 000 will be carried forward.

4. Back-to-back loans

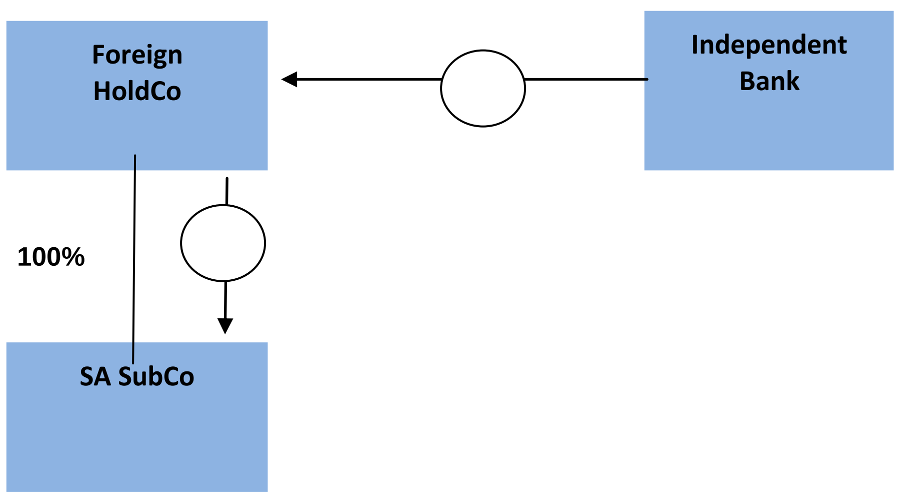
Back-to-back loans require special consideration depending on the location of the initial funding source. A loan from an exempt person with a controlling relationship could originate from an outside source. Similarly, a loan from an independent source could originate from an exempt person with a controlling relationship. These arrangements typically come in the form of a back-to-back loan or guarantee. In either case, the focus should be directed toward the original source, not the intermediary making the loan to the domestic company.

a. Relief for back-to-back loans: The debt limitation should not apply to a loan to a domestic company from an exempt person with a controlling relationship if: (1) the exempt person obtained those funds with amounts that are directly derived from an unconnected lending institution, and (2) the financial institution loan funding of the exempt person is based directly on the strength of the balance sheet of the domestic company.

b. Tainted backing from exempt persons: The debt limitation should apply to loans to a domestic company from any person without a controlling relationship if: (1) that person obtained those funds with amounts that are directly derived from a person with a controlling relationship, or (2) the loan to the debtor company is guaranteed by a person with a controlling relationship.

**Example:**

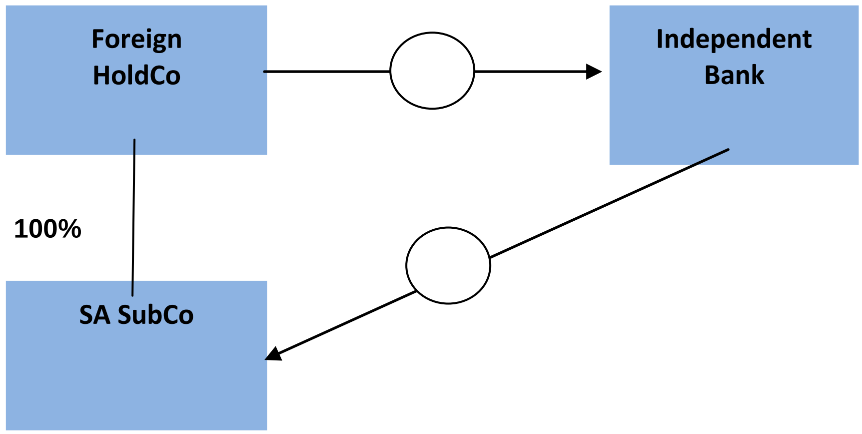
Relief for back-to-back loans




***Facts:***
1. Foreign HoldCo obtains a loan of R7,5 million at 10 per cent interest from Independent Foreign Bank
2. Foreign HoldCo onlends the R7,5 million at 12 per cent interest rate to SA SubCo

***Result:*** The interest limitation rule will not apply because the loan was directly funded by an independent lending institution and because the loan was advanced on the strength of the balance sheet of Foreign HoldCo

**Example:**
Tainted backing from exempt persons




***Facts***:
1. Foreign HoldCo advances an amount of R7,5 million at 10 per cent interest to Independent Foreign Bank
2. Independent Bank lends the amount of R7,5 million at 12 per cent interest rate to SA SubCo

***Result***:
Although the loan is obtained from a person who does not have a controlling relationship in relation to SA SubCo, the interest limitation rule will apply because the funds were derived directly from a person with a controlling relationship.

**IV. Effective date**

The provisions will be effective from 01 July 2013 in respect of interest expenditure incurred on or after that date.

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## 2.9. TENANT CONSTRUCTION OR IMPROVEMENTS ON LEASED LAND

[Applicable provision: Section 12N of the Income Tax Act]

**I. Background**

*A. Basic framework for claiming depreciation allowances*

The Income Tax provides a variety depreciation allowances for the erection or acquisition of certain movable and immovable assets (e.g. buildings and fixed structures). In order to qualify for these allowances (especially in the case of immovable property), the taxpayer must generally be the owner of the assets.

*B. Depreciation allowances for obligatory tenant improvements undertaken on leased property*

In addition, if a tenant undertakes improvements in respect of leased land, the tenant can deduct the cost of the improvement over time but only if the improvement was undertaken pursuant to an obligation incurred under an agreement (e.g. typically imposed by the landlord). The cost of these improvements is generally deductible over the rental contract period (subject to a maximum 25 year limitation). If the allowance is not fully exhausted at the end of the lease period, the remaining amount is deductible by the lessee.

This allowance is only available to a lessee if the value (or expenditure) associated with the improvements constitutes income in the hands of the lessor (e.g. the allowance does not apply if the lessor is a tax-exempt entity such as Government). However, this income inclusion is subject to another allowance that effectively ensures that the lessor is only taxed on the present value of the improvements (at the end of the lease term or on termination of the lease).

*C. Allowances for obligatory tenant improvements undertaken on leased governmental and certain quasi-governmental property*

In 2010, a new provision (i.e. section 12N) was inserted to provide for depreciation allowances in respect of obligatory leasehold improvements undertaken on leased land or buildings owned by the government or certain exempt quasi-governmental entities. Tenants claiming these depreciation allowances can claim the allowances as if the improvement were directly owned. These depreciation allowances in respect of buildings and structures typically have a 10-to-20 year duration.

**II. Reasons for change**

Oftentimes, tenants may voluntarily embark on improvements on leased land or buildings in order to make their places of business commercially suitable or viable. Improvements by tenants may take the form of erecting a building on leased land or improving or extending existing buildings owned by lessor.

In terms of the Roman-Dutch law principle of *superficies solo cedit* (owner by accession), buildings or other structures affixed or attached to land become the property of the owner of the land. Once the lease expires or is cancelled, the buildings or other structures fall under direct possession and control of the lessor. However, landlords typically receive little value for voluntary improvements of this kind because the tenant is undertaking the improvement solely for the tenant’s benefit (with the useful life of the improvement typically matching the lease period).

**III. Proposal**

It is proposed that the provisions of section 12N be extended to provide for depreciation allowances in respect of costs voluntarily incurred by a tenant to undertake construction or improvements on leased premises. In these certain circumstances, the tenant is deemed to be the owner for purposes of claiming allowances (i.e. the focus of the allowance is on the deemed useful life of the asset at issue as opposed to the duration of the lease).

Given that the proposed allowances will only be applicable in respect of voluntary construction of improvements, no income inclusions will be required for the lessor in respect of the construction or improvements. The rules for obligatory tenant improvements in respect of private and government/quasi-government land will remain as before.

**IV. Effective date**

The proposed amendments to will come into effect on 1 January 2014 and will apply in respect of amounts incurred on or after that date.

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

## 3.1. REFINEMENT: INVESTMENT POLICIES DISGUISED AS SHORT-TERM INSURANCE POLICIES

[Applicable provision: Section 23L]

**I. Background**

*A. 2012 income tax anti-avoidance rule*

The Taxation Laws Amendment Act 2012 introduced a new section 23L to curb avoidance in the case of disguised capital investments in the wrapper of short-term insurance policies. More specifically, section 23L targets short-term insurance policies where the insurer fails to accept significant risk from the policyholder. This type of policy is viewed as an investment policy, meaning that the policyholder may not deduct premium payments in respect of the policy.

*B. Investment versus risk contracts under IFRS*

The International Accounting Standards Board (IASB) issued phase one of the accounting standards addressing the accounting and reporting of insurance contracts; phase two is expected in the near future. These standards focus on the accounting and disclosure of insurance contracts by insurers. No official standards exist in regards to the treatment of insurance policies in the hands of policyholders. However, a policyholder must treat the premiums paid in respect of a policy as an asset (as opposed to an expense) if the insurance contract is more properly viewed as an investment.

**II. Reasons for change**

*A. Misplaced focus*

The current reliance on IFRS 4 for determining whether a short-term insurance policy should be treated as a capital investment or a deductible expenditure in the hands of a policyholder is misplaced. As stated above, IFRS 4 focuses on the insurer as opposed to the policyholder. The net result is that the anti-avoidance rule is over-inclusive and under-inclusive. The rule inadvertently covers many insurance contracts merely because the policyholder is a shareholder of the insurer (e.g. captives and cell captives where a genuine risk transfer arises). In addition, the rule often misses many forms of insurance contracts treated as an investment by policyholders in terms of IFRS, and it is often impractical for a policyholder to determine the tax character of a payment based on the IFRS characterisation of the insurer.

**III. Proposal**

*A. Revised focus for non-deductible premiums*

The anti-avoidance rules for investment policies disguised as risk insurance will be changed from an insurer focus to a policyholder focus. More specifically, policyholders of short-term insurance policies will not be eligible to deduct short-term insurance premiums in respect of policies unless the premiums are reflected as a current or future expense for financial reporting purposes. As under pre-existing law, current expenses are deductible in the current year (under section 11(a)) and future expenses are allocated to future years (under section 23H)).

**IV. Effective date**

The proposed amendment will apply in respect of premiums incurred by policy holders on or after 1 January 2014.

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## 3.2. ANNUAL FAIR VALUE TAXATION OF FINANCIAL INSTRUMENTS IN RESPECT OF BANKS AND BROKERS

[Applicable provisions: section section 24JB]

**I. Background**

*A. Income taxation of financial instruments*

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

In respect of certain debt instruments (and other arrangements based on time-value-of-money principles) income and expenses are determined on a constant, compounding basis. Legislation exists that allows for mark-to-market taxation in respect of certain financial instruments (e.g. debt, interest-rate swaps and certain options); otherwise, the overall income tax system remains on a realisation basis. This mark-to-market system is allowed in respect of dealings in debt instruments if the taxpayer makes an election and if SARS provides approval.

*B. Accounting treatment of financial instruments*

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

The International Financial Reporting Standards (IFRS) address the full array of financial instruments (e.g. shares, debt and derivatives) (see IAS 39 and IAS 32, which will soon be transformed to IFRS 9). Many of these financial instruments fall under the new mark-to-market approach. More specifically:

1. Financial instruments held for trading (as determined under IFRS principles) and derivatives are always within mark-to-market treatment.

2. Other financial instruments must also be within mark-to-market treatment but only to the extent treatment outside the mark-to-market regime will result in a measurement inconsistency.
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3. Lastly, a financial institution may also manage a group of assets and liabilities through the mark-to-market regime for purposes of risk management and investment strategy. This latter option focuses on how that institution manages and evaluates performance rather than on the nature of use associated with the financial asset or liability. This inclusion within the mark-to-market regime is essentially elective and is often used for certain strategic stakes in a company (e.g. private equity and uniquely managed large-scale share interests).

**II. Reasons for change**

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

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

## III. Proposal

*A. Overview*

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

*B. Covered persons*

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

a. Brokers that are members of the JSE (i.e. authorised users);

b. The Reserve Bank of South Africa;

c. Entities regulated by the Banks Act, 1990 (Act 94 of 1990) (e.g. local banks, local branches of foreign banks, foreign branches of local banks and controlling companies in respect of banks) as well as any company or trust that forms part of a banking group in terms of the Bank Act. However, this latter category of companies or trusts are to be excluded under the following circumstances; and

d. Long-term and short-term insurers as well as subsidiaries directly or indirectly held by these insurers if these companies are not part of the same section 1 group of companies as the bank (for instance, assume a bank owns 60 per cent of a long-term insurer and that insurer owns all of the shares of a company, both the insurer and the company will fall outside of the mark-to-market regime).

*C. Annual fair value taxation*

A covered person must include in its income the aggregate amount of all changes in value that are recognised through profit and loss in respect of financial assets and liabilities. For this purpose, financial assets and liabilities include all instruments falling under IAS 32 of IFRS and any standard replacing IAS 32 (i.e. IFRS 9) as well as any commodities taken into account at at fair value less selling costs (typically commodities held by broker-dealers as envisioned in the exclusion of inventory accounting in IAS 2).

Mark-to-market treatment is subject to two notable exceptions. Firstly, this treatment does not apply to instruments subject to mark-to-market treatment for IFRS purposes solely by choice (i.e. solely for management and risk purposes). Instruments within IFRS mark-to-market treatment solely by choice are often illiquid, thereby creating a cash-flow problem if a deemed tax event were to arise. The following financial assets that are upon initial recognition designated by the covered person as at fair value through profit or loss will be excluded from the mark-to-market regime:

a. a share;

b. an endowment policy;

c. an interest held in a portfolio of a collective investment scheme; or

d. an interest in a trust,

which is of a capital nature.

