Standing Committee on Finance (SCOF): Report-Back Hearings

DRAFT Taxation Laws Amendments Bills, 2011

Draft Response Documentfrom National Treasury and SARS, as presented to SCOF
(Final version of this document will be published by date of introduction of the Bills)

1. BACKGROUND

1.1 Process

The Draft Taxation Laws Amendment Bills, 2011 were publicly released on 2 June 2011. National Treasury and SARS conducted the initial briefing before the Standing Committee on Finance on 15 June 2011. Public responses to the Committee were presented at hearings held on 21 and 22 June 2011.

1.2 Public comments

The National Treasury/SARS deadline for public written responses was 11 July 2011 (thereby providing more than a month for official comment). These responses amounted to over 500 pages provided by approximately 60 organisations. Pursuant to recent practice, a series of National Treasury/SARS workshops were conducted with interested stakeholders to review all comments. In total, two core workshops were held in mid-July (one for business issues and one for international issues). Separate meetings were also held to review specific issues (e.g. medical credits, research & development, film and the value-added tax).

Given the number of responses received involving the proposed suspension of section 45, a series of one-on-one meetings were held with impacted taxpayers, covering more than 50 transactions. Information from these meetings resulted in the 3 August 2011 release of revised legislation pertaining to section 45 and related matters. Comments in respect of this revised legislation were received by 17 August 2011. A workshop on the matter was additionally held on 31 August 2011. This response document takes comments on the revised proposals into account to the extent possible.

2. POLICY ISSUES AND RESPONSES

Provided below are the responses to the policy issues raised by the public comments received. Both policy and technical issues have been fully reviewed and included within the revised Bills as appropriate. Comments that fall wholly outside the scope of the Bills have not been taken into account for purposes of this response document. The references to the Bill provided below only link to the main references (i.e. the references are not exhaustive).

INCOME TAX: EMPLOYMENT, INDIVIDUALS AND SAVINGS

2.1 Conversion of medical scheme contribution deductions to tax credits
(Bill references: Clauses 10 and 47; Sections 6A and 18)

Comment:The proposal to convert medical scheme deductions to credits will cause severe hardship for low income earners if the benefit can only be extracted at year end when returns are submitted. It is proposed that the credit be applied on a monthly basis.

> *Response:*Comment misplaced. The medical scheme credit has always been intended to be available on a monthly basis. The credit will provide greater relief for taxpayers in marginal brackets below 30 per cent.

Comment:It is not clear whether the medical scheme credit will be available only for registered members of medical schemes.

> *Response:*Comment misplaced. Yes. The credit relates only to medical scheme fees, regardless of whether those fees are paid in respect of members or their dependents.With respect to out-of-pocket expenses, those expenses related to all economically dependent members of the immediate family to the taxpayer will become eligible for a deduction.The conversation of out-of-pocket expenses from a deduction to a credit will be considered next year.

Comment:Credits will adversely affect the elderly (age 65 and over) and the disabled, who are currently eligible for an unlimited deduction for all medical expenses.The credit proposal should not limit relief in this regard.

> *Response:*Noted.For the next two years taxpayers aged 65 years and older will continue to receive the unlimited deduction in respect of medical expenses. The disabled will be entitled to the monthly credit and additionally claim the balance of their medical expenses (less four times the credit received) at year-end assessment. The possibility of converting deductions relating to out-of-pocket expenses into a credit (and at which rate) for those aged 65 years and older and for those with disabilities will be explored next year.

Comment:The proposed tax credit is not in line with medical aid scheme costs. The proposed amounts do not come close to covering these fees.

> *Response:* Noted. The purpose of the medical aid scheme credit is not to cover full medical aid scheme costs. The primary purpose of the credit is to provide reasonable and equitable relief. This approach is in line with the prior policy decision taken some time ago. At that time, the 2/3rds rule was eliminated in favour of monthly monetary thresholds. The proposed credit is consistent with this prior decision.

Comment:The supplementary credit would be very difficult to implement because employers would be reliant on employees to provide critical information. For instance, the employer does not automatically know if an employee or the employee's dependants are disabled or whether the employee's dependants are over age 65.

> *Response:* Accepted. The supplementary credit has been dropped. For the next two years the current unlimited deduction for taxpayers aged 65 years and older will remain, and those with a disability will be able to continue to claim their additional expenses as per the current deduction regime (less four times the credit). As noted earlier, the conversion to credits for these categories of taxpayers and dependants will be further explored next year.
>
> It should also be noted that medical scheme contributions on behalf of taxpayers 65 years of age and older will henceforth become a taxable fringe benefit. However, these taxpayers should be in a tax neutral position as they will be able to claim all their medical expenses as a deduction for the next two years.

2.2 Conversion of living annuities to a Retirement Income Drawdown Account
(Bill reference: Clauses 7(1)(z); Section 1 (retirement income drawdown account definition))

Comment:While the proposal to expand the product providers of living annuities is welcome, the proposal is premature.The tax changes should be postponed until full and final clarity has been attained in respect of a revised regulatory framework. These regulatory changes include prudential oversight and reporting requirements, as well as protection for account holders against creditors. This revised framework is not only needed for new post-retirement income products but also for pre-existing products.

> *Response:* Accepted:A separate set of bills will be issued in due course that will fully address the regulatory and tax aspects of allowing equal access to the prospective providers of living annuity products. Items relating to living annuity products will be shifted from the current tax proposals and added to the subsequent post-retirement income bills.

2.3 Pension preservation fund amendment
(Bill reference: Clauses 7(1)(zF); Section 1 (pension preservation fund definition))

Comment:The proposed amendment seeks to allow transfers from provident and provident preservation funds to pension preservation funds. Unfortunately, the proposed amendment does not allow for these transfers to be tax-free, particularly in the case of divorce orders and retrenchment benefits transferred.

> *Response:* Accepted. The proposals will be amended to ensure that transfers from provident fund and provident preservations funds can be made tax-free if made to pension preservation funds. The tax-free nature

of these transfers (like all permissible retirement savings transfers) was always intended. These funds should only be taxed upon withdrawal from the overall retirement system.

Comment:The definition of 'retirement annuity fund' does not specifically allow transfers from preservation funds, even though the proposed amendments seek to make these transfers tax-free.It is proposed that the definition be amended to firstly allow for transfers from preservation funds to retirement annuity funds.

Response: Accepted: The definition of retirement annuity fund will be amended to allow transfersfrom preservation funds. The permissible nature of these transfers was always intended.

2.4 Lump sum withdrawal table
(Bill reference: Appendix to Draft Bills; paragraph 6)

Comment: The pre-retirement withdrawal table of the Draft Taxation Laws Amendment Bill, 2011 (TLAB) refers to "retirement lump sum withdrawal benefits received by or accrued to that person on or after 01 March 2010". Is the reference to 2010 correct or should the reference be 1 March 2009?

*Response:*Accepted.Reference should be to 1 March 2009. The proposed legislation will be corrected accordingly.

2.5 Judicial long distance commuting
(Bill reference: Clause 111; Paragraph 7(8A) of the Seventh Schedule)

Comment:There is no clear distinction between the positions of judges and other employees. The proposal should be applied equally to all those in similar circumstances. Otherwise, the proposal is discriminatory in nature.