Secondly, dividends and foreign dividends fall outside mark-to-market treatment so dividend and foreign dividend yields remain competitive with other shareholders.

In order to prevent double counting, amounts taken into account under the mark-to-market system of taxation will not be taken into account under the standard system. For instance, a debt instrument subject to the mark-to-market system will not fall under the implied compounding interest/deduction system of section 24J.

*D. Anti-tax avoidance between group members*

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

1. In order to protect the fiscus, agreements with regard to financial instruments entered into between a covered persons and a counter parties who is not a covered person will fall outside the new mark-to-market system if that agreement was entered into solely or mainly for purposes of reduction, postponement or avoidance of tax by the covered person

*E. Two-Year Transitional Charge*

Covered persons falling under the new system will be required to shift their method of taxing financial assets and financial liabilities from a realisation approach to an IFRS approach. This tax shift from realisation approach to a mark-to-market approach should trigger an immediate tax gain or loss with potential serious cash-flow consequences for new entrants into the system. In order to alleviate this cash-flow concern, the potential gain or loss will be spread over a two-year period (arising after the shift). The gain or loss will be measured by relying on the differences between the tax base and financial values as stated within the company's IFRS statements. Reliance on IFRS for this purpose simplifies compliance and enforcement for all parties involved.

If a covered person ceases to be a covered person before the expiry of the two-year post-realisation period, all untaxed amounts associated with the spread differential will be triggered during the year of cessation. This rule prevents artificial avoidance of the transitional charge.

*F. Mark-to-market exits*

If a covered person ceases to be a covered person, the exit from the mark-to-market system will trigger a deemed disposal and re-acquisition of financial instruments to which that covered person is a party (in addition to the acceleration of the transitional charge if applicable). The deemed disposal will ensure that all unrealised gains are accounted for before existing the market to mark-to-market regime and that all instruments enter the standard rules and market value. This deemed disposal/re-acquisition rule will also apply to an instrument held by a covered person if that instrument separately leaves the mark-to-market system.

**IV. Effective date**

The proposed amendment applies in respect of years of assessment ending on or after 1 January 2014.

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## 3.3. SIMPLIFICATION OF TAX REGIME FOR COLLECTIVE INVESTMENT SCHEMES IN NON-PROPERTY INVESTMENTS

[Applicable provisions: New Section 10(1)(dA), section 25BA, and paragraph 61 of the Eighth Schedule]

**I. Background**

Collective investment schemes come in a variety of forms. Schemes exist for securities, participating bonds, declared items and property. As a general matter, a semi-flow-through regime exists for collective investment schemes in securities and participating bonds with a separate regime existing for property schemes (the latter now being viewed as real estate investment trusts with deemed rental distributions). Schemes in declared items have been largely non-existence with a new regulatory regime pending for hedge funds.

In the case of non-property schemes, disposals of capital assets by the scheme are tax-exempt. Amounts other than of a capital nature are tax-free to the scheme as long as the scheme itself distributes amounts within a 12-month period. Non-capital amounts retained beyond this 12-month period are treated as ordinary revenue in the hands of the collective investment scheme.

Distributions by non-property schemes within the requisite 12-month period generally result in flow-through treatment. In effect, these earnings are deemed to directly accrue to the unit holders. Hence, dividends distributed by a non-property collective investment scheme within the 12-month period are deemed to directly accrue to the unit holders (with interest earnings of the scheme following the same flow-through characterisation if distributed within the same 12-month period).

**II. Reasons for change**

Non-property collective investment schemes have grown in sophistication over the years in terms of products and strategies. While many non-property schemes have seemingly taken the position that all of their activities are capital in nature because of the long-term objectives of their unit holders, this position is theoretically questionable because the capital versus ordinary distinction is essentially an issue based on the intent of the person disposing of the asset. In the case of a collective investment scheme, the scheme itself undertakes the decision to dispose of assets – not the unit holders. Given these concerns, a larger set of collective investment scheme activities may require distribution within the requisite 12-month period than widely believed, especially activities involving derivatives (which should trigger ordinary revenue at least in large part).

## III. Proposal

*A. Overall policy considerations*

Savings investment vehicles are best subject to a single level of tax. In the case of collective investment schemes, the overall policy has been to keep this level of tax at the unit level (as opposed to the vehicle level – the model chosen for insurance funds). The current capital versus ordinary distinction adds unnecessary complications when applying this approach with certain schemes being potentially exposed to ordinary revenue treatment if these schemes unwittingly treat ordinary items as capital. No policy reason exists to expose these schemes to this form of risk, especially when inadvertent taxation undermines the savings of unit holders (many of whom may hold units when the scheme is subject to an additional assessment even though these unit holders may not have been present when the underlying activity was undertaken).

*B. Tax exemption at the scheme level*

In order to avoid these concerns, it is proposed that non-property collective investment schemes be wholly exempt from tax. This exemption will apply regardless of whether the income is of ordinary revenue in nature or of capital in nature.

*C. Revised tax-treatment of scheme distributions*

Distributions by non-property collective investment schemes will be treated as ordinary revenue in the hands of unit holders subject to two exceptions. The first exception is for dividends; the second exception is for scheme unit repurchases.

1. **Unit scheme repurchases:** Unit holders surrendering their units to a collective investment scheme will determine their gain or loss from their units pursuant to the basic ordinary versus revenue paradigm as if these units had been sold in the open-market. The fact that the proceeds stem from the scheme itself (i.e. from scheme distributions) will not impact this analysis.

2. **Dividends:** Dividends received by a collective investment scheme retain their nature as dividends in the hands of unit holders as long as the scheme distributes those dividends to unit holders within 12 months after the scheme receives those dividends. Otherwise, those dividends will be treated as ordinary revenue when distributed to the unit holders.

## IV. Effective date

The proposed amendments are effective for collective investment scheme years of assessment commencing from 1 January 2014.

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## 3.4. DEEMED ORDINARY TREATMENT IN THE CASE OF CERTAIN DISPOSALS OF PARTICIPATORY UNITS IN COLLECTIVE INVESTMENT SCHEMES

[Applicable provisions: Definitions under Section 1; new section 9CA]

## I. Background

### A. Collective Investment scheme categories

A collective investment scheme (CIS) is an investment vehicle that operates on behalf of the unit holders in a portfolio. These schemes come in four statutory categories, namely a CIS in securities, a CIS in participation bonds, a CIS in properties and CIS portfolios declared by the Financial Services Board (FSB). In all but the property schemes, financial instruments are held by a trust to be managed by a separate management company. A CIS in properties are now taxed as real estate investment trusts and are subject to additional regulation via the JSE.

CISs are regulated by the FSB. To date, the CIS in securities has been the main focus of CIS regulation and investment with a small group of CISs dedicated to participating bonds. Another class of investment vehicles has been unregulated hedge funds. However, the FSB is now planning to issue a regulation declaring hedge funds as CISs (in accordance with section 63 of the Collective Investment Scheme Act (CISCA)). The proposal envisages two types of hedge funds, namely retail and restricted funds. Regulated retail hedge funds will be allowed to issue participatory interest to the general public and institutional investors. Regulated restricted hedge funds will not issue participatory interest to the general public but will instead be limited to qualified (high-end) investors.

### B. Capital versus ordinary distinction

Under current law, the ordinary versus capital character of gain or loss upon disposal of a unit is largely based on judicial precedent. However, the disposal of CIS units in a CIS in securities is be deemed to be of a capital nature if the unit was held for a minimum period of 3 years prior to disposal. This deemed capital rule currently does not apply to the disposal of units in respect of the other CIS categories.

Because the capital versus ordinary classification is a taxpayer-by-taxpayer determination based on the disposing taxpayer’s intent, the disposal of financial instruments by any form of CIS is initially determined at the CIS-level. The nature of this disposal is again based on judicial precedent (with the three-year deemed capital legislative override).

## II. Reasons for change

While significant progress has been made toward the regulation of hedge funds, little consideration has been undertaken in respect of tax issues. If hedge funds enter the CIS domain with no change in law, the CIS will be exempt from tax in respect of capital gains but subject to tax on the disposal of trading stock. Unit holders will largely be subject to tax on the disposal of hedge fund units as capital gains and losses given the long-term investment purpose of the unit holders. In essence, the CIS should operate as a deferral mechanism. While capital gain is exempt at the CIS level, the unit holders should be subject to tax on the deferred gain upon disposal of the CIS unit.

At issue is the character of transactions undertaken by hedge funds. Like the CIS in securities, hedge funds invest in listed securities and money market instruments. However, the one distinction of a hedge is the fund’s greater focus on derivatives and derivative strategies. Given that derivatives are acquired for the purpose of eventual close-out, the gain or loss in respect of derivatives should be treated as falling within ordinary revenue as opposed to being of capital nature (in at least many instances). This ordinary treatment would mean that the CIS will be required to pay tax on the ordinary revenue unless distributed within a 12-month period. Failure to tax the gain at ordinary rates would mean that the CIS is operating as more than a mere deferral mechanism but instead as a character converter. If untaxed at the CIS level, CIS ordinary revenue will effectively be taxed only as deferred capital gain when a unit holder disposes of a CIS unit.

**III. Proposal**

Because ordinary treatment of disposals at a CIS level would be highly disruptive, it has been decided that all ordinary and capital disposals will be henceforth exempt (see **SIMPLIFICATION OF TAX REGIME FOR COLLECTIVE INVESTMENT SCHEMES IN NON-PROPERTY INVESTMENTS**). However, a CIS with gain that is largely of revenue in nature should not be allowed to effectively act as a character converter (i.e. the only benefit of a CIS should be deferral). Therefore, the disposal of certain categories of CIS units should be treated as ordinary as a simplifying proxy (rather than determining the actual capital versus ordinary percentages within a CIS).

Under this approach, amounts received or accrued by the unit holder on the disposal of units in a restricted hedge fund will always be deemed to be of an ordinary nature. A CIS in this category would typically have large amounts of (now exempt) ordinary revenue given that this category of CIS would be involved in a large proportion of derivative trading (much of which would be unhedged). Judicial precedent would no longer be a factor in the analysis of whether the disposal of a unit in a restricted hedge fund would be capital or ordinary.

Disposals of units in a retail CIS hedge fund will now be subject to the same regime as disposal of units in collective investment schemes in securities. Section 9C will apply which will result in amounts received or accrued on the disposal of these units after a three-year holding period will automatically be treated as profits of a capital nature.

With regard to the disposal of units in collective investment schemes in participation bonds, the character of unit disposals will remain a judicial determination.

**IV. Effective date**

The proposed amendment will apply in respect of disposals on or after 1 January 2014.

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# 4. INCOME TAX: BUSINESS (INCENTIVES)

## 4.1. REFINEMENTS TO THE RESEARCH AND DEVELOPMENT INCENTIVE

[Applicable provision: Section 11D]

**I. Background**

Innovation, research and technological development are key factors for improved productivity (leading to new or improved products, processes or services). This enhanced productivity in turn leads to increased economic growth and international competitiveness. However, research and development (R&D) is costly. While South Africa offers a variety of direct subsidies for R&D, the

South African tax regime for R&D also provides substantial tax incentives aimed at ensuring that local R&D is globally competitive.

The tax incentive for R&D is two-fold. Firstly, operating expenses incurred directly and solely for purposes of conducting R&D are 100 per cent deductible even if those expenses could be characterised as being capital in nature. Moreover, these expenses will generate a further 50 per cent deduction if the R&D is approved by the Minister of Science and Technology. Thus, some R&D expenses may be eligible for a 150 per cent deduction (i.e. where Ministerial approval has been granted).

In order for R&D operating expenditure to fall within this incentive regime, R&D activities must be undertaken within South Africa. In addition, this R&D must be performed for purposes of discovering novel, practical and non-obvious information of a scientific or technological nature; or the creation of any invention, patent, design or a computer copyright or essential knowledge.

In essence, the R&D must be directed towards advancing scientific or technological knowledge (as opposed to routine learning associated with ongoing processes). Hence, certain specific forms of knowledge (for example, management, enhancement of internal business processes, social science and humanities, market research, sales or marketing promotion) fall outside the scope of the incentive.

## II. Reasons for change

Information uncovered by the adjudication committee during the approval process for the additional 50 per cent uplift reveals that the incentive can possibly be claimed in respect of R&D activities that were never intended to fall within the ambit of this regime. The language in the provision also gives rise to uncertainties in interpretation and can be a deterrent to certain legitimate applications. All of these and other anomalies need to be eliminated in order to accelerate the approval or adjudication process.

## III. Proposal

### *A. Overview*

The proposed amendments contain a number of amendments based on the R&D application received. The purpose of these amendments is to ensure that the incentive achieves the objectives initially intended. In summary, these changes are as follows:

1. Adjustments to the R&D definition;
2. Clarification of section 11D deductible R&D expenditures;
3. Interaction between the basic deduction and the 50 per cent uplift;
4. Clarification of R&D exclusions; and
5. Miscellaneous.

### *B. Adjustments to the R&D definition*

The current R&D definition contains wording that is somewhat inconsistent and confusing. As an initial matter, the definition confuses activities with end-results – the sole focus should be on end-results. The rules between new knowledge/registrations and improvements are also confused. The first part of the definition should focus on the creation and development aspects whilst the second part of the definition should focus on significant improvements.

In terms of the creation and development aspect of the definition, the creation or development should lead to:

1. An invention capable of registration under the Patents Act;

2. A design capable of registration under the Design Act, but only functional designs of a scientific and technical nature (as opposed to designs of an aesthetic nature);

3. Innovative commercial computer programs intended for sale or use to unrelated customers (as opposed to internal upgrades or improved internal use by the entity and related members);

4. Applied innovative scientific knowledge (e.g. medical science or engineering sciences) or innovative technological knowledge intended for sale or use by unrelated customers (as opposed to internal upgrades or improved internal use by the entity and related members); or

5. Pure theoretical scientific knowledge (knowledge to obtain an understanding or prediction of the natural world) of an innovative nature

The revised definition essentially ensures that the R&D is intended for wider use than internal business use (e.g. by the taxpayer or those connected to taxpayer). The overall flavor of the definition is also shifted more toward a technical scientific/technological bias with an added emphasis on innovation.

In terms of the significant improvement aspect of the definition, the significant improvement must also be innovative. The definition is further linked to the initial portion of the definition so that the improvement enhances the inventions, designs, computer software and knowledge referred to above with improvement also being intended for sale or use by unrelated customers.

*C. Clarification of section 11D deductible R&D expenditures*

1. <u>Excluded expenditures</u>

R&D is deductible even if the expense is of a capital nature. Expenses of a capital nature are included within the deduction because taxpayers should not lose the deduction merely because the activities can lead to the development of an intangible asset. However, this acceptance of expenses of a capital nature also arguably allows for the immediate deduction of capital allowance assets (e.g. buildings and machinery) when these items should be depreciable over time as specified elsewhere (e.g. section 12C). Capital allowance assets (and registration expenses associated with intangibles) will accordingly be excluded from the immediate write-off (while other expenses of a capital nature will be permitted).

Some of the current R&D definition exclusions have been shifted to expenditure exclusions, meaning that the expenditure falls outside the R&D rules without tainting the overall R&D objective. Expenditures of this nature include expenditures solely to satisfy regulatory and other legal requirements, finance, administration and indirect overhead.

2. South African activities must be meaningful

Under current law, the R&D regime is available solely in respect of R&D undertaken within South Africa. The proposed legislation clarifies that these activities must have some level of significance, meaning that local persons should have some level of control over research methodology. Stated differently, the activities must enhance local skills development. One potential exception is clinical medical trials as determined by the Department of Science and Technology (with the Department determining whether the local trials at issue enhance local skills even though no local decision-making occurs).

*D. Interaction between the basic deduction and the 50 per cent uplift*

The relationship between the basic deduction and the 50 per cent uplift for R&D is not entirely clear. Some taxpayers are taking the position that the 50 per cent uplift is available even if the expense is not within the basic R&D deduction. This result was never intended. The uplift should only be available for expenses falling within the basic definition.

*E. Clarification of R&D exclusions*

The current R&D regime contains a number of exclusions that should more rightly be viewed as exclusions to the R&D definition as opposed to a denial of deductible section 11D expenditures. These exclusions are accordingly adjusted as a counterpart to the R&D definition itself.

More notably, some taxpayers are seeking to claim R&D deductions for pre-existing discoveries and technology on the basis that the discovery and technology is new to the taxpayer. This result was never intended. Taxpayers should not be able to claim section 11D deductions merely for upgrading their technology to match competition. The activities must yield an outcome that is novel from an industry or global perspective. The purpose of the incentive was to place South Africa at the forefront of scientific and technological development – not just to assist taxpayers in maintain competitive in respect of pre-existing discoveries and technologies. Hence, for any R&D to fall within the R&D incentive regime, the discovery or knowledge must not have already been offered, used or available commercially by other persons within the domestic or global market place (other than generic drugs as prescribed by DS&T regulation).

*F. Miscellaneous*

1. Government and quasi-governmental funding

Current law prohibits the additional 50 per cent deduction to the extent the expenditure is funded by Government grant (i.e. an exempt grant). This denial of the 50 per cent deduction is too narrow. No reason exists to provide the 50 per cent uplift when Government or quasi-Governmental agencies fund the expenditure. The purpose of the incentive is to enhance private funding.

2. Special criteria for approval of the 50 per cent uplift

It was always intended that additional criteria above the basic R&D definition would be required for 50 per cent additional allowance. These criteria will now be modified based on experience. Under the revised rules, the committee will provide approval only if the R&D contains significant additionality. The regulatory criteria have also be adjusted so regulations can consider the context of the industry involved. The focus on specialized skills will no longer be required (but will instead be required for reporting purposes).

3. <u>Withdrawal of approval for additional allowance</u>

Under current law, the Minister of Science and Technology may withdraw approval for an additional allowance (even though the R&D was previously approved) if any material facts change that would have had the effect that the approval would not have been granted. This provision does not comprehensively deal with other factors which that would necessitate withdrawal of approval, such as fraud or non-disclosure.

**IV. Effective date**

The proposed amendments to will come into effect on 1 October 2012 and will apply in respect of amounts incurred on or after that date.

## 4.2. TAX INCENTIVES FOR SPECIAL ECONOMIC ZONES

[Applicable provision: New section 12Q]

**I. Background**

*A. General*

In order to promote productivity and innovation within the South African manufacturing industry, Industrial Development Zones (IDZs) were introduced as special incentive regimes for processing areas for exporters and other investment locations. In line with the envisaged investment support-element associated with IDZs, various value-added tax and customs duty incentives were introduced. These areas consist of entrance and exit points controlled by customs personnel (technically referred to as a customs controlled area), and a dedicated customs office provides rapid inspection and clearance around coastal or inland ports for dedicated exporters.

*B. Income tax incentive for industrial investments*

Income Tax incentives available to companies include an additional allowance for an industrial policy project as determined according to type (greenfield or brownfield) and status (qualifying or preferred). The incentive is generally available if the investor invests in improved production equipment and contributes towards skills training of employees.

For a project to qualify for this incentive, the project must be solely or mainly for the manufacture of products, goods, articles or other things as classified under “Major Division 3: Manufacturing” (as contained in the recent Standard Industrial Classification Code issued by Statistics South Africa). In respect of the scoring mechanism used for the approval criteria, an extra point is awarded for greenfield investments into IDZs.

The incentive comes in the form of an additional deductible allowance equal to 35 per cent of the cost of a manufacturing asset used in industrial policy projects with qualifying status (or 75 per cent if these projects are located within an IDZ), 55 per cent of the cost of a manufacturing asset used in industrial projects with preferred status (or 100 per cent in cases where such projects are located in an IDZ). Another incentive exists for the training of employees.

## II. Reasons for change

The Department of Trade and Industry (the DTI) has explored the viability of industrial development zones over the last decade in an attempt to encourage investment, exports and job creation. In an effort to improve governance, streamline procedures and provide more focused support for businesses operating within these zones, the DTI is in the process of introducing a new set of incentives for areas called special economic zones (SEZs). These incentives are set to build on the existing policy for industrial development zones. According to the DTI, the lack of dedicated income tax incentives is one factor that has operated as an impediment to pre-existing IDZs.

## III. Proposal

### *A. Overview*

All special economic zones will qualify for VAT and customs relief (similar to that for the current IDZs), and the employment tax incentive. Businesses operating within approved SEZs (by the Minister of Finance, after consultation with the Minister of Trade and Industry) will be eligible for two additional tax incentives. Firstly, all such businesses can claim accelerated depreciation allowances on capital structures (buildings) and, secondly, certain companies (carrying on qualifying activities within an approved SEZ) will be subject to a reduced corporate tax rate (i.e. 15 per cent instead of 28 per cent).

### *B. Entry criteria*

1. <u>Basic conditions</u>

The proposed tax incentives will be available for qualifying companies located within approved SEZs (by the Minister of Finance, after consultation with the Minister of Trade and Industry). A qualifying company must be:

Formed and effectively managed within South Africa and generating 90 per cent of its income from services or the sale of goods (i.e. trading stock) from activities attributable to a fixed place of business within an SEZ.

2. <u>Qualifying criteria</u>

a. The DTI will be responsible for deciding on (and regulating) the qualifying criteria for entry into a special economic zone. All companies that meet such entry requirements will be eligible for the building allowance, employment tax incentive and VAT and customs relief.

b. Once a qualifying company is located within an SEZ, it has to be carrying on certain activities to be eligible for the reduced corporate tax rate of 15 per cent (instead of 28 per cent). The Standard Industrial Classification codes issued by Statistics South Africa will be used to generate a list of activities that will automatically fall outside the scope of the reduced corporate tax rate.

*C. Detailed nature of incentives*

1. Lower company tax rate

As stated above, qualifying companies will be subject to a 15 per cent corporate tax rate for all taxable income if they are carrying on certain activities within a SEZ. However, in light of this lower rate, transactions between qualifying (SEZ) companies and other companies may be subject to transfer pricing considerations (i.e. deemed to be an affected transaction the purposes of section 31).

2. Accelerated capital allowances for fixed structures

Qualifying companies that erect or improve buildings and other fixed structures will be entitled to a special rate of capital (depreciation) allowances in lieu of normal allowances. This rate will equal 10 per cent per annum over 10 years.

3. Note on employment incentive

It should be noted that all employers employing low-salaried employees (below R60 000 per annum) within SEZs will be entitled to the employment incentive. The incentive will apply regardless of employee age. The specific rules associated with the employment incentive are contained within the Employment Incentive Bill, 2013.

4. Value-added Tax and Customs

As stated above, the current IDZs receive both VAT and customs relief. It is envisioned that the SEZs will receive the same relief as the DTI transitions to the new regime. Legislation will be forthcoming in this regard.

**IV. Effective date**

This provision will come into effect on 1 January 2014 and apply in respect of all years of assessment commencing on or after that date. The effectiveness of these incentives will be reviewed after a period of 10 years, in 2024, with an interim review after 5 years, in 2019.

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## 4.3. EXEMPTION OF CERTIFIED EMISSION REDUCTIONS

[Section 12K of the Income Tax Act]

**I. Background**

The Clean Development Mechanism (CDM), established as a part of the Kyoto Protocol, provided developed countries (parties included in Annex I) with a mechanism to reduce their own greenhouse gas emission (GHG) reduction obligations by purchasing credits from CDM projects that avoid GHG emissions in developing countries (parties not included in Annex I). CDM projects, which can only be implemented within developing countries, facilitate financing and technology transfer for GHG reduction in developing countries. The CDM includes projects in renewable energy, energy efficiency and other related fields designed to achieve emission reductions.

Specific criteria and procedures must be fulfilled in order for CDM projects to be eligible for registeration and approval An important feature of CDM projects is the demonstration of "additionality", whereby it is required that the project participants demonstrate that GHG emissions reduction that the carbon offset project delivers are additional and would not have occurred under a 'business as usual' scenario (i.e. without intended sale of credits in the CDM market) Equally, CDM projects must be developed according to methodologies approved by the CDM Executive Board. If these conditions are satisfied the CDM Executive Board can approve CDM projects to yield reduction credits (commonly known as carbon emission reduction credits). The carbon emission reduction credits from the CDM projects are known as certified emission reductions (CERs). These CERs are saleable to and usable only by developed countries for the purpose of meeting legally binding Kyoto Protocol emission reduction obligations.

After the inception of the first commitment period under the Kyoto Protocol in 2008, there was very limited uptake of CDM projects within South Africa. As a result, an income tax incentive was introduced in 2009 for any person holding a CDM registered project. The incentive exempts amounts received or accrued upon disposal (or anticipated disposal) of these CERs for purposes of normal and capital gains tax.

**II. Reasons for change**

During the COP18 meetings held in December 2012, it was agreed that parties engaged in CDM projects may continue their activities under those projects and new projects may be registered after December 2012 (i.e. second commitment period). The second commitment period commenced at the beginning of 2013 and ends on 31 December 2020. In line with the second commitment period, the CDM has been extended as a flexibility mechanism under the Kyoto Protocol, enabling developing countries to continue their participation in the global carbon market. However, the current tax incentive is limited to CERs obtained from CDM projects registered before 31 December 2012 (to coincide with the date on which the first commitment period under the Kyoto Protocol would lapse). Therefore, CERs obtained from CDM projects registered after 31 December 2012 could no longer qualify for the incentive.

**III. Proposal**

It is proposed that the exemption of income resulting from the sale of CERs be extended in line with the renewed Kyoto Protocol commitment. The exemption is accordingly extended to 31 December 2020. Therefore, new CDM projects registered after the former cut-off date of 31 December 2012 and by 31 December 2020 will still be eligible for the tax relief.

**IV. Effective date**

The amendments to section 12K will come into effect on 1 January 2013 and shall apply in respect of disposals on or after that date.

## 4.4. OIL AND GAS INCENTIVE

[Applicable provision: Tenth Schedule]

### I. Background

*B. General Overview*

The oil and gas industry was initially regulated in 1977 via OP26 prospecting lease agreements. These agreements became subject to the Mineral and Petroleum Resources Development Act, 2002 (Act No. 28 of 2002) ("MPRDA"). The MPRDA reordered these rights with all OP26 right holders being forced to convert their rights in to new order rights. Oil and gas rights are now issued under the MPRDA by the Department of Minerals and Resources with the facilitation of the Petroleum Agency of South Africa. Transfers of oil and gas rights are similarly regulated.