Response: Not Accepted. Judges by their very nature are in a unique position, not only due to the nature of their positions but also in respect of the statutory requirements imposed and the nature of their working conditions. This unique treatment of certain statutory posts can also be observed in other jurisdictions where the difference is linked to job activity. The rotating circuits that some Judges serve should be viewed in this light.

2.6 Long-term insurance policy premiums incurred by employers
(Bill reference: Clauses 33 and 113; sections 11(w) and paragraph 12C of the Seventh Schedule)

Comment:Whereas the proposed amendments only refer to policies issued by long-term insurers, the amendments should also include short-term policies with the same objective (e.g. coverage against death and disability). Disability income protection policies often fall within this paradigm. However, no fringe benefit income should arise merely because an employer is the policyholder of a work-type accident policy, even though the employer may ultimately make discretionary payments from policy proceeds to cover employees from harm caused by a workplace event.

Response: Accepted. The legislation will be extended to include short-term insurance that covers injury, disability or death of an employee (or a director of the employer).However, a carve-out will be created for employer-policies exclusively aimed at providing cover for events that occur in the normal course of work.

Comment:The proposed amendments dealing with employer-provided insurance are too wide. More specifically, the legislation may inadvertently include payments made by the employer to a retirement fund that includes risk cover foremployees (known as approved group life schemes).

Response: Accepted. The proposed amendments were not intended to alter the tax treatment of approved group life schemes. This position will be clarified in the legislation.

Comment:In respect of employer group income protection policies, the legislation must be amended to allow for employee deductions to the extent that premiums paid by employers were taxed as a fringe benefit in the employee's hands. This deduction will ensure parity with employees who can deduct premiums directly paid by them for their own plans.

Response: Accepted. Employer-paid premiums in respect of the employer group income protection policy will be deemed to be a payment made by the employee to the extent that the premium is taxed as a fringe benefit in the hands of the employee. This amendment will ensure that the employee can claim a monthly deduction for PAYE.

Comment:The retrospective implementation date of 1 January 2011 in respect of fringe benefit treatment for employer group insurance policies is unfair (especially if the employer did not account for these premiums as fringe benefits before). These employers will struggle rectifying their payroll positions, especially if the employees' tax submissions are complete and employee tax certificates have been issued.

Response: Accepted. It is recognised that the various implementation dates are causing confusion and administrative difficulties. The effective date will accordingly be deferred so employers are not left in a difficultposition.

Comment:It seems that there is no deduction available in terms of section 11(w) for policies on the life of an employee or director of an employer if the policy is intended to provide cover for a contingent liability or a debt of the employer. For example, a policy of this nature would arise if the employer has a policy on the life of an employee to cover the employee's death with the employee standing surety for a debt of the employer. Policy proceeds would be paid to cover these potential surety obligations. Was this exclusion intentional?

Response: Noted. No deduction should be allowed because the expense will be of a capital nature (i.e. to indirectly cover a capital obligation). Section 11(w) should not alter this rule. This position will be expressly confirmed in the legislation to the extent that a lack of clarityothereise exists.

2.7 Employer long-term insurance policy payouts
(Main bill reference: Clauses 7 (1)(x) and 122(1); section 1 (gross income (mP) definition) andparagraph 55 of the Eighth Schedule)

Comment:It seems from the legislation that exempt employers need not treat the premiums paid in respect of employer group insurance policies as a fringe benefit because the premiums are not be deductible. Employees of exempt employers (or their dependants) will instead be taxed when the policy proceeds are paid. This difference between exempt and taxable employers seems unfair and illogical.

Response: Comment misplaced. The phrase "ranked for deduction" does not mean "deducted" or "deductible". The phrase is broader. The phrase "ranked for deduction" is designed to address the problem raised. An item is "ranked for deduction" regardless of the tax status of the employer. Hence, employer group plans for the benefit of employees "rank for deduction" under section 11(w) regardless of the taxable or tax-exempt status of the employer.

Comment:Outside of the employee-employer context, the recipients of the proceeds of an insurance policy (dependants or beneficiaries) would often be unaware of the tax treatment of the premiums relating to that policy. The recipients would therefore not know how to treat the proceeds for income tax purposes.

*Response:*Accepted. Due to its inherent complexity, the tax regime around long-term insurance policies will mostly remain common law. The proposed changes will be limited solely to plans involving employers. This limitation would prevent many of the anomalies raised.

Comment: The proposed change creates effective date problems for policy payouts. Many employer-provided group plans prior to the effective date of the change were operating without deductions for employers even though the policies were pure risk. This lack of a deduction prior to the pre-effective date will taint future policy pay-outs (i.e. make the payouts includible), even if premiums after the effective date generate taxable fringe benefit income.

*Response:*Accepted. The proposal will be modified to account for deductible premiums only from the effective date of the legislation. Under this revision, pre-effective date non-deductible premiums would no longer be an issue. Measurement of premiums would only be taken into account after the effective date.

Comment:Unwinding pre-existing deferred compensation investment policies that are indirectly offered by employers via insurers is overly complex. While the transfer of these policies to employees on a tax-free basis is welcome, the partial tainting of policy payouts for deductible employer-paid premiums is too high a price.

Response: Accepted. The initial proposal was to defer tax upon cession of an insurance policy from an employer to an employee. It is now proposed that the value of the ceded policy will be taxed in the hands of the employee when ceded (with the policy valued at time of cession), Subsequent policy payouts will mostly be viewed as tax-free (as capital in nature under common law principles).

2.8 Trust Assets
(Bill reference: Clause 30; section 10(1)(k)(i)(dd))

Comment:The revised proposal alleviating dividends in respect of equity shares held in trust from ordinary treatment is welcome. However, the requirement that the trust contain no assets other than equity shares is impractical. Employee share trusts often contain incidental assets, such as cash from dividends, to sustain the trust scheme.

Response: Accepted. The rule restricting trust assets to equity shares will be slightly relaxed. Assets arising from incidental amounts associated with the shares will be permitted.

Comment: Reliance on “equity shares” as redefined may be intended to eliminate shares other than ordinary shares. However, the actual definition used makes little sense.

*Response:*Accepted. The purpose of the equity share limitation is to prevent taxpayers from disguising salary through dividends. This disguise typically requires shares with a preferred-type yield. The definition will accordingly be modified so as to rely on the standard “equity share” definition while excluding shares qualifying as hybrid shares (without regard to the three year rule).

3. INCOME TAX: BUSINESS

General business issues

3.1. Dividends Tax issues
(Bill reference: Clause 91; Part IX)

Comment: The Value Extraction Tax should be retained because the tax contains an automatic deeming rule that provides taxpayer certainty. Without this certainty, small business-relationships may find themselves with unwelcome and unwarranted audits.

Response:Partially accepted. The deemed dividend rules in the old STC system created numerous anomalies in an area that is inherently driven by facts and circumstances. It appears that the main issue of concern relates to company loans to shareholders when these loans are, in fact, dividends (often never subject to repayment). It is accordingly proposed that deemed dividend treatment automatically applies to loans made by companies to connected persons that are non-company residents (e.g. that are domestic natural persons and trusts). The loan will give rise to tax on an annual basis to the extent the interest rate falls below set market levels.

Comment: While the explanatory memorandum states that the proposed changes for timing of the Dividends Tax withholding should be based on cash principles. The literal language of the proposed rules seems to lean in favour of accrual. In particular, "amounts set aside" or "unconditionally available" in the dividend context have an accrual-type flavour.

Response: Accepted. A dividend will be treated as being paid on actual payment date or the date on which the dividend becomes payable to the shareholder. The key question is whether money is freely available for withholding.

Comment:Taxing in specie dividends at a company-level goes against the principle of taxing dividends at a shareholder level. The *in specie* rule effectively goes against international norms.

*Response:*Not accepted. Given all the practical alternatives relating to concurrent withholding, the focus on the company payor is clearly the most viable. The company payor has the greatest access to funds for tax payments when cash is lacking. International practice also suggeststhat a number of jurisdictions follow the same practice.

Comment:The "dividend" and "return of capital" definitions should be defined in relation solely to the recipient of the distribution. The alternative definition for the holder of the share seems unnecessary and confusing.

Response:Accepted. The dual definition will be eliminated. A single definition will apply to both the company payor and the holder of the share. The reasons for the dual definitions no longer exist given other changes to the Bills.

Comment:Clarity should be provided as to whether the anti-dividend stripping rules apply to foreign dividends. The draft Explanatory Memorandum suggests that the anti-dividend stripping rules will apply to foreign dividends; whereas, the draft Bill is silent on the issue.

Response:Comment accepted. Exempt foreign dividends will be specifically included in the coverage of the anti-dividend stripping rules. These exempt dividends pose the same dividend stripping concerns (i.e. a tax-free devaluation via dividend, followed by a sale of a reduced-value company.

Comment:A definition for the holding of shares should be added. Unlike other assets, a holder can easily be registered as a nominal owner of shares despite the lack of beneficial economic ownership.

Response: Comment misplaced. The term “hold” for tax purposes implies beneficial ownership as opposed to registered ownership. Nominal registered ownership and beneficial ownership are often split in other circumstances, such as listed debt instruments. Clarification of the term “hold” in the current circumstance may indirectly undermine the desired interpretation elsewhere. It is also accordingly proposed that the shareholder definition be dropped (which treats both registered and beneficial owners of shares as “shareholders’).

Comment:Dividends accrued to a collective investment scheme should be deemed to be income only when actually paid out or applied for purposes other than for distributions to the unit holders. The present language seemingly also has the effect of producing a dividends withholding tax for these funds applied for other purposes.

Response: Partially accepted. We believe that the currently proposed rule applies to trigger ordinary revenue as requested (i.e. if not distributed to unit holders). However, withholding in respect of the Dividends Tax seems to additionally apply to the undistributed income. This latter application of the Dividends Tax will be removed to prevent double taxation of the same amounts.

Comment: Dividends received or accrued by the individual policyholder funds areused in the four funds formula so asto reduce deductions. This formula assumes thatthe dividends are wholly exempt in the hands of the policyholder funds and the change caused by thenew Dividends Tax, the returns in the individual policyholder fund will be taxed as 10 per cent, meaning that the formula has to be adjusted.

Response: Accepted. The tax formula in the individual policyholder fund will be adjusted to take into account the 10 per cent tax charge.

3.2 Capital distribution issues
(Bill reference: Clause 7(d); section 1)

Comment: The amendments to the contributed tax capital definition must apply to all transfers of contributed tax capital without differentiating between ordinary distributions, share buy-backs and liquidations. Different rules for different share-related transfers create unintended anomalies with little corresponding benefit.

Response:Accepted. The proposed differentiation will be withdrawn for reconsideration. The issue forms part of a larger set of policy questions as to whether different share-related transfers create unnecessary deviations, especially once the interplay between the Dividends Tax and the capital gain rules are considered.

Comment: Application of the 1 July 2011 deemed capital distribution rule is unclear in terms of time and impact. The explanatory memorandum appears to be seeking to delay the date with the charge falling under the revised rules.

*Response:*Accepted. All 1 July 2011 deemed capital distributions will be delayed to 1 January 2012. These deemed capital distributions will be subject to the new capital distribution rules (reduction of base cost with gain triggered once the distribution would otherwise drive the base cost below zero versus the current part disposal system).

3.3 New dispensation for foreign dividends
(Bill reference: Clause 32; section 10B)

Comment: It appears that dividends in relation to dual listed shares of foreign companies will be taxed twice. In these circumstances, the Dividends Tax seems to apply as well as partial inclusion in gross income as a foreign dividend.

Response: Accepted. The dual tax on dual listed foreign company dividends will be removed. To the extent that a foreign company distributes dividends in respect of JSE listed shares, the Dividends Tax of 10 per cent will apply (so all dividends in respect of JSE shares are treated equally). To the extent a foreign company distributes dividends in respect of foreign listed shares, the normal tax will apply to the "foreign dividends" with a partial inclusion rate that yields a maximum 10 per cent effective rate.

Comment: The foreign dividend definition is unclear as to how this definition will apply to Dutch co-operative distributions. The amounts may qualify as foreign dividends (eligible for the participation exemption) or as a return of capital distribution that triggers capital gain.

Response:Accepted. The foreign dividend definition will be modified. Firstly, the rules will be clarified so that the amounts must be treated as foreign dividends or similar payments in respect of the tax on the company payor's income pursuant to the tax laws of the foreign country in which that company is located. Secondly, the payment must not be deductible under the tax laws of that country. In the case of Dutch co-operative distributions, profit co-operative distributions are not deductible. These distributions are also treated the same as dividends in respect of determining income of the entity payor. The fact that the payment is not subject to cross-border withholding tax (unlike a dividend) is irrelevant.

Comment: The concept of foreign return of capital is unworkable. Many foreign countries do not apply this concept.

Response: Accepted. The definition of foreign return of capital will no longer rely on foreign treatment as a return of capital distribution. Instead, this treatment will apply as a residual category (a non-deductible foreign distribution other than a dividend).

Comment: *In specie* dividends declared and paid by foreign companies trigger tax for the foreign company payor like domestic *in specie* dividends. However, South Africa lacks taxing jurisdiction in this regard because South Africa (like all countries) does not have the authority to tax foreign residents in respect of foreign activities.

Response: Comment accepted. In specie dividends declared by a foreign company will not trigger tax for that company. These dividends will be subject to the normal tax (at the maximum effective rate of 10 per cent) without regard to the Dividends Tax even if the foreign company has dual listed JSE shares.

Comment: The "dividend" and "foreign dividend" definitions are not aligned with regard to redemptions of participation interests by foreign collective investment schemes. The definition of a "dividend" excludes redemptions by foreign collective investment schemes whilst the definition of "foreign dividend" has no special exception. As a result, the foreign dividend definition might potentially include these redemptions, depending on the laws of the relevant foreign country.

Response: Accepted. The definition of "foreign dividend" will be realigned with the definition of "dividend" so as to explicitly exclude redemptions by foreign collective investment schemes. Because this is a technical correction of last year's legislation, the effective date of this amendment will be 1 January 2011.