In 2006, a new tax oil and gas regime was enacted within the Income Tax Act (58 of 1962) under the Tenth Schedule ("the Tenth Schedule"). This regime simplified many of the tax incentives offered under the OP 26 agreements. Like the original OP26 agreements, the purpose of the Tenth Schedule is to provide incentives for oil and gas exploration and production. In addition, the Tenth Schedule offers stability against future tax changes in relation to oil and gas exploration and production (via fiscal stability agreements issued by the Minister of Finance). This stability is needed because investors require a greater level of certainty given the long-term nature of the investment and the substantial upfront capital costs.

*C. Incentives*

The incentives provided by the Tenth Schedule include:

a. The corporate income tax rate for oil and gas companies will not exceed 28 per cent;

b. The Dividends Tax rate may not exceed 5 per cent in respect of dividends paid out of amounts attributable to oil and gas income (or zero per cent if the oil and gas rights were obtained by virtue of previously existing OP26 rights);

c. An additional 100 per cent deduction is available for all capital expenditure incurred in respect of oil and gas exploration, and an additional 50 per cent deduction is available for all capital expenditure incurred in respect of oil and gas production;

d. The provision of a legislative safe harbor exists to prevent the application of thin capitalisation rules to the extent that the amounts borrowed by an oil and gas company do not exceed three times the total fixed capital of that company;

e. An election exists for roll-over or participation treatment on disposal of oil and gas rights in lieu of the application of normal tax treatment for those disposals; and

f. An ability to enter into a fiscal stability agreement with the Minister of Finance so that the oil and gas incentives of the Tenth Schedule are protected against future changes in tax law.

## II. Reasons for change

Since the inception of the Tenth schedule six years ago, a growing number of oil and gas exploration and production rights are now being granted under the MPRDA. Several transfers among oil and gas producers are also taking place. Recent experience now indicates that the Tenth Schedule is giving rise to certain anomalies that distort commercial practices. The Tenth Schedule also appears to contain ambiguities and unintended outcomes in terms of technical wording.

## III. Proposal

### *A. Overview*

In view of the above, the proposed legislation contains a number of technical changes to the Tenth Schedule to eliminate the above concerns. The proposed changes are listed below.

### *B. Differential Dividends Tax rates*

As discussed above, the Tenth Schedule contains two sets of Dividend tax rates for holders of oil and gas rights. Rights holders that hold their rights by virtue of the former OP26 agreements have the benefit of the zero rates; whereas, newer rights are subject to a 5 per cent rate. This differential gives rise to unfair competition (and distortive transactions to preserve the zero rate). Moreover, little policy reason exists for discriminating against newer rights because incentives for new oil and gas investment remains a priority, and the 5 per cent rate offers little relief because this 5 per cent rate is often available in respect of general foreign investments via tax treaty. The differential will accordingly be removed with the Dividends Tax rate reduced to zero for all dividend amounts paid out of oil and gas income.

### *C. Ambiguity concerning the Development Phase*

As stated above, an additional 100 per cent deduction is available for all capital expenditure incurred in respect of oil and gas exploration, and an additional 50 per cent deduction is available for all capital expenditure incurred in respect of oil and gas production. At issue is whether the development phase should be viewed as part of the exploration phase or the production phase.

Upon review of the facts, it was never intended that the development phase be viewed as part of exploration. The purpose of the 100 per cent incentive for exploration was to assist companies in their search for oil and gas sites; the 50 per cent incentive was intended to facilitate the capital expenditure needed to extract the discovered value from the site. Moreover, the 100 per cent incentive was offered with the added understanding that exploration costs are far less significant in value terms than capital extraction costs. In terms of oil and gas, the bulk of total extraction costs are associated with development (even exceeding those of the production phase). The definition of the production phase will accordingly be removed and replaced with a definition that explicitly includes the development phase.

*D. Removal of the thin capitalisation limitations and a zero rate for cross-border interest withholding*

As stated above, the Tenth Schedule provides a legislative 3:1 safe harbor from any thin capitalisation rules imposed under previously existing transfer pricing limitations. This safe harbor is being removed because the concept of thin capitalisation no longer exists in the South African transfer pricing arena. It is also questionable whether the oil and gas tax system should allow taxpayers to obtain a safe harbor in the case of base erosion because excessive interest allows taxpayers to effectively undermine the 28 per cent company rate in a wholly uncontrolled way.

In order to ensure that oil and gas companies are not disadvantaged by the change, the Tenth Schedule will now limit cross-border withholding in respect of interest to zero. This zero rate will apply if the interest paid by the oil and gas company is paid to another company within the same international group. Hence, a foreign parent will not be subject to tax wen receiving interest from a wholly owned oil and gas South African subsidiary.

*E. Deemed trade*

It is unclear whether a company engaged solely in exploration can be viewed as engaged in a trade, thereby being eligible for deductions under the general deduction formula of section 11(a). Other circumstances could also arise where trade may not exist (e.g. temporary cessations and post-production rehabilitation). It is accordingly proposed that any holder of an oil and gas right be deemed to engaged in a "trade" and any expenses in respect of an oil and gas right be deemed to be "incurred in the production of income."

*F. Clarification of options when disposing of oil and gas rights*

Under current law, taxpayers have the option of choosing three different methods of taxation when disposing of oil and gas rights. In addition to the normal rules, taxpayers may choose to receive rollover treatment or participation treatment via an election. While this intention is explicit in the 2006 explanatory memorandum, arguments continue to arise that reliance of the normal rules is no longer possible under the literal terms of the legislation. The wording of the Tenth Schedule will accordingly be further clarified to reflect this intention.

In addition, taxpayers will no longer be required "to elect" out of the normal rules should they seek rollover or participation treatment. Both the seller and the purchaser can simply achieve this result via an agreement in writing, thereby obviating the need for an election on a SARS form or return. Lastly, it is unclear whether rollover or participation treatment is available when disposing of rights to a newly formed company because a newly formed purchasing company can only become an oil and gas company after acquiring the right. The law will accordingly be clarified to allow rollover or participation treatment whenever disposing of oil and gas rights to any company (because these companies will automatically become oil and gas companies after the acquisition).

*G. Fiscal stability agreement delegation*

At present, oil and gas companies seeking fiscal stability agreements must undergo two administrative processes. These companies must first seek to obtain the underlying oil and gas right from the Minister of Minerals and Resources and then obtain fiscal stability rights from the

Minister of Finance. This dual approval slows the overall process and often gives rise to coordination issues. The Minister of Finance will accordingly be allowed to delegate the power to enter into fiscal stability agreements to the Minister of Minerals and Resources in appropriate circumstances. It is envisioned that the Minister of Minerals and Resources should issue fiscal stability agreements when granting, converting or renewing rights so all processes work in unison. Subsequent changes to fiscal stability rights (if so desired by the relevant company) will continue to be issued by the Minister of Finance.

**IV. Effective date**

The amendments will be effective in respect of years of assessment commencing on or after 1 January 2014.

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# 5. INCOME TAX: INTERNATIONAL

## 5.1. EXIT CHARGE ON INTERESTS IN IMMOVABLE PROPERTY

[Applicable provision: Section 9H]

**I. Background**

*A. South African exit charge and sourced-based taxing jurisdiction*

When a South African taxpayer ceases to be a resident, the taxpayer is subject to an exit tax charge. Upon becoming a non-resident, the taxpayer remains liable to South African tax only on a source basis.

An exit charge is a tax on gains (mostly capital) levied on the taxpayer as if the taxpayer had actually disposed of all of the taxpayer's assets. More specifically, the taxpayer is treated as having disposed of each asset (other than excluded assets) for an amount received or accrued equal to the market value of the asset on the day before ceasing to be a resident. The taxpayer is then deemed to have immediately reacquired the same asset at a cost equal to the same market value. Excluded assets consist of assets that remain taxable by South Africa even after the taxpayer has ceased to be a resident.

Besides assets that are attributable to a permanent establishment, the main set of excluded assets consists of immovable property situated in South Africa or any interest therein. An interest in immovable property specifically includes a direct or indirect interest of at least 20 per cent in an entity if 80 per cent of the market value of that entity is attributable to South African immovable property. All of these assets are subject to tax on a source basis if held by foreign residents.

*B. Tax treaty definitions of "immovable property"*

Tax treaties preserve a source country's primary taxing rights in respect of capital gains arising from immovable property located therein even if owned by a foreign resident. Capital gains arising from property other than immovable property generally fall outside the source country's taxing jurisdiction (unless attributable to a local permanent establishment). For tax treaty purposes, the term "immovable property" is defined with reference to the definition in the contracting country in which the property is situated (i.e. in terms of the law of the source country). In the case of South African based immovable property, the definition of immovable property is determined with reference to the definition in South African tax law (which covers immovable property but not indirect interests therein). However, many of the newer DTAs expressly extend the definition of immovable property to include interests in immovable property, such as shares in companies mainly holding immovable property.

### II. Reasons for change

The Income Tax Act fails to expressly define "immovable property". As a result, it could be argued that the term "immovable property" as expressed in certain older tax treaties is limited solely to the common law definition. This definition would not include any direct or indirect interests in immovable property (such as shares in companies mainly consisting of immovable property).

The exit charge does not apply to exiting residents in respect of South African immovable property or direct or indirect interests therein because these interests are assumed to remain within taxing jurisdiction. However, this assumption fails to take into account the potentially narrow definition of "immovable property" in the context of domestic law that arguably limits South Africa's source jurisdiction solely to "immovable property" itself (as opposed to wider interests therein). As a result, South African residents exiting to certain countries appear to receive the best of both worlds:

1. The exit is free from tax in respect of immovable property interests because these assets are presumed to remain within South African taxing jurisdiction,

2. But no further tax is applied because the tax treaty eliminates future source taxation as a result of the narrow "immovable property" definition.

### III. Proposal

The proposed amendment deletes the exclusion of interest in immovable property from the exit charge. As a result, a person that ceases to be a resident will be deemed to have disposed of all assets, including any interest in a property company, for an amount received or accrued equal to the market value of those assets on the day before ceasing to be a resident and to have immediately reacquired the same assets at a cost equal to the same market value.

Under this approach, a direct holding of immovable property will remain subject to South African tax on a source basis once the person is a non-resident. This retention of source jurisdiction would mean that no exit charge would be necessary because these assets would remain within South African taxing jurisdiction despite the cessation of a person's status as a South African tax resident.

### IV. Effective date

The proposed amendment will apply in respect of any year of assessment commencing on or after 1 July 2013.

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## 5.2. CURRENCY RULES FOR DOMESTIC TREASURY MANAGEMENT COMPANIES

[Applicable provisions: Sections 1 (new definition of "Domestic Treasury Management Company"; 24I and 25D of the Income Tax Act and paragraph 43(7) of the Eighth Schedule)

### I. Background

*A. Newly announced Exchange Control dispensation*

On 27 February 2013, the Minister of Finance announced the establishment of a treasury management holding company regime as part of the Budget proposals (see Exchange Control Circular No 7/2013). In the main, companies listed on the Johannesburg Stock Exchange will now be allowed to establish one subsidiary to manage the group treasury functions free from exchange control despite that subsidiary's domestic incorporation.

*B. Base currency for tax purposes*

For tax purposes, domestic companies must generally use the Rand as the starting point for their currency translations (measuring foreign currency gains and losses against the Rand). One notable exception is for headquarter companies (i.e. companies subject to tax relief so that funds can be derived from foreign subsidiaries and transferred onward without incurring a layer of South African tax when no value is added within South Africa). Headquarter companies of this nature can use their functional currency as the starting point for their currency tax calculations as opposed to the Rand despite the existence of South African incorporation. For income tax purposes, a functional currency is defined as the currency of the primary economic environment in which business operations are conducted.

### II. Reasons for change

There is currently no special currency tax dispensation for South African based treasury management holding companies sanctioned by the South African Reserve Bank. Like any other taxpayer, treasury management holding companies are deemed to operate on a Rand functional currency. This starting point is often problematic because treasury management companies often have a functional currency that differs from their place of operation or incorporation. Required use of the Rand is accordingly impractical, thereby potentially inhibiting the new regime.

### III. Proposal

It is proposed that qualifying domestic treasury management companies (as determined by the South African Reserve Bank) become eligible for tax relief in respect of currency in the same fashion as headquarter companies. More specifically, treasury management holding companies will be allowed to utilise their functional currency as a starting point for tax purposes. The new dispensation will apply to taxable income, monetary items and capital gains items.

**IV. Effective date**

The proposed amendment will apply in respect of any year of assessment commencing on or after 27 February 2013 [i.e. the date that Exchange Control Circular No.7/2013 was initially released].

## 5.3. REFINEMENT OF PARTICIPATION EXEMPTION IN RESPECT OF FOREIGN DIVIDENDS DERIVED FROM NON-EQUITY SHARES

[Applicable provision: Section 10B(2)]

**I. Background**

Under current law, foreign dividends are exempt from normal tax if the recipient holds at least 10 per cent of the equity shares and voting rights in the company declaring the foreign dividend. A similar exemption exist for capital gains derived from the disposal of foreign shares if the person holds at least 10 per cent of the equity shares and voting rights in the foreign company. These exemptions are colloquially referred to as the participation exemptions.

An equity share is specifically defined as excluding shares with certain debt-like features. More specifically, an equity share does not include any share that has limited participation rights in a corporate distribution. The foreign dividend participation exemption is also not available to any foreign dividend that is deductible by the payor in terms of law of the payor’s country of residence.