3.4 Miscellaneous withdrawn issues

Comment:*(Bill reference: Clause 7(n); section 1):*The inclusion of debt reduction in gross income without coordinating the new inclusion with the recoupment rules or the reduction of assessed loss rules is inequitable. The change seems to be without merit because the debt reduction rules announced in the Budget Review sought to alleviate debt cancellation from inadvertent tax.

Response: The proposed amendment was intended as the initial leg for larger reforms regarding debt cancellation. As such, the proposal in isolation is not having the effect intended and will accordingly be delayed until the 2012 legislative cycle.

Comment:*(Bill reference: Clause 36; section 11F):*Different viewsexist as to which party should be entitled to the deduction (seller or purchaser) when contingent liabilities are assumed as part of a saleof a business as a going concern. It is accordingly questionable whether new rules are needed or whether the matter can be clarified via interpretation.

Response: The amendments dealing with the contingent liabilities associated with the sale of a business will be withdrawn. A general binding ruling (or an interpretation note) will be released to clarify the tax treatment of contingent liabilities assumed.

Comment:*(Bill reference: Clause 73; section 42):* The proposals include an amendment to treat the assumption of debt within a section 42 rollover as a capital distribution. This treatment triggers an immediate reduction of tax cost as well as potential immediate gain. This result undermines the utility of section 42 versus the current paradigm, the latter of which allows the gain to be deferred until subsequent disposal.

*Response:*Accepted. While the excess liability rule within a section 42 rollover is of concern, this result may be overly harsh because section 42 utilises an asset-by-asset approach. This approach means that the liability assumed can only be offset against the tax cost of a single asset as opposed to the tax cost of all assets transferred. The proposed amendment will accordingly be delayed until the asset-by-asset approach of section 42 can be reconsidered.

3.5 Small Business: Micro-business Turnover Tax Relief
(Bill reference: Clause 108; paragraph 8 ofthe Eighth Schedule)

Comment: The proposed de-linkage of the micro-business turnover tax from the Value-added Tax is welcome, but the loss of flexibility between the Income Tax and turnover tax is overly harsh. A business may be forced to leave the turnover tax because gross receipts exceed R1 million in one year and then total receipts fall below that amount due to uncontrolled market conditions in a subsequent year. Taxpayers in these circumstances should be allowed to re-enter the turnover tax.

Response:Comment misplaced. Taxpayers that temporarily exceed the R1 million limit already have available relief. Under current law, SARS can waive the R1 million limit if satisfied that the excess is nominal or temporary.

3.6 Debt used to facilitate tax-free reorganisations
(Bill reference: insertion of sections 23K and 45)

Comment:The discretionary powers given to SARS via Ministerial regulation are too wide and far reaching. More objective rules are required to provide taxpayers with greater certainty.

Response: Partially accepted. The proposal will be revised so that the core factors in the decision-making process will be made explicit in the legislation. More specifically, the legislative factors to be taken into account in exercising this discretion are (i) the potential tax leakage associated with the debt issued to facilitate the reorganisation, (ii) the level of debt to total equity of the debtor company, (iii) the estimated interest expenses in relation to the estimated income after the reorganisation, (iv) the debt versus equity features of the so-called debt instrument, and (v) the ownership relationship between debtor versus creditor (i.e. whether the creditor is a shareholder in the debtor).

Comment: The consultation process between the Minister and the Commissioner may result in delays in the approval process.

Response: Accepted. The consultation process will be streamlined with only Commissioner involved. It is envisioned that the Commissioner will delegate this power to competent officials within SARS. The process will operate in similar fashion to the current advanced rulings process. SARS may consult with National Treasury about policy issues arising from the approval process in accordance with the current legal framework.

Comment: The powers of SARS to deny the deduction should be made subject to objection and appeal. The decision at issue goes beyond mere interpretation.

Response: Accepted. The proposal will be amended to enable taxpayers to object and appeal an adverse approval decision of SARS.

Comment: Borrowers have no control over the affairs of the funder. It also might not be feasible for the funders to arrange undertakings regarding the source of funding if that funding is fixed. Therefore, taxpayers should be allowed to rely upon the facts in existence as atthe date of the approval request. The approval should not be subsequently denied due to a mere subsequent change in holder unless part of an overall scheme or arrangement.

*Response:*Noted. The currently proposed approval process looks solely to the debtor. It is anticipated that the debtor will protect itself contractually by limiting the creditor's ability to dispose of the debt to another creditor. The issue of loan syndication typically arises in the case of larger loans where the debtor will have more contractual leverage.

That said, the process in this area is still developing as new information unfolds. At issue is whether the sole onus of the tax burdenshould fallon the debtor when the debt relationship ultimately involves at least two parties (e.g. debtor and creditor). If keeping the sole onus on the debtor proves impractical in terms of enforcement (or too unworkable for the debtor), future consideration will be given to strengthening the legislation to directly bring the creditor to the table. Under this approach, the creditor would obtain pre-approval before disposing of debt stemming from a rollover reorganisation. If the holder of the debt instrument does not receive this approval,the debt instrument would be deemed to have a tax cost of nil.

Comment:In a liquidation transaction, the acquiring company obtains the assets by way of an *in specie* distribution for no consideration. It is not understood how the acquiring company can incur interest on a debt instrument used to fund the acquisition. The proposed potential of denial of interest deductions in respect of debt involved in a tax-free liquidation accordingly makes no sense.

*Response:*Comment misplaced. In the liquidations of concern, the acquiring company borrows funds to acquire target company shares with the intention to liquidate the target. The supposed basis for the deduction under the section 11(a) general formula is the link of the debt to the indirect acquisition of target assets (to the extent both companies have complementary businesses). Hence, the proposed rules simply deny the interest deductions (unless approval is obtained otherwise) if the debt is used to "procure or facilitate" the liquidation (i.e. the indirect acquisition of target assets).

Comment: How does section 23K apply to amalgamation transactions? It is hard to envision a situation in which debt will be used to facilitate an amalgamation under the current paradigm.

> *Response:* Accepted. The amalgamation rules already do not allow for cash or debt notes to be issued by the resultant (acquiring) company in exchange for target assets. The only permissible debt is target company debt to be assumed by the resultant company as long as the debt does not arise as part of the amalgamation. The section 23K rules will accordingly be dropped in this regard. The amalgamation rules will be adjusted slightly to remove any arguable implications to the contrary.

Comment: Approval should not be required if the changes to the debt instrument are immaterial. Required subsequent approvals in this regard will become cumbersome for both taxpayers and Government.

> *Response:* Accepted. Regulatory authority will be added to provide SARS with the ability to disregard immaterial changes. The distinction between material and immaterial will be provided in regulations based on further facts received.

Comment: External funding is discouraged by deeming the tax cost of the debt instrument to be nil in all cases. The rule should apply only to holders of debt within a group setting as suggested by the explanatory memorandum.

> *Response:* Accepted. The automatic nil tax cost rule will be changed solely to apply to holders who form part of the same group of companies as the issuer.

Financial products

3.7 Anti-avoidance: Dividend Cessions
(Bill reference: Clause 30(1)(n); section 10(1)(k)(i))

Comment: No reason exists to trigger ordinary treatment for dividend cessions receivedor accrued by trusts. The tax charge can potentially fall on the trust as well as a further charge when the trust makes a distribution to its beneficiaries (even though the same underlying amounts are involved). The net result is a potential double tax.

> *Response*:Accepted. Ordinary treatment will be limited to company shareholders because only companies are entitled to a complete exemption for dividends received under the new Dividends Tax.

Comment: The holding period rules to close cession schemes can be greatly simplified by simply targeting dividend cessions directly.

> *Response:*Accepted. The revised rules will target dividend cessions directly. The current cession swap rules will also be adjusted to cover technical shortfalls. In consequence of these changes, other related anti-

avoidance rules can be greatly simplified as requested (see responses below).

Comment:The proposed focus on the dividend declaration date for calculating the 45-day period is impractical. Listed shares are not monitored in this way but instead focus on the record date. Moreover, the differing rules between capital and ordinary shares are hard to monitor during the course of the year when dividends are made. One simplified rule would be preferred.

Response: Accepted. The 45-day period will be determined with reference to the record date as requested. The capital versus ordinary distinction will also be dropped. Lastly, the penalty for shorter-term holdings will be changed. Instead of triggering ordinary revenue, the tax cost of the shares will be reduced to the extent of the dividend received during the short holding period. The focus on tax cost will mean that the impact of the 45-day rule can be addressed as part of the annual income tax process (as opposed to the monthly Dividends Tax process).

Comment:The anti-hedging rules for disregarding days within the 45-day rule are overly harsh. Taxpayers often use hedges for valid non-tax commercial purposes and hedges are costly in non-tax financial terms. These rules should either be dropped or drastically curtailed.

Response: Accepted. The anti-hedging rules will be dropped. The 45-day period should add sufficient financial costs to the holding period for shares to render the avoidance transactions of concern unviable. Moreover, many commercial hedges protect against risk of loss in respect of share value instead of protecting against dividend stream\ shortfalls (with the proposed anti-hedging rule treating both forms of hedges equally).

3.8 Anti-Avoidance: Perpetual debt
(Bill reference:Clause 23; section 8G)

Comment: The proposed tax treatment of perpetual debt as shares impacts the "debt" portion of dual linked units of property loan stock companies (i.e. widely traded real estate investment vehicles that amount to a multi-billion rand industry). This debt portion operates like a perpetual instrument. The net impact of the proposal would be to eliminate the deductible nature of property loan stock distributions, thereby making their yield uncompetitive internationally (since their international counterparts operate like a conduit).

*Response: Partially a*ccepted. Property loan stock companies have long been a problem for the tax system because the format used to obtain deductible interest payments is questionable. In response, Government has taken a long-term view that these entities should be folded into a special regulatory dispensation to be supervised by the Financial Services Board. This revised dispensation would allow for the deduction of property loan stock distributions without the current violation of fundamental principles. However, a number of regulatory technical issues have delayed this process. Therefore, it is now proposed that a special regulatory or legislative framework be enacted in 2012 or 2013. In the meantime, the perpetual debt proposal willbe deferred until this new regulatory regime is established for property loan stock companies (known internationally as real estate investment trusts)

3.9 Anti-avoidance: Third-party backed shares

(Bill reference: insertion ofsection 8EA)

Comment: It is not clear if the proposed rule treating dividends from third-party backed shares as ordinary revenue taints all preference shares guaranteed, secured or pledged by third parties even if the share loses the third-party security at some stage. At present, "once tainted always tainted". This permanent taint is unfair.

Response:Accepted. Once a third-party backed share loses the associated guarantee or pledge, the shares should lose their taint. The "once tainted always tainted" rule was inadvertent and will be removed.

Comment:The safe haven for the acquisition of equity shares through the issue of hybrid shares is welcome. Hybrid share refinancing of the same equity shares should likewise be permissible.

Response: Accepted. Hybrid share refinancing will be permissible as long as the capital value of the newly issued hybrid shares does not exceed the capital value of initial hybrid shares.

Comment: Acquisition of equity shares through the issue of preference share falls within the safe haven as described above. In some instances, back-to-back hybrid share arrangements are used to fund an equity share acquisition. Back-to-back hybrid share financing should be permissible under the same rationale.

Response: Accepted. The issue of preference shares to acquire other preference shares in a second company with the ultimate aim of acquiring equity sharesin a third company will be permitted within the safe harbour. The end goal is the same.

Comment: The acquisition of domestic equity shares is permissible within the safe haven. No reason exists as to why the safe haven should not be extended to cover acquisitions of equity shares in a foreign company.

Response: Accepted. Foreign target acquisitions will be added to the safe harbor. No tax leakage exists in either circumstance described and the link between the funding and the target shares is equally traceable.

Comment: The group third-party guarantee exception is too narrow. For instance, the guarantor may be an individual or a non-group company or a consortium of parties. Insolvency remote vehicles should also be permitted.

Response: Accepted. Third party guarantors will be permitted within the safe haven if the third party has a 20 per cent or greaterequity share stake in the applicable party (i.e. either the funded company issuing the preference share or the target company that is the object of the financing arrangement). The group rule will be dropped.

Comment:While the safe haven is a great improvement over the initial proposal, hybrid share funding should be permissible whenever funds are being applied for a non-deductible purpose or where the interest deduction is of no value to the debtor (e.g. the debtor is in an excess loss position). In effect, a shift of taxable income among taxpayers should be acceptable as long as the system is eventually neutral overall.

Response:<u>Not accepted</u>. The income tax is designed to measure net accretions to wealth on a taxpayer-by-taxpayer basis. Each taxpayer is taxed according to the taxpayer's own means – the fact that other parties may or may not pay additional tax is irrelevant. This objective against shifting is already evidenced in the Income Tax Act in a number of ways (e.g. anti-loss trafficking, cession swaps and anti-financial leasing rules). Moreover, the aggregate principle fails to account for time-value of money principles. At an audit level, the aggregate approach is even more problematic because the tax impact of the funder (ordinary or exempt treatment) requires SARS to determine the use of the funds and tax position of the borrower (plus related parties). This inability to audit on an aggregate multi-party basis is at the heart of many schemes with each party claiming procedural protections to prevent a meaningful aggregate review. The proposed safe harbor for target share acquisitions is a special deviation given the important policy reasons involved (e.g. the lack of interest deductions for debt used to acquire shares). The safe harbor should not be viewed as an initial gambit for an open-ended and unmanageable exemption.

Comment:The proposed amendment is retroactive because the tax on hybrid share dividends will apply to pre-existing share issues. The proposed rule should only apply to dividends in respect of shares issued after 1 April 2012.

Response: <u>Partially accepted.</u> The tax system has long recognised that applicable receipts or accruals are the basis for the cut-off point, not the existence of pre-existing arrangements. Taxpayers are essentially requesting fiscal stability for prior arrangements into the indefinite future. Nonetheless, it is recognisedthat a number of pre-existing arrangements will need to be adjusted in light of the proposed changes. It is accordingly proposed that the effective date of this proposal be delayed by a further six months (i.e. to 1 October 2012).