A further exemption is provided for foreign dividends declared to a controlled foreign company if the company declaring the dividend and the CFC are resident in the same country (i.e. same country exemption). As with the participation exemption, the same country exemption is also not applicable to interest-like foreign dividends. More specifically, foreign dividends that are deductible for the purposes of the foreign law of the company declaring the dividend do not qualify for the same country exemption.

**II. Reasons for change**

It was always intended that the foreign dividend participation and same country exemptions should apply only to foreign dividends received from equity shares. However, the current wording of these exemptions seems to suggest otherwise. The wording of the foreign dividend participation exemption seems to suggest that the participation exemption applies to all shares, as long as the taxpayer holds 10 percent of the equity shares and voting rights. This arguably means that once the taxpayer has the required participation of 10 percent in a foreign company, any foreign dividend received from the company is exempt. The foreign dividend same country exemption does not expressly refer to equity shares.

**III. Proposal**

It is proposed that the Income Tax Act should specifically stipulate that the participation and same country exemptions apply only to dividends derived from equity shares. The participation will therefore not apply to dividends derived from non-equity shares merely because of a qualifying 10 per cent holding elsewhere.

**IV. Effective date**

The proposed amendment will come into operation on 1 January 2014 and apply in respect of foreign dividends received or accrued on or after that date.

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## 5.4. CONTROLLED FOREIGN COMPANY AND THE WORKING CAPITAL EXEMPTION

[Applicable provision: Section 9D(9A)(a)(iii)(cc)]

**I. Background**

The controlled foreign company (CFC) rules are mainly designed to create deemed income when a CFC generates passive income and certain forms of diversionary income (i.e. income susceptible to transfer pricing). In recognition of the fact that most companies typically generate small amounts of passive income from available cash-flows, a working capital exemption was introduced many years ago. Under current law, the working capital exemption generally applies to the extent that tainted financial instrument (i.e. passive) receipts and accruals do not exceed 5 percent of total gross CFC receipts and accruals that are attributable to a foreign business establishment. Technically, in the calculation of the 5 percent limit, the total gross receipts and accruals will include amounts attributed to non-resident policyholders who are not CFCs and amounts that would have been subject to withholding taxes on royalties and interest. Previously SA taxed amounts and certain intra-group payments are specifically excluded from the calculation.

**II. Reasons for change**

Receipts and accruals from CFC treasury operations and CFC captive insurers trigger CFC income (i.e. are viewed as passive) even if these activities otherwise fall within the business establishment exception (i.e. are exempt as active income). However, current application of the five per cent working capital exemption applies to CFC treasury operations and CFC captive insurance operations even though business establishment relief does not otherwise exist. No reason exists to provide working capital relief in the case of CFC treasury operations and CFC captive insurers when these operations are not viewed as active for CFC purposes.

There is also no policy reason, why the calculation of the 5 percent limit should take into account amounts that would not otherwise fall under the indirect CFC taxing jurisdiction. More specifically, amounts attributed to non-resident policyholders and amounts previously subject to withholding taxes on interest and royalties are specifically excluded from the CFC tax net.

**III. Proposal**

In view of the above, it is proposed that the five per cent working capital exemption should not apply to CFC treasury operations and captive insurers. Passive receipts and accruals will trigger deemed CFC income without regard to the working capital exception despite the fact that these treasury and captive insurer operations may technically constitute a business establishment. The calculation of the working capital 5 percent limit will also specifically exclude amounts attributed to non-resident policyholders and amounts previously subject to withholding taxes on interest and royalties.

**IV. Effective Date**

The proposed amendment will be effective for foreign tax years of CFCs ending during years of assessment commencing on or after 1 January 2014.

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## 5.5. RING-FENCING OF NET FOREIGN TRADE LOSSES

[Applicable provision: Paragraph (b) of the proviso to section 20(1)]

**I. Background**

As a general matter, South Africa imposes income tax on residents on a world-wide basis. Theoretically, this world-wide basis of taxation also permits the deduction of expenses incurred in the production against both domestic and foreign income. However, in order to protect the domestic tax base against foreign erosion, the tax system ring-fences foreign losses. More specifically, the Income Tax Act forbids the deduction of foreign assessed losses or the balance of foreign assessed losses (i.e. net foreign trade losses) against income derived from carrying on a South African "trade".

**II. Reasons for change**

At issue is whether a taxpayer can set off net foreign assessed losses from a foreign trade against South African passive income. It was always intended that these foreign losses should be fully ring-fenced to foreign income without offset against South African income. However, the current wording of the ring-fencing provision suggests otherwise. The current wording merely states that net foreign trade losses cannot be offset against domestic trading income. This language arguably means that net foreign trade losses (such as rental losses) may be set off against South African passive income (such as South African sourced salary).

**III. Proposal**

In view of the above, it is proposed that the net foreign loss ring-fencing provision be realigned according to the provision's initial intended purpose. The wording will expressly forbid the setting-off of net foreign losses against any South African sourced income.

**IV. Effective date**

The proposed amendment will apply in respect of any year of assessment commencing on or after 1 January 2014.

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## 5.6. EXEMPTION FOR INTERNATIONAL SHIPPING TRANSPORT ENTITIES

[Applicable provisions: Sections 9D(1) ("foreign business establishment" definition), 10(1)(o)(i),12C and a new section 12Q]

### I. Background

*A. Shipping transport owned by South African companies*

As a general matter, international shipping transport conducted by South African companies is largely subject to a corporate income tax rate of 28 per cent. The only incentives for international shipping are some depreciation incentives for capital investment in shipping transport.

*B. Shipping Transport owned by controlled foreign companies*

Income from controlled foreign companies generates deemed income for certain South African shareholders unless the income falls within certain exemptions – the most notable of which is income attributable to a foreign business establishment. The most common form of foreign business establishment involves a foreign fixed place of business but other forms are possible. One of these other forms is international transport, including international shipping transport. More specifically, international shipping transport falls within the ambit of a foreign business establishment if the international shipping transport is conducted solely outside of South Africa.

### II. Reasons for change

Government has long been aware that the international trend has been toward greatly reduced taxation of international shipping transport due to the highly mobile nature of this activity. Many leading shipping centres now impose a tonnage tax regime in lieu of income tax. In the case of a tonnage tax, tax is calculated by measuring the tonnage of the ship rather than through reliance on profits with the tax essentially amounting to small license fee. Other countries exempt international transport shipping income altogether. In view of these trends, the 28 per cent South African rate is wholly uncompetitive and is cited as one of the reasons that South Africa can no longer attract ships to its flag despite South Africa's strategic naval location.

### III. Proposal

*A. Overview*

In view of the above, it is proposed that a new tax regime providing tax relief for shipping companies be introduced. In order to qualify for this relief, the company at issue must be a resident and hold at least one or more vessels that: (i) are flagged in South Africa in terms of the Ship Registration Act, 1998 (Act No. 58 of 1998), and (ii) designed for international transportation of passengers or goods for reward.

*B. Relief mechanisms for domestic shipping companies*

The new shipping tax regime for qualifying domestic shipping companies includes exemptions from normal tax, the capital gains tax, the dividends tax as well as cross-border withholding tax on interest. These companies also have added flexibility in terms of functional currency.

3. Exemption of shipping income and gains

Receipts and accruals in respect of income derived from South African flagged ships of a qualifying shipping company will be treated as exempt income if that ship is engaged in the international traffic of passengers or cargo for reward by sea. The disposal of the ship is also exempt regardless of whether the gain generates ordinary revenue or capital gains.

4. Exemption of company withdrawals

Dividends paid by a qualifying shipping company will not be subject to the dividend tax if the dividend is derived from South African flagged international transport ship. Interest paid by shipping companies to foreign lenders in respect of debt obtained to finance the acquisition, construction or improvement of a South African flagged international transport ship will be exempt from withholding tax on interest.

5. Permissible use of a non-South African functional currency

Many international transport companies use a currency more suitable to an international environment than the local currency of residence. Given the blanket income tax exemption of receipts and accruals of international shipping income, an international shipping company will not be subject to tax on currency gains and losses. As a collateral measure, a qualifying shipping company may use a currency other than the Rand as the company's functional currency. This new dispensation will apply to the determination of taxable income, monetary items, capital gains items and other tax issues. A functional currency is defined as the currency of the primary economic environment in which business operations are conducted. This overall reliance on a non-Rand currency for tax purposes should eliminate inadvertent currency gains and losses

*C. Collateral amendments (depreciation and officers/crew)*

Given the proposed exemptions going forward, domestically flagged ships designed for international traffic for reward of passengers or goods will no longer be depreciable. Other ships will remain depreciable over a five-year period at a rate of 20 per cent per annum.

Under current law, the officers and crew of an international transport ship are exempt from tax on their salary (i.e. remuneration) if those persons are outside South Africa more than 183 days. In order to avoid potential issues of pay-as-you-earn withholding for employers of South African officers and crew, officers and crew of domestically flagged ships designed for international traffic will be wholly exempt without regard to the days abroad.

*D. Revised foreign business establishment classification for international ships*

The special rules for determining foreign business establishment relief for international shipping are too narrow, thereby giving rise to inadvertent controlled foreign company income. International transport ships should not lose the benefit of this relief merely because of occasional visits to South Africa. Therefore, any vessel used for transport that is engaged in international traffic will be treated as a foreign business establishment.

**IV. Effective date**

The proposed amendments will generally be effective for years of assessment beginning on or after 1 January 2014.

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## 5.7. UNIFORM CROSS-BORDER WITHHOLDING REGIME TO PREVENT BASE EROSION

[Applicable provisions: Sections 37J through 37O and section 49A through 49G; new sections 49; 50 and 51]

**I. Background**

*A. South African cross-border withholding taxes*

South Africa has long history of imposing withholding tax in the case of cross-border royalties (at 12 per cent). From 1 April 2012, South Africa introduced a dividends tax on cross-border dividends (which replaced the Secondary Tax on Companies). From 2011, an announcement was made to enact a unified cross-border withholding regime for interest at 15 per cent (and in 2012, a 15 per cent royalty withholding regime was proposed to replace the pre-existing royalty regime). Both regimes have been enacted for future implementation as of 1 July 2013. All of the above cross-border withholding regimes can be reduced or eliminated by an applicable tax treaty.

*B. Local permanent establishments*

Withholding taxes are designed to tax passive income. Once a non-resident entity has a permanent establishment in South Africa, the permanent establishment will be taxed on a source basis at a rate of 28% (i.e. at ordinary rates under the normal tax). As a result, the pending withholding regime contains an exemption for South African sourced interest/royalties if a non-resident carries on business in South Africa through a permanent establishment at any time during the year of assessment. South African sourced interest/royalties earned by foreign entities outside of this permanent establishment rule will be subject to a 15 per cent withholding.

**II. Reasons for change**

*A. Lack of cross-border withholding taxes on management/technical fees*

Unlike most developing countries, South Africa does not have a withholding tax on management or technical fees. Like interest and royalties, these fees generate local deductions, thereby giving rise to potential base erosion. Internal data suggest that these fees amount to billions per annum, much of which is shifted to low-tax jurisdictions. Hence, some form of protection in the form of withholding is needed to protect the tax base as has already been enacted for cross-border interest and royalties.

*B. Taxation of permanent establishments*

The current nexus between taxation under normal tax versus 15 per cent withholding is partially inappropriate. While the permanent establishment test is an international standard, OECD principles suggest that normal taxation should be limited solely to amounts that are effectively connected to the permanent establishment. The mere existence of a permanent establishment should not push all locally sourced income away from withholding taxes.

In addition, concerns exist that many foreign entities with permanent establishments are not properly filing their tax returns while acting as the basis for exemption from withholding taxes. Lack of proper registration means that certain foreign entities are improperly avoiding South African tax altogether.

## III. Proposal

*A. Proposed withholding taxes on cross-border fees*

In view of the above, it is proposed that pending withholding taxes be extended to cross-border consultancy, management and technical fees. This new withholding tax will be a final withholding tax that will be used to identify and collect revenue from non-resident taxpayers who provide certain services within a South African source that fall outside the normal tax. More specifically, all payments for services to a foreign resident from a South African source will be subject to withholding tax if those services are of a technical, managerial or consultative nature. These services should be understood as being comparable to technical fees covered in the context of certain tax treaties. Less technical services (such as hair stylists, real estate commissions and the like) should not be viewed as falling within the withholding paradigm.

In line with other cross-border withholding taxes, the withholding tax on technical, managerial or consultative service fees will be levied at the rate of 15 per cent of the gross amount of fees paid to a foreign-resident (subject to tax treaty relief). The structure of the regime will largely follow the structure for withholding taxes on royalties (more specifically as described below).

1. <u>Liability for tax</u>

As with other withholding taxes, the liability to withhold tax on technical, managerial or consultative service fees will remain with the person making payment (payor) of those service fees to or for the benefit of a foreign person. As stated above, the liability is limited solely to South African sourced amounts. Payment of this withholding charge satisfies any potential liability of the foreign payee.

2. <u>Exemption from withholding tax on service fees</u>

Like withholding taxes on interest and royalties, withholding tax on service fees will be subject to the following exemptions:

a. A foreign payee will be exempt from withholding tax if that foreign payee is a natural person who was physically present in South Africa for a period exceeding 183 days during the twelve month period preceding the date on which the fees are paid;

b. A foreign payee will also be exempt if the service fees are effectively connected to a South African permanent establishment (see the discussion of the permanent establishment exemption below).