3.10 <u>Anti-Avoidance: Hybrid shares</u>
(Bill reference: insertion of section 8E))

Comment: The proposed amendment to the hybrid equity definition is too wide when targeting dividends derived directly and indirectly mainly from interest. Banks and other financial institutions can never directly or indirectly issue preference shares without violating the rule because the underlying source of income for these entities is interest, even if wholly unrelated to the preference share issue.

Response: Accepted.The anti-avoidance rule will be revised. The revised rule will apply to preference share issues that are guaranteed, pledged or otherwise secured by financial instruments other than shares. While the institutions at issue generate large portions of interest income, no reason exists for the preference share issue to be directly collateralised bydebt and similar instruments.

Comment: It is not clear if the proposed rule targets only domestic preference shares or both domestic and foreign preference shares.

Response:Comment misplaced.The rule will apply to both domestic and foreign shares. The anti-avoidance rules have always applied equally in this regard.

Comment: The proposed amendment is retroactive because the tax on hybrid share dividends will apply to pre-existing share issues. The proposed rule should only apply to dividends in respect of shares issued after 1 April 2012.

Response: Partially accepted. As stated above, the tax system has long recognised that applicable receipts and accruals are the basis for the cut-off point, not the existence of pre-existing arrangements. Given the high-level of avoidance in this area (e.g. funnel schemes), the date will remain at 1 April 2012.

Comment: The Bills state that the target company envisioned will be an operating company. The operational nature of the company as a requirement appears to be missing from the legislation. Also, if the target company must be operational, it should be acceptable to acquire a holding company with operational subsidiaries.

Response: Accepted. The operational nature of the target company will be added as a requirement. In essence, the target company must be conducting a "for profit" enterprise or activity of a continuous or regular nature. It is alternatively acceptable to acquire a holding company that controls a group of companies conducting the same level of activities.

Comment: The removal of the ten-year minimum holding period for hybrid shares (back down to three years) is a welcome development. It is also assumed that the ten-year minimum rule for hybrid debt will be eliminated (back down to three years).

*Response:*Accepted. The removal of the ten-year rule was intended for both hybrid shares and hybrid debt. Both instruments will retain the historic three-year minimum period.

3.11 Income tax: Islamic finance
(*Bill reference: Clause 58; section 24JA)*

Comment (murabaha):*The* murabaha provisions should be extended to cover transactions that do not involve a Bank on either side of the transaction (for example, the provisions do not cover situations where an insurer is the financier). This extension will encourage competition and growth within the Islamic Finance industry.

> *Response:*Accepted. The comment is theoretical at this stage. The insurance industry does not currently operate in this space. This issue will be re-examined at a later date after engagement with the relevant players.

Comment (murabaha)*:*The current 30-day limitation period between the first sale (i.e. from the third-party seller to the financier) and the second sale (i.e. from the financier to the client) is too short. This period should be extended to 180 days. In addition, the SARS should have the discretion to extend the period beyond this 180-day cut-off

> *Response:*Accepted. In most transactions, the 30 day period is insufficient. However, it is understood that the time delay between the first sale and the second sale may be extended due to circumstances beyond the control of the parties to the transaction. For instance, if a bank purchases goods from a foreign jurisdiction on behalf of the client, shipping issues may delay the sale dates because the bank may not resell the goods until it has physical control and ownership of the goods. It is accordingly proposed that the term be extended to a 12 months period. However, a condition will be added that no receipts or accruals must be derived from the property during the interim periodby the financier (other than upon the second disposal of the property).

Comment (diminishing musharaka):The current straight line method for calculating income in respect of Diminishing Musharaka is not in line with the actual calculation. The actual calculation follows the yield-to-maturity method (i.e. as in section 24J), but the legislation allocates amounts on a straight-line basis. It is accordingly requested that the section 24J method be allowed as an alternative method for the recognition of the profit element.

> *Response:*Partially accepted. The proposed section 24J formula cannot be applied because the financier's interest in the asset is sold on an annual basis in terms of separate agreements. Instead, it is proposed that the agreement should be the basis for determining the interest (i.e. profit) element. More specifically, the difference between the amount paid by the bank for the acquisition of a portion of the asset and the amount paid by the client for the same portion will be deemed to be interest. The net effect of this proposal is to reach the same compounding method result as section 24J.

Comment (Government sukuk):It is not clear whether ownership of the asset by the trust acquiring Government property will be recognised for tax purposes. This lack of clarity creates the impression that investors will be entitled to claim depreciation allowances in respect of the Government asset held by the trust.

> *Response:* Accepted. The transfer (sale and repurchase) of the asset involving the trust will be completely ignored for tax purposes. The

arrangement operates akin to a financial lease with the trust merely holding the asset as security. Clarification of the law will accordingly be added in this regard (thereby eliminating unintended deprecation and asset-related ownership issues).

Comment (Government sukuk): It is not clear how the treatment of Sukuk is linked to the tax treatment of interest. The impact of the Sukuk should be directly linked to section 24J.

*Response:*Partially accepted. Direct linkage to section 24J will be overly complicated and confusing. However, the profit element of arrangement (i.e. the lease payments) can simply be treated as interest because the sale and repurchase is at cost.

Comment (Government sukuk): The repurchase of the asset by Government from the trust should not trigger value-added tax. The current version of the proposed amendment unsuccessfully seeks to achieve this result. The impact of the lease payments is also unclear.

*Response:*Accepted. The trust will be deemed not to be carrying on an enterprise. This removal of enterprise treatment will eliminate the trust as a VAT vendor, thereby eliminating the potential application of VAT upon the repurchase and in respect of the lease payments.

Comment (general Islamic finance):Clarity is required when the permissible Islamic finance methods ("diminishing musharaka", "mudaraba", and "murabaha") will be effective. The effective date will be determined by Government Gazettte, and this Gazette is still pending.

Response: Accepted. The effective date was delayed to resolve technical issues. With these issues eliminated, the effective date will be set for early January via the Gazette.

Comment (general Islamic finance):The yield in respect of all Islamic finance arrangements should receive the same tax benefits as traditional Western-style interest. These tax benefits include the de minimis exemption for interest and the current exemption for cross-border interest.

Response: Accepted. All Islamic finance amounts deemed to be interest will be treated as such for Income Tax purposes. The net result will be automatic application of the de minimis exemption and the cross-border exemption.

Comment (general Islamic finance):It is unclear whether donations will be deductible in the hands of a collective investment scheme. Deductible donations are important for collective investment schemes within the Islamic finance space because Islamic institutions often donate impermissible income (e.g. interest or dividends derived from interest)

*Response:*Comment misplaced. The proposal specifically allows for collective investment schemes to deduct charitable donations. The limit is based on net asset values as opposed to the current 10 per cent net income threshold because net income of a collective investment scheme is small or nil. This donation is deductible against undistributed dividends (which are viewed as ordinary revenue).

Income tax: Domestic incentives

3.12 Research and development revisions
(Bill reference: Clause 35; section 11D)

Comment: The definition of research and development should be changed to better reflect the underlying concept of research and development. For instance, the term "new" should be dropped because this term arguably does not allow for adjustments to pre-existing products or processes.

Response: Accepted. The research and development definition will be revised so as to better reflect the aim of the incentive. The "new" concept will be dropped as misleading. The term "technical" should be "technological" and other changes will be made to emphasise the scientific and technological aspects of the desired projects.

Comment: The definition of research and development should be read in line with its scientific and technological purpose. SARS should not interpret the terms solely from an overly legalistic perspective.

Response: Noted. Much of the existing problem stems from the existing weaknesses in the research and development definition. However, it is understood that interpretation of the definition will require a specialised scientific and technological expertise in addition to the standard legal (or audit) perspective. SARS will accordingly be empowered to share information relating to the application of the definition with the Department of Science and Technology. This outside expertise should assist SARS when interpreting the definition for administration of the Income Tax Act.

Comment:Activities falling within the prohibitions should not prevent application of the allowance, only the 50 per cent uplift.

Response:Accepted. The prohibitions (e.g. against overheads and social sciences) will only prevent application of the 50 per cent uplift, not the basic 100 per cent deduction. Moreover, even if expenses fall outside the 100 per cent research and development regime, the tax system should allow for the deduction if the deduction otherwise falls within the basic deduction formula (of section 11(a)).

Comment: The prohibition against overhead expenses for purposes of the 50 per cent uplift should not cover expenses, such as electricity costs and general physical overhead. Electricity costs can be an expensive overhead associated with the research and development process, especially if electricity is central to experimentation.

Response:<u>Accepted</u>. The prohibition against overheads for purposes of the 50 per cent uplift will be limited to legal, audit, payroll and human resource management and similar administrative overheads. Other (more physically related) overhead costs directly incurred in respect of research and development will be permitted to fall within the 50 per cent uplift.

Comment: Internal business processes should not be prohibited if the taxpayer develops these innovations primarily for sale or license.

Response:<u>Accepted</u>.The current prohibition against internal business processes for purposes of the uplift will be removed. Development of research and development related to business processes will be permitted if mainly intended for external exploitation (sale to customers or license by customers).

Comment:The 50 per cent uplift should not be limited solely to companies. Non-company taxpayers should remain within the uplift portion of the incentive.

Response:<u>Not accepted</u>. The exclusion of non-company taxpayers was intended to eliminate the incentive for operations that are not fully committed to research and development (individuals performing research and development outside of normal working hours). Monitoring the deductible costs of R&D from a SARS perspective is also easier in relation to companies.

Comment: The shift of the 50 per cent uplift from the party conducting the activity versus the funder will be administratively burdensome. For instance, if a general supervisor of the activity subcontracts the work, the uplift will now be passed onto multiple subcontractors).

Response: <u>Partially accepted</u>. The party conducting the activity will remain the only party eligible for the 50 per cent uplift because only the party conducting the actual work has full knowledge and information associated with the research and development process. The core parties needed for interacting in respect of approval and for audit enforcement. Nonetheless, it is recognised that the subcontracting relationships will have the unintended impact of spreading the incentive amongst smaller more diverse parties, thereby making the incentive more burdensome and less meaningful. It is accordingly proposed that the 50 per cent uplift be limited solely to those parties managing and controlling the project (so that the uplift remains with the main party running the project).

Comment:While it is desirable that approval be obtained from the Department of Science and Technology as a pre-requisite for the 50 per cent uplift, the pre-approval nature of the requirement is overly burdensome. Taxpayers cannot be expected to obtain approval from the Department of Science and Technology "before" every R&D project begins as a price for the 50 per cent uplift. R&D projects do not have a clearly demarcated beginning or ending (one project often runs seamlessly into the next). Taxpayers should be allowed to receive the uplift as long as approval is obtained before the annual return is submitted for assessment.

> Response: Partially accepted. While it is accepted that the current pre-approval process is too onerous, a complete post-hoc approval is alsoundesirable. In response to the above, the pre-approval process will be changed in two respects. Firstly, pre-approval need not precede project inception. However, pre-approval cannot be back-dated. However, the 50 per cent uplift will begin in respect of research and development expenses incurred from the date that an application, which is ultimately successful, is submitted to the Department of Science and Technology.

Comment: The proposal for an uplift relating to a research and development facility is unrealistic. This form of demarcated facility is not essential or common in respect of commercial practices.

> Response: Accepted. The proposed uplift for research and development facilities will be withdrawn.Taxpayers will retain the automatic accelerated depreciation for research- and development-related buildings, plant and machinery.

Comment: The number of adjudication committee members should be increased to fully address all the potential technical aspects of South African research and development. For instance, additional members (such as local scientists and patent lawyers) should be added.

> Response: Not accepted. Independent experts can be contracted by the adjudication committee. These experts need not be added to the panel.

3.13 Industrial policy project revisions
(Bill reference: Clause 41; section 12I)

Comment: Investment allowance ceilings of R900 million and R550 million should be increased in the case of industrial development zones to match the underlying increased incentive. Without this change, the increased deduction levels of industrial development zones will not be fully effective as intended.

> Response: Not accepted. The investment allowance ceilings are designed to ensure that the total funds committed to this incentive are spread among a variety of projects. Commitments to industrial development zone projects should not undermine this objective.

Comment: The location of industrial development zones should be extended or changed. For instance, many underdeveloped rural areas should be treated as falling within these zones.

> Response: Noted. The location of industrial development zones is an issue within the purview of the Department of Trade and Industry. National Treasury is only making the adjustment to facilitate the policy of

the Department of Trade and Industry. National Treasury will accordingly consult with the Department of Trade and Industry on the matter.

Comment: The proposed change to the pre-approval process is unfair. Projects should be allowed even though the assets at issue have been acquired or contracted for before the approval date.

*Response:*Not accepted.Taxpayers are essentially requestingincentivised treatment for projects that represent a deadweight loss to the fiscus. The goal of the incentive is to encourage projects that would not have otherwise occurred. If the underlying assets have either been acquired or contracted for, the project will clearly proceed without regard to the tax incentive.

Comment: The legislation and the explanatory memorandum differ as to the percentage uplift for industrial zone projects without preferred status. Is the uplift 70 or 75 per cent.

*Response:*Accepted. The difference between the explanatory memorandum and the legislation was unintended. It is proposed that the uplift be set at 75 per cent.

3.14 Venture capital company revisions
(Bill reference: Clause 42; section 12J)

Comment:The deduction for investing in a venture capital company should not be subject to recoupment (or subject to recoupment after a three year period). The recoupment reduces the incentive to a mere timing difference.

Response: Not accepted. The purpose of the incentive is to promote medium-term to long-term investments. As a comparison in the retirement arena, the deduction is matched by a subsequent recoupment in the form of a lump sum or annuity income stream. No reason exists to provide the venture capital company regime with a greater set of incentives. A straight deduction for share investments without an ordinary recoupment may also prove to be magnet for avoidance transactions.

Comment: The venture capital company incentive is wrongfully premised on the intermediary vehicle operating as a company. This premise is misguided because the model for venture capital investment funds is a trust.