In addition, service fees paid in respect of services rendered by any person in his or her capacity as an employee will be exempt (because these amounts fall within Fourth Schedule pay-as-you-earn withholding).

3. Obligation to withhold and declaration for exemption or reduction

Persons potentially subject to withholding can be relieved of their withholding liability only if these payors receive a declaration of exemption/treaty relief from the payee. This declaration must be submitted by the earlier of the date set by the payor or the date of payment.

4. Payment and recovery of tax

Payment to SARS of withholding tax on service fees must be made at the close of the month following the month in which service fees are paid.

5. Refund mechanism

The foreign payee may claim a refund from SARS if a withholding tax on fees is improperly withheld. The foreign payee may claim a refund if the refund claim is made to SARS within three years after payment of the applicable service fees.

6. Currency translation rules

If the payment of service fees is denominated in a foreign currency, the currency must be converted to the South African Rand at the spot rate on the date of withholding.

*B. Permanent establishment exemption*

Both the pending interest withholding regime and the pending royalty regime exempt payments to foreign persons from withholding tax if those foreign persons have a South African permanent establishment. This exemption will also apply in the case of the proposed withholding tax on cross-border services. This exemption exists because the South African permanent establishment is subject to normal tax (i.e. 28 per cent of taxable income).

However, the permanent establishment exemption will be adjusted in the case of all three withholding taxes. The exemption will apply only if the payment is "effectively connected with" the permanent establishment (because only this income is subject to the normal tax). The mere existence of a permanent establishment will not generate an exemption for wholly unrelated income. An explanation of the term 'effectively connected' is provided in the OECD Commentary on paragraphs 4 of Article 10 on dividends, 4 of Article 11 on Interest and 3 of Article 12 on Royalties. The "effectively connected" concept should be understood in the same context.

In addition, for the permanent establishment exemption to apply, the foreign payee must provide proof of SARS registration as a taxpayer. Without this proof, the payor must still withhold and no refund of withholding tax is possible. This proof requirement ensures that foreign persons can no longer escape the ambit of legally required withholding taxes and the normal tax in the case of South African source interest, royalties or services fees.

**IV. Effective Date**

The proposed amendment will be effective for interest, royalties and service fees that are paid or payable on or after 1 January 2015. The effective date rules also contain anti-avoidance mechanisms to prevent artificial accelerations of incurrals before the effective date so as to otherwise avoid the new withholding regimes.

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## 5.8. TRANSFER PRICING RELIEF FOR EQUITY LOANS

[Applicable provision: Section 31]

**I. Background**

Generally, transfer pricing adjustment rules apply to any loan provided by a South African person to a foreign connected party irrespective of the substantive character of the loans involved. For example, transfer pricing equally applies to both short-term and long-term loans as well as interest bearing versus non-interest bearing loans.

However, there are two exceptions to potential transfer pricing treatment. Firstly, loans advanced to a comparably-taxed controlled foreign company are exempt from transfer pricing adjustments. Secondly, transfer pricing relief applies to headquarter company back-to-back loans so loan funds can pass-through the headquarter company without attracting unintended South African tax.

**II. Reasons for change**

South African companies often capitalise offshore operations through equity-like loans. These loans generally bear little or no yield and are deeply subordinated with long-term or indefinite maturity dates. This form of “capital” financing is normally undertaken for a variety of reasons unrelated to tax. For example, quasi-equity loans are seldom subject to foreign regulatory restrictions, such as divestment and exchange controls.

While the current relief mechanism for loans to comparably taxed controlled foreign companies provide relief in this regard, this relief is fairly limited, especially because quasi-loans are often made to foreign companies that are uncontrolled by the South African shareholder. Oftentimes, the South African shareholder is part of a joint venture arrangement, whereby a consortium of multinational shareholders are capitalising a foreign company with loans with quasi-equity features. Without relief, potential transfer pricing concerns leave the South African shareholder in a compromised tax position vis-à-vis that shareholder’s multinational counterparts.

**III. Proposal**

In view of the above, it is proposed that transfer pricing relief should be extended to outbound loans that clearly resemble equity. In effect, taxpayers should not be forced to pay tax on notional interest from a share loan that is in substance nothing more than share capital. In particular, this relief will be limited to loans that meet the following qualifying criteria:

- The creditor must be a South African resident;
- The creditor must hold at least 10 per cent of the equity shares and voting rights in the offshore debtor;
- The loan must be perpetual or be non-redeemable within a period of 30 years from the date the loan is granted;
- The loan must have no preferences over any other debt, meaning either that: (i) full redemption of the loan requires approval from all other creditors, or (ii) the redemption of the loan is legally conditional upon the solvency of the offshore debtor.

A loan that meets the above criteria is in substance exposed to the same economic risk as equity and thus poses little or no risk to the South African tax base if interest is under-charged (because interest should not be charged at all as an economic matter).

**IV. Effective date**

The proposed amendment will apply in respect of years of assessment commencing on or after 1 January 2014.

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## 5.9. REMOVAL OF SOURCE FOCUS FOR COPYRIGHT AUTHORS

[Applicable provisions: Sections 10(1)(m) and paragraph 64 of the Eighth Schedule]

**I. Background**

The current tax framework exempts authors of copyright on revenue amounts received for the foreign assignment or licensing of copyright. More specifically, the exemption applies if the author is a natural person, the first owner of the copyright and the amount received is taxable in another country. There is no similar exemption if the transfer of copyright is subject to capital gains taxation.

**II. Reasons for change**

The copyright blanket exemption for residents is out of sync with the current world-wide taxation paradigm and does not take into consideration the provisions of DTAs. As a general matter, South Africa has a primary taxing right in respect of the foreign transfer of copyright by a resident unless the transfer is attributable to a foreign permanent establishment. On the other hand, royalties received in respect of the foreign licensing of copyright are subject to a residual secondary taxing right. The exercise of the secondary taxing right means that South Africa will generally grant a credit (i.e. rebate) for the foreign taxes paid.

**III. Proposal**

In view of the above, it is proposed that the copyright exemption for copyright authors should be deleted.

**IV. Effective Date**

The proposed amendment will be effective for years of assessment commencing on or after 1 March 2014.

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## 5.10. SHARE ISSUES IN EXCHANGE FOR FOREIGN SHARES AS A MEANS OF CORPORATE MIGRATION

[Applicable provisions: Paragraph 11(2)(b) of the Eighth Schedule to the Income tax Act]

**I. Background**

The expanded corporate reorganisation rules allow for the tax-free restructuring of both domestic and foreign company assets. In a purely domestic restructuring, assets are moved within a purely domestic company context. Offshore restructuring entails the restructuring of assets between controlled foreign companies and the transfer of foreign assets into the domestic tax framework.

The above restructurings receive rollover relief because the assets concerned remain within the same scope of the South African tax net or move to a more direct form of South African taxing jurisdiction. Outbound restructurings (transfers of domestic assets to foreign entities) are not entitled to rollover relief because an outbound transfer shifts value to a lower level of South African taxing jurisdiction (i.e. to a location wholly outside the South African tax net or from a direct to an indirect position within the South African tax net).

**II. Reasons for change**

The income tax framework seeks to strike a balance between permissible tax-free restructuring and the shifting of value offshore in order to effect an indirect corporate migration. More specifically, reorganisation rollover relief is not intended to be utilised as a means of shifting untaxed gains offshore. Of concern are various loop structures intended to achieve the same effect.

Many of the transactions of concern involve the dual cross-issue of shares between a resident and a non-resident. The purpose of the cross-issue is to shift control offshore free of tax. Many of these transactions also have the added benefit of the participation exemption, whereby the foreign shares received by the domestic transferor are also free of tax upon the subsequent disposal.

**Example**

***Facts:*** SA Holdco, a South African company, owns 100 percent of SA *Sub*, a South African trading subsidiary. Foreign HoldCo also owns 100 percent of Foreign Sub, another trading subsidiary. The two groups plan to combine their subsidiary operations with the foreign group obtaining majority control. In order to achieve the combination, SA Sub issues shares representing 60 percent of the value of SA Sub in return for 40 percent of the Foreign Sub shares. The value of the Foreign Sub shares received equals the value of the SA Sub shares exchanged.

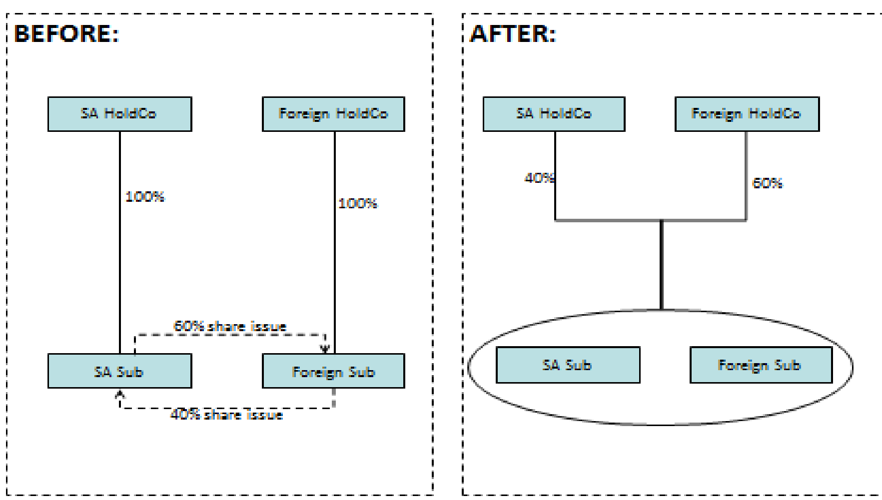
***Result:*** The shares issued by SA Sub are tax-free (i.e. not viewed as a disposal). The transfer by Foreign Sub is outside the South African taxing jurisdiction. In the end, control has been shifted to foreign persons free of tax. SA Sub can probably sell the Foreign Sub shares tax-free due to the existence of the participation exemption.

## III. Proposal

In order to prevent the above tax-free shift of control offshore, it is proposed that the tax exemption of the issue of shares should be denied if the issue of shares is in exchange for foreign shares. This anti-avoidance measure includes indirect exchanges involving the domestic company issuer and exchanges where the foreign shares are received by other persons. The issue of domestic shares under these circumstances will now trigger a disposal for capital gains tax purposes.

**Example**

***Facts:*** SA Holdco, a South African company, owns 100 per cent of SA *Sub*, a South African trading subsidiary. Foreign HoldCo also owns 100 per cent of Foreign Sub, another trading subsidiary. The two groups plan to combine their subsidiary operations with the foreign group obtaining majority control. In order to achieve the combination, SA Sub issues shares representing 60 percent of the value of SA Sub in return for 25 per cent of the Foreign Sub shares issued by Foreign Sub. The value of the Foreign Sub shares received equals the value of the SA Sub shares exchanged.



***Result:*** SA Sub is issuing its own shares for shares of Foreign Sub. SA Sub will be subject to capital gains tax on the disposal (i.e. the issue) of its shares. The SA Sub shares have a zero base cost so the gain equals the market value of the Foreign Sub shares received.

**Example 2**

***Facts:*** South African Individual owns all the shares of SA Company. Foreign HoldCo owns all the shares of Foreign Sub. In order to combine the operations of the two subsidiaries, South African Individual will contributes all of his or her shares in SA Company to SA Newco for 30 per cent of the SA Newco shares. Foreign Holdco transfers all of its Foreign Sub shares to SA Newco for the remaining 30 per cent of the SA Newco shares.

***Result:*** SA Newco is issuing its own shares for shares of Foreign Sub. SA Newco will be subject to capital gains tax on the disposal (i.e. the issue) of its shares. The SA Newco shares have a zero base cost so the gain equals the market value of the Foreign Sub shares received.

**Example 3**

***Facts:*** SA HoldCo owns all the shares of SA Sub. Foreign HoldCo also owns all the shares of Foreign Sub. In order to combine the operations of the two subsidiaries, SA Sub issues shares to Foreign Sub. Foreign Holdco issues its shares to SA Holdco. Upon completion of the transaction, SA Holdco owns 10 per cent of the shares of Foreign Holdco, and Foreign Sub owns 80 per cent of the SA Sub shares.

***Result:*** SA Sub is involved in an issue of shares indirectly in exchange for the receipt of Foreign Holdco shares by another person. SA Sub will be subject to capital gains tax on the disposal (i.e. the issue) of its shares. The SA Sub shares issued have a zero base cost so the gain equals the market value of the Foreign Holdco shares received by SA Holdco indirectly in exchange.

**Example**

***Facts:*** SA HoldCo owns all the shares of SA Sub. Foreign HoldCo also owns all the shares of Foreign Sub. In order to combine the operations of the two subsidiaries, SA Sub issues shares to Foreign Sub in exchange for cash, and SA Sub uses the same cash amount to acquire shares in Foreign Sub. Upon completion of the transaction, SA Sub owns 10 per cent of the shares of Foreign Sub, and Foreign Sub owns 80 per cent of the SA Sub shares.

***Result:*** SA Sub is involved in an indirect issue of shares for foreign shares. The SA Sub shares issued have a zero base cost so the gain equals the market value of the Foreign Sub shares received indirectly in exchange.

**IV. Effective date**

The proposed amendment will apply in respect of any issue of shares arising on or after 1 January 2014.

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# 6. INDIRECT TAX

## 6.1. GOODS IMPORTED FOR OIL AND GAS PRODUCTION

[Applicable Value-Added Tax Act provision: Schedule 1 Item no. 460.23]

**I. Background**

Goods imported into South Africa are generally subject to VAT when goods are entered for home consumption in terms of the Customs and Excise Act. Both the VAT and the Customs and Excise Act contain a number of exceptions to this rule that largely match one another. For instance, both the VAT Act and the Customs and Excise Act contain relief for the temporary import of goods intended for processing and manufacturing before export.

In terms of oil and gas, goods imported into South Africa by prospecting and mining for natural oil or gas exploration or production are entitled to a rebate of the customs duty when these goods are deemed entered for home consumption (in terms of Schedule 4 Item No. 460.23 of the Customs and Excise Act). The type of goods imported into South Africa relating to oil and gas exploration and production include seismic survey vessels, offshore drilling rigs or drill ships for drilling wells. No comparable relief exists for VAT.

**II. Reasons for change**

As discussed above, Customs and Excise relief often matches the VAT relief on imports. No reason exists to omit VAT relief for the import of goods relating to oil and gas exploration and production. Still worse, the lack of VAT relief is giving rise to cash-flow problems when large items (such as oil rigs) are involved.

**III. Proposal**

It is proposed that the VAT Act be amended to accommodate goods imported by prospecting or mining entities into South Africa for use in the exploration or production of oil or gas. This relief will match the relief currently existing within the customs environment.

**IV. Effective date**

The proposed amendment applies to goods imported into South Africa on or after 1 January 2014.

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## 6.2. SUPPLY OF SERVICES FOR CONTINGENT CONSIDERATION

[Applicable Value-Added Tax Act provision: new section 9(4)(b)]

### I. Background

A special time-of-supply rule exists for goods supplied under an agreement if the consideration for the goods cannot be determined upfront (excluding instalment credit agreements and rental agreements). In these circumstances, the supply is deemed to take place at the earlier of the date when (and to the extent): (i) payment in terms of the agreement is due or received, or (ii) an invoice relating to the supply is issued.

Typically, these deferred supplies relate to goods in the mining, forestry, or agricultural industries where the prices for those goods are dependent on international markets and/or the price is subject to exchange rate fluctuations. For instance, in the forestry industry, the price of logs supplied to a wood mill is dependent on the quality and moisture content of the logs (which is determined by the purchaser only after risk and ownership passes). In the mining industry, the price for ore is often dependent on the quality of the metals extracted from the ore and the average prevailing exchange rate.

### II. Reasons for change

As a general matter, no special time-of-supply rule exists for services offered for contingent consideration. There is no cogent reason for this omission. Like goods, the performance of certain services may also be linked to a future contingent event (for instance, the payment for risk services performed for a company may be linked to the share price performance of the company over a certain period). The payment for certain agency services supplied may be inextricably linked to the price of the underlying goods supplied (for instance, an agent's facilitation fee for wool may be dependent on the price a sheep farmer obtains for the wool supplied – a price which itself is dependent on the quality of the wool supplied, the international wool price and/or the prevailing exchange rate).

### III. Proposal

It is proposed that a special time-of-supply rule comparable to that of goods be added for services if the consideration for the performance of the services is determined with reference to a future event. The triggering date again occurs on the earlier of the date when (and to the extent): (i) payment is due or received, or (ii) the date of invoice.

### IV. Effective date

The proposed amendment applies to services supplied on or after 1 January 2014.

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## 6.3. ENTERTAINMENT SUPPLIED ON BOARD A FLIGHT OR SHIP

[Applicable Value-Added Tax Act provision: Section 17(2)(a)(iii)]

**I. Background**

Generally speaking, input tax deductions relating to entertainment expenditure are disallowed. However, this prohibition does not apply in several circumstances where business objectives dominate. More specifically, meals and refreshments provided to passengers (or crew members) by a vendor in conjunction with taxable transport services often qualify for input deductions.

**II. Reasons for change**

Unlike meals and refreshments, entertainment such as movies and electronic games supplied on-board a plane or ship falls under the general VAT definition of "entertainment." This form of entertainment is ancillary to the trip, merely being ancillary especially if this entertainment is provided at no additional cost. There is no sound basis for differentiating between meals and refreshments versus ancillary entertainment if all occur as ancillary to air or sea travel.

**III. Proposal**

Despite the general VAT prohibition against entertainment, it is proposed that input tax deductions for a vendor's cost to supply entertainment be allowed if:

1. that entertainment is ancillary to air or sea travel; and
2. that entertainment is provided at no additional charge

For practical reasons, all entertainment supplied by a vendor on board a ship or aircraft will be allowed as a deduction for input tax purposes (provided that the entertainment is supplied in conveyance of the underlying taxable transport service).

**IV. Effective date**

The proposed amendment applies to all supplies made on or after 1 January 2014.

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## 6.4. IMPORTED GOODS ABANDONED, DESTROYED OR DAMAGED

[Applicable Value-Added Tax Act provisions: Section 13(2B) and Schedule 1 Item no. 412.07]

**I. Background**

Generally speaking, goods imported into South Africa are subject to VAT at the rate of 14 percent when those goods are imported and entered in South Africa for home consumption in terms of the Customs and Excise Act. Goods that are imported into South Africa but which are abandoned, destroyed or damaged are considered to have been entered for home consumption in terms of the Customs and Excise Act. Hence, the VAT applies to these imported goods are abandoned, destroyed or damaged.

### II. Reasons for change

Goods imported into South Africa that are abandoned, destroyed or damaged are deemed to be entered for home consumption for Customs purposes, but a rebate applies for Customs purposes (see Schedule 4 Item no. 412.07 of the Customs and Excise Tax Act). This relief exists because the economic value never really enters South Africa with the relief being applied in a controlled way to ensure that goods are actually abandoned, destroyed or damaged as alleged.

While abandoned, destroyed or damaged goods are entered into for home consumption for VAT purposes in similar fashion to the Customs and Excise Act, no corresponding VAT relief is applicable to these goods. As a result, a 'notional' consumption of goods arises, even though the economic value of these goods never really enters the South African tax net.

### III. Proposal

It is proposed that the VAT Act (in Schedule 1) be amended to accommodate goods abandoned, destroyed or damaged in terms of the Customs and Excise Act. In effect, goods of this nature will be removed from the VAT net.

### IV. Effective date

The proposed amendment applies to goods abandoned, destroyed or damaged on or after 1 January 2014.

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## 6.5. CONVERSION OF A SHARE BLOCK SCHEME TO SECTIONAL TITLE

[Applicable Value-Added Tax Act provision: The (definition of "second-hand goods in section 1]

### I. Background

In a share block scheme, shareholders hold a share in a share block company with the share providing a personal right of exclusive use and occupation of a specific unit in the share block scheme. Share block schemes originated when South African property law did not permit persons to hold separate title to an individual flat within a block. With the advent of the Sectional Titles Act in 1986, share block schemes became less attractive to developers (e.g. sale documentation for share block schemes is more onerous and expensive than sectional title, and banks often charge a higher interest rate for share block financing because of the centralized company risk).

Under the Sectional Titles Act, a share block company may convert a share block scheme to a sectional title scheme by special resolution (i.e. Item 8 of Schedule 1 of the Share Blocks Control Act). Under current VAT law, supplies of immovable property made by a share block company to the shareholder pursuant to this form of conversion to sectional title are regarded as out of scope. The shareholder waiver of rights of use in the immovable property (associated with the shares in the share block company) is similarly viewed as out of scope.

**II. Reasons for change**

Under current law, the shareholder of the share block company can potentially claim a notional input tax deduction in respect of the immovable property acquired as part of the sectional title conversion if the shareholder is a VAT vendor. This claim is based on the argument that the acquisition of the immovable property is like the acquisition of any other second-hand good (especially in view of the wording in the "second-hand goods" definition).

Despite the potential literal language to the contrary, the creation of notional inputs upon a conversion from a share block scheme to a sectional title interest makes no sense. The purpose of the out of scope rules is to ensure that the conversion was a complete non-event. The ultimate owners of the immovable property are merely converting their property rights – the underlying economic interests in the immovable property remain roughly the same. Hence, just as the conversion should be out of scope in the case of outputs, no person should receive input credits for the conversion (as second-hand goods or otherwise).

**III. Proposal**

Share block owners acquiring direct ownership of immovable property pursuant to a sectional title conversion (i.e. the circumstances referred to in Item 8 of Schedule 1 to the Share Blocks Control Act) will be prohibited from claiming a notional input tax deduction in respect of that acquisition. The net effect is to treat the conversion as a general non-event for VAT purposes from both an input and an output point of view.

**IV. Effective date**

The proposed amendment applies in respect of goods supplied on or after 1 January 2014.

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## 6.6. STREAMLINING OF VAT REGISTRATION

[Applicable Value-Added Tax Act provision: Section 23(1)(b), section 23(3); new section 24(5A); new section 44(3)(e);]

**I. Background**

*A. Compulsory registration*

Persons that make taxable supplies in the course of an enterprise are required to register as a VAT vendor in certain circumstances. More specifically, VAT registration is required if the total value of taxable supplies made by a business enterprise at the end of a month exceeds R1 million after taking into account the prior 12-month period. Further, VAT registration is required if reasonable grounds exist for believing that the total value of taxable supplies to be made by that person will exceed R1 million in the next 12 months. In both scenarios, the person must apply to register. Compulsory registration ensures that businesses enter the VAT system in a timely manner.

*B. Voluntary registration*

Persons may also voluntarily register as a VAT vendor under certain conditions. In the main, businesses may voluntarily register for VAT if the enterprise has already reached a R50 000 turnover taking into account the prior 12-month period or if the business enterprise is acquired from another party as a going concern after having reached that threshold. Persons intending to carry on an enterprise may also voluntarily register for VAT if the R50 000 threshold will be reached in any 12-month period.

Requests for voluntary registration typically arise in the case of start-ups, small businesses and capital-intensive business with long-lead times. Taxpayers typically seek voluntary registration to obtain legitimacy of business operations vis-à-vis retail or commercial customers or to satisfy other regulatory requirements (e.g. as a pre-entry requirement for obtaining Government business). The need for VAT refunds for legitimate input costs is also a factor if input costs are substantial.

**II. Reasons for change**

VAT registration requires contradictory considerations. On the one hand, VAT registration places businesses squarely within the VAT system so as to trigger the 14 per cent charge on outputs. The fiscus needs these persons to be within the net to ensure that VAT is appropriately collected. On the other hand, businesses seek VAT registration for business legitimacy and potential VAT refunds.

These contradictory considerations place SARS in a difficult position. While VAT registration is a critical component of VAT collections, VAT registration poses a risk of unwarranted VAT refunds. In order to balance these risks, SARS must be certain that persons entering the VAT net represent genuine viable businesses. It is not unknown for certain persons to seek VAT registration to reduce the VAT cost for disguised personal consumption or to operate as an entry point for fraudulent VAT refund claims. One unfortunate by-product of these contradictory forces is the increased level of proof required for VAT registration, thereby hindering many legitimate businesses from timely VAT registration.

**III. Proposal**

*A. Overview*

In view of the above concerns, VAT registration will be streamlined. Firstly, compulsory registration will be simplified to reduce the predictive element. Secondly, voluntary registration will be divided into two elements – fast-track registration (with potentially restricted refunds) and full registration (with unrestricted refunds).

*B. Streamlined compulsory registration*

In order to reduce the subjectivity around compulsory registration, compulsory registration will be restricted so as to remove the predictive element (i.e. the need to determine the level of business going forward). More specifically, under the revised rules, compulsory registration will be required solely for the following two scenarios:

1. Existing businesses with taxable supplies that have already exceeded the threshold of R1 million within the preceding 12 months (same as current law); and

2. Existing or future businesses that have a written contractual commitment to make taxable supplies exceeding R1 million within the next period of 12 months.

Examples of circumstances falling within the ambit of the second scenario include commercial leasing contracts or a commitment by Government in a contractual tender to provide goods and services. Removal of compulsory registration based solely on a "reasonable grounds" expectation will eliminate most of the disputes involving compulsory registration.

*C. Streamlined voluntary registration*

It is proposed that the current provisions for voluntary registration be overhauled through a two pronged approach - traditional registration with unrestricted refunds and fast-track registration with restricted refunds.

1. <u>Type 1: Traditional VAT registration</u>

   a. Entry points

Taxpayers may continue to seek traditional VAT registration. Under this method of entry, the party must either be:

i. A municipality;

ii. A designated enterprise (e.g. parastatals and welfare organisations); or

iii. Any activity with a R5 million level of expenditure or a contractual commitment to make this level of expenditure in order to pursue or carry on the enterprise.

The R5 million category effectively assists capital-intensive businesses, such as mining, industrial, warehousing and forestry that require a large level of capital expenditure long before any taxable supplies are generated. The R5 million threshold amount ensures that questionable businesses with a hobby-like element do not enter the VAT system, such as vacation guest-houses and ranch farms.

   b. Refunds and de-registrations

Municipalities, designated enterprises and taxpayers within the R5 million expenditure category are fully entitled to refunds from commencement.

SARS also has the power to de-register taxpayers within this category if SARS determines that the business enterprise has ceased activities. This power to deregister applies in respect of all voluntary forms of registration, not just registration via a R5 million minimum investment.

2. Type 2: Fast-track VAT registration

Under the new system for fast-track VAT registration, every person can obtain VAT registration if SARS is satisfied that: (i) the person is carrying on an enterprise, or (ii) that the person intends to carry on an enterprise (that makes taxable supplies) within the next 12 months. No R50 000 or other monetary thresholds will apply.

Because this form of flexible entry poses a risk to the fiscus in respect of artificial refund claims, businesses obtaining fast-track VAT registration will be subject to limitations in respect of VAT inputs. In particular, VAT inputs can only be claimed to the extent of outputs with excess inputs (i.e. refunds) suspended until a second set of criteria is satisfied. Under this second set of criteria, the fast-tracked business will be eligible for refunds only once that business makes taxable supplies of R100 000 within a 12 month period.

Refunds will continue unfettered from that point onwards. However, SARS has the discretion to deregister a fast-tracked entry into the VAT system if one of either two conditions apply – the business ceases operations or the business fails to make taxable supplies of at least R100 000 over a two year period. This discretion empowers SARS to intervene so as to prevent excessive refunds for intermittently active businesses once these business start to lose their active nature.

**IV. Effective date**

The proposed rules relating to compulsory and voluntary registration will be effective from 1 January 2014.

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## 6.7. REGISTRATION OF E-COMMERCE SUPPLIERS

[Applicable Value-Added Tax Act provision: Section 15(2)(a)(viii); section 20(5B); and section 23(1A); Paragraph (b)(vi) of the definition of “enterprise” and “e-commerce services” in section 1]

**I. Background**

*A. General – Place of supply*

Under current law, foreign suppliers of e-commerce (e.g. electronic books, music and programs) are not compelled to register as a VAT vendor. These foreign suppliers of e-commerce wholly transact over the internet with their customers. As a result, these foreign suppliers do not have any physical presence in South Africa despite the existence of multiple South African customers.

On a related note, the VAT Act does not contain any place of supply rules to determine which jurisdiction (South Africa or another country) has taxing rights in respect of e-commerce transactions. This lack of a specific rule for place of supply means that a foreign supplier’s liability to register for VAT requires an interpretative exercise with no clear answers.

The generic rule to determine which jurisdiction has taxing rights is usually based on customer location. This generic rule appears appropriate in the case of foreign suppliers of e-commerce to

South African business customers. The foreign supplier should be subject to VAT at a zero rate in the foreign home country (based on the destination principle), and the recipient should be subject to VAT on imported services based on the reverse charge mechanism (see below).

*B. Imported services*

As stated above, customers that purchase services (e.g. e-books, e-music and e-movies) from a foreign supplier for final consumption must account for VAT on imported services via the reverse charge mechanism. Owing to the self-assessment nature of this mechanism, these customers must declare the VAT on imported services. The foreign supplier does not charge VAT for the services rendered because the foreign supplier is not registered for VAT.

**II. Reasons for change**

Placing reliance on the reverse charge mechanism for imported services as a means of enforcing VAT is impractical. Customer compliance with the reverse charge mechanism is low, especially in the case of e-commerce. This lack of compliance can be attributable to two causes: (i) some customers do not comply based on sheer ignorance, while (ii) other customers do not comply because they perceive the tax to be wholly voluntary as a practical matter (e.g. enforcement is impossible).

This lack of compliance has left local e-commerce suppliers (especially e-book providers) in an uncompetitive position vis-à-vis foreign suppliers of e-books. Foreign suppliers benefit because these suppliers are not required to charge VAT on their sales to South African customers (due to their wholly foreign location), and customers simply don't pay the VAT. Meanwhile, local e-book suppliers are subject to VAT like any other vendor. The net result is a near 14 per cent competitive advantage for foreign suppliers.

**III. Proposal**

As previously mentioned, the determination of place of supply for VAT purposes (i.e. the actual or deemed location of the supplier) is important to determine whether a foreign supplier must charge VAT on a supply. In line with OECD principles, it is proposed that place of supply rules be introduced in terms of e-commerce to bolster the current imported services reverse-charge mechanism. Under these new rules, foreign suppliers will be required to register as a VAT vendor because these suppliers provide supplies to South African customers. In view of the fact that customer location is often unknown in the case of e-commerce, a proxy for customer location will be used. It was decided that either of the following will serve as a proxy for customer location: (i) payment from a South African bank, or (ii) customer residency in South Africa. Other proxies were also considered but rejected:

1. **Place of performance:** Unlike physical services, it is impossible to determine the place of performance of an electronic service.

2. **Customer IP address:** Internet Protocol (IP) address depends on where the Internet Service Provider (ISP) is located and does not provide any indication of the exact location of the person with that IP address. Customers can also mask their IP addresses (someone in one country can show that they are located in another country). ISPs may also buy bandwidth from other ISPs based on traffic volumes, which means that the location/country can change.

3. **Customer's billing address:** Customers can easily manipulate their billing address details to avoid the tax.

It should be noted that the reverse-charge mechanism will remain as backstop to the new place of supply rules. In order to further safeguard the system against fraud, foreign suppliers of e-commerce will be entitled to VAT refunds only to the extent cash payments exceed total outputs.

All foreign suppliers of e-commerce services to South African customers will fall into the compulsory VAT registration category – a special compulsory category will be created with no monetary thresholds being applicable. Further, these vendors will be allowed to register for VAT on the payments basis in order to streamline compliance.

**IV. Effective date**

The proposed amendment applies in respect of supplies of e-commerce services on or after 1 January 2014.

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## 6.8. THE SUPPLY OF SERVICES BY A HOME OWNERS ASSOCIATION

[Applicable Value-Added Tax Act provision: Section 12(f)]

**I. Background**

The supply of services by a sectional title body corporate to its members in the course of the body corporate management is generally exempt from VAT. Historically, a sectional title body corporate provided (amongst other services) the service of paying the aggregated rates on behalf of the individual owners of the sectional title scheme; the body corporate would then recover these amounts on an individual basis from owners. Hence, imposing VAT on a sectional title body corporate would have effectively triggered an additional layer of VAT for conduit payments that did not contain any meaningful value –addition.

Home owners associations, however, are not exempt from VAT. Unlike a sectional title body corporate, home owners associations had no historical requirement to act as a conduit for municipal rates. Owners of full title properties always paid their municipal rates directly without involvement of the homeowners association.

**II. Reasons for change**

Since 2006, the requirement that a sectional title body corporate pays over the property rates of the sectional title owners, fell away. Sectional title owners now pay their rates directly. However, these body corporates remained exempt. The exemption remained because the supply of services by the sectional title body corporate to the members is not essentially a business enterprise. The sectional title body corporate is merely a cost sharing device. Homeowners associations essentially operate under the same premise.

**III. Proposal**

It is proposed that a supply of services by a home owners association to any of its members be exempt from VAT. This exemption will match the current exemption for sectional title body corporates.

**IV. Effective date**

The proposed amendment applies in respect of the supply of services on or after 1 January 2014.

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## 6.9. SURRENDERING GOODS IN TERMS OF A CREDIT AGREEMENT

[Applicable Value-Added Tax Act provisions: Section 8(10); section 9(8) and section 10(16)]

**I. Background**

A vendor (debtor) that has goods repossessed under an installment credit agreement is deemed to make a supply to the person exercising the right of repossession (creditor). The deemed supply effectively operates as a claw-back of the initially creditable input tax. In effect this claw-back fully or partially reverses the original input claimed by the vendor.

**II. Reasons for change**

In terms of the National Credit Act, 2005, a vendor can now opt to terminate an installment credit agreement by surrendering the goods that are subject to the agreement back to the credit provider. Under the VAT, however, this form of surrender of the goods by the vendor is not caught by the deeming provision. No reason exists for this omission.

**III. Proposal**

It is proposed that the current deemed supply pertaining to the repossession of goods be expanded to cater for a surrender of goods by a vendor to a financier (creditor) in terms any installment credit agreement by virtue of the terms of the agreement or by virtue of any law (such as the National Credit Act, 2005).

**IV. Effective date**

The proposed amendment applies in respect of goods deemed surrendered on or after 1 January 2014.

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## 6.10. CLARIFICATION OF MINIMUM SPECIFIED CONDITIONS FOR MINERAL RESOURCES

[Applicable Royalty Act section: Section 6A and Schedule 2]

## I. Background

The royalty for an extractor is triggered on the transfer of mineral resources. However, the value for royalty purposes is based “on the higher of”: (i) the value in the condition specified, or (ii) the value on extraction. Schedule 1 specifies the condition for refined mineral resources, and Schedule 2 specifies the condition for unrefined mineral resources. If the transfer occurs in a state when the condition is below the specified condition, the value is grossed-up to the minimum condition. If the transfer occurs in a state when the condition is above the specified condition, the value is based on the higher of the specified condition or the condition upon extraction.

The minimum condition rules have a two-fold purpose. The minimum condition ensures that taxpayers do not transfer mineral resources without undergoing any meaningful transformation of those minerals to undermine the royalty charge. The gross-down ensures that taxpayers are not penalised for beneficiating minerals.

## II. Reasons for change

The minimum condition rules are causing uncertainty. The basic minimum condition rules are fully explained in the text, but Schedules 1 and 2 are confusing. Some minerals list the condition as a “minimum” while others do not. It is unclear what the word “minimum” as contained in the Schedules adds to the text.

Moreover, certain minerals contain a range of specified conditions with no explicit rules covering this circumstance. At present, “chrome ore” and “manganese” contain a range as listed in Schedule 2. Coal previously had a range as listed in Schedule 2, but coal now has a specified point of 19.0 MJ/kg.

## III. Proposal

### *A. Minimum condition*

The term “minimum” will be removed from the Schedules as superfluous. The minimum condition concept will apply to all mineral resources listed in the schedule (except for minerals with a range of specified conditions as discussed below).

### *B. Range mineral resources (and coal)*

The rules associated with minerals containing a range will be clarified. If the transfer occurs at a specified condition below the range, the value will be determined at the bottom point specified within the range. If the transfer occurs at a specified condition above the range, the value will be determined at the highest point specified within the range. If the transfer occurs between the bottom and top points, the transfer condition will apply. Like the basic minimum condition rules, in no case can the condition fall below the specified condition at extraction.

Certain minerals are given a range (as opposed to the standard minimum condition) in recognition of the fact that certain minerals come in a variety of grades. If a group of minerals come in a variety of high-grade and low-grade conditions falling within the set range, the extractor can simply apply the condition upon transfer of the said mineral. One mineral that previously had this range was coal. This range should be restored because the condition of coal typically falls within a range. Under the revised rules, the range for coal will be from 19.0 MJ/kg to 27.0 MJ/kg.

**IV. Effective date**

The proposal will apply to all mineral resources transferred on or after 1 March 2014.

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## 6.11. SMALL BUSINESS EXEMPTION ELIGIBILITY

[Applicable Royalty Act section: Section 7(1((d)]

**I. Background**

The Mineral and Petroleum Royalty Resources Act applies to a person (essentially the extractor) that transfers a mineral resource extracted from within the Republic. However, as part of Government's initiative to encourage and support small business development, relief for small mining operations is available in the form of an exemption. This exemption is subject to four requirements: (a) a gross sales limit of R10 million in respect of a year, (b) a royalty liability limit of R100 000 for the year, (c) residency requirement for the year, and (d) a registration requirement (i.e. required registration in terms of the Mineral and Petroleum Royalty Resources Administration Act).

**II. Reasons for change**

The registration requirement for the royalty exemption is often unrealistic in the case of small business. Many smaller businesses often fail to register due to a lack of knowledge or staff capacity. This lack of registration leaves small business vulnerable to unnecessary royalty charges and related penalties. Small businesses should receive relief regardless of registration.

**III. Proposal**

It is proposed that the registration requirement be deleted. Small businesses will be eligible for royalty relief regardless of registration.

**IV. Effective date**

The proposal will come into effect for years of assessment ending on or after 1 March 2014.

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## 6.12. ALIGNING INCOME TAX AND ROYALTY EARNINGS IN THE CASE OF OIL AND GAS COMPANY CAPITAL ALLOWANCES

[Applicable Royalty Act section: section 5(3)(g)]

## I. Background

### *A. Overall royalty formula*

The Mineral and Petroleum Royalty Act imposes a royalty charge based on gross sales and an adjustable rate. The adjustable rate takes into account a mineral extractor's profits via an earnings before interest and taxes (EBIT) calculation. EBIT is calculated taking into account: (i) gross sales, (ii) recoupments, and (iii) deductions. In terms of deductions, permissible capital expenditure is allowed in order to promote growth and investment in the mining industry. However, the carry-over of excess operating losses is not permitted.

### *B. Oil & Gas 10th Schedule capital allowances*

The 10$^{th}$ schedule to the Income Tax Act provides oil and gas companies with a special deduction for capital expenditure in addition to the normal allowance. Capital expenditure for exploration receives a 100 per cent uplift, and capital expenditure for production receives a 50 per cent uplift. All excess losses, including excess losses stemming from these uplifts can be carried over to following years in the form of assessed losses.

## II. Reasons for change

While Income Tax and the royalty EBIT calculation are largely aligned, the EBIT calculation fails to take the exploration and production capital expenditure uplifts into account. No reason exists for this deviation, especially because other mining capital allowances within the income tax are fully reflected in the EBIT calculation.

## III. Proposal

It is proposed that all of the capital allowance uplifts for oil and gas exploration and production be fully reflected within the royalty EBIT calculation. This parity ensures that capital investments for oil and gas are fully incentivized under both the income tax and royalty regimes. Parity of treatment will also greatly simplify compliance and administration of both systems.

## IV. Effective date

The proposal will come into effect for years of assessment commencing on or after 1 March 2014.