Response: Not accepted. Taxpayers are effectively requesting an additional incentive. Taxpayers are seeking conduit treatment for the intermediary vehicle on top of the currently proposed deduction for making an investment into that vehicle. The nature of the incentive would have to be wholly reconsidered before making the desired change.

Comment: Current law requires the intermediary investment vehicle to comply with the Financial Advisory and Intermediary Services Act. Satisfaction of this condition should alternatively be allowed by reliance on an investment advisor to the intermediary investment vehicle.

Response: Noted.Insufficient information exists in respect of this issue to proceed at this stage. The investment advisory relationship described appears to be more akin to the trust relationship requested than the intermediary company regime envisioned. Concerns also exist about how to tie the relationship of the investment advisor to the intermediary investment vehicle in legislative terms.

Comment: The investment limit for junior mining companies should be further increased from the proposed R300 million to a R500 million level.

Response: Not accepted. Taxpayers are really seeking to incentivise projects that are large-scale in size. While junior mining companies are relatively large in absolute terms, a reasonable cut-off must be made.

Comment: No reason exists to prevent taxpayers from deducting share venture capital company investments merely because the shares at issue are hybrid in nature. The key is to promote investment into high-risk vehicles; the nature of the shares issued in exchange should be viewed as irrelevant.

Response: Not accepted. The purpose of the incentive is to channel risk capital into a venture capital company vehicle. Hybrid shares (i.e. shares with debt features) essentially provide taxpayers with an opportunity to make investments that are comparable to loan capital. Loan capital lacks the desired risk element associated with the incentive.

3.15 Film incentive
(Bill reference: Clauses 43 and 54; sections12O and 24F)

Comment:While the exemption for profits is welcomed, the total denial of losses for qualifying films is overly harsh. Investors need some sort of relief if all funds dedicated to a qualifying film are lost. The loss element insures that investors are somewhat willing to invest in riskier films, especially since the majority of films in South Africa (and abroad) lose money.

Response: Partially accepted. The current tax rules of section 24F over-emphasize losses. This over-emphasis has created an incentive to generate artificial losses as opposed to the development of a viable film industry. Nonetheless, it is recognised a limited form of loss should be retained as a form of downside protection. It is accordingly proposed that the net loss associated with acquiring and developing exploitation rights in a qualifying film be allowed two years after completion date of the film. This net loss provision provides limited downside protection without re-opening the problems associated with the current regime. As a further protection for the fiscus, no losses can be taken if the losses stem from unpaid borrowed funds.

Comment:New investors added after the principal photography date should also be eligible for the exemption. Flexibility around this rule is important so that new funds can be obtained to complete the film if a funding short-fall develops.

Response: Partially accepted. The purpose of the incentive is to promote risk capital. The risk of film production is highest before and during the early production phases. Therefore, the main focus of the incentive should remain with the initial investors. However, it is conceded that new investors may be needed if production funding falls short, and the law should recognise this practicality to ensure film completion.Therefore, new investors added to film production before completion date will be eligible for the incentive as long as the funds are not used to compensate pre-existing investors.

Comment:The proposed cut-off date for the current section 24F film allowance is unfair. Many taxpayers have pre-existing investments in films that are still in development before the close of 2012. These investors invested in films with the understanding that the current section 24F allowance would apply.

Response: Accepted. The proposed legislation will contain a more flexible cut-off date. Investors acquiring exploitation rights before 1 January 2012 will remain under the ambit of section 24F as long as the film is completed before 1 January 2013. Investors acquiring film rights from 1 January 2012 will fall under the new regime.

Comment:The approval role of the National Film and Video Foundation (NFVF) is not entirely clear. The NFVF's approval authority appears wholly discretionary and wrongly appears to provide the Foundation with the authority to dictate content.

Response: Accepted. The NFVF will merely have the authority to provide approval on the basis that the film is either a local production or a valid co-production (under an international agreement). Content approval was never intended.

Comment:The Department of Trade and Industry should be the governmental authority that provides pre-approval for qualifying films as opposed to the NFVF. In the main, the Department of Trade and Industry already provides approval for the rebate so the Department can operate as a one-stop shop in respect of the tax incentive.

Response: Not accepted. The NFVF will be the entity responsible for pre-approval in light of fact that the NFVF is developing criteria for the assessment and scoring of whether a film has sufficient South African film content. Moreover, not all films seek rebates from the Department of Trade and Industry.

Comment:The exemption should also cover films that qualify for the location film and television production incentive

Response: Not accepted. The proposed relief is meant to support the production of South African film content by the South African film industry.

Comment: The ring-fencing rule for non-qualifying films is overly harsh. Losses from non-qualifying films should not be ring-fenced per film.

Response: Accepted. Taxpayers that acquire exploitation rights outside of the regime will be subject to the normal rules (e.g. capital versus ordinary). Ring-fencing will apply only pursuant to the normal ring-fencing rules for potentially suspect trades (if applicable).

4. INTERNATIONAL TAX

4.1 Unification of the source rules
(Bill reference: Clause 24; section 9(1)

Comment: Interest and royalties attributable to a foreign permanent establishment of a South African resident should be foreign sourced. This foreign source treatment would match the implicit source rules of tax treaties.

*Response:*Accepted: Interest and royalties of a South African resident attributable to permanent establishment located outside of South Africa will be foreign sourced. The purpose of the source amendments is greater alignment with tax treaties.

Comment: It is not clear whether the fall back to the doctrine of originating cause is intended to cover income streams not covered elsewhere (e.g. other income such as leases and insurance premium income) or whether the doctrine also applies to the same income streams to the extent not otherwise viewed as South African sourced. If the latter applies, the proposed changes will merely retain the same uncertainties caused by the doctrine of originating cause of pre-existing law.

*Response:*Accepted: Interest, dividends, royalties, gain from the disposal of assets and the listed categories of income should be sourced solely pursuant to the newly added statutory rules. The doctrine of originating cause should not apply to these income streams covered by paragraph (a) through (g) – only to the other unlisted income streams (e.g. leasesand insurance premiums). This latter concept was always intended (as expressed in the explanatory memorandum).

Comment:As a general matter, pensions and annuities should be allocated pro rata based on years of service but for the de minimis rule (a wholesale exclusion where the service is less than 2 out of 10 years). The proposal to eliminate the de minimis rule is onerous and should be withdrawn.

*Response:*Not accepted. The services source rule will be substituted for a source rule dealing specifically with pensions and annuities. In line with international practice, the new source rule for pensions and annuities will look to where the services were rendered and maintain the current time apportionment rule without the 2/10 rule. The 2/10 rule is a rule of administrative convenience that has been abused so the burden of the rule outweighs the benefits.

Comment:The source rules must specifically cater for exchange differences and gains arising from securities lending arrangements. It is unclear whether these categories of income fall within the residual category of income (with continued taxation under the doctrine of originating cause) versus the new statutory paradigm (as a disposal of assets).

*Response:*Partially accepted:A new special rule will be inserted to cover exchange differences. Generally, exchange differences will be sourced in South Africa if these differences arise from exchange items attributable to a South African resident or attributable to a South African permanent establishment (like the proposed treatment for the disposal of assets). However, there is no need for a special rule dealing with gains arising from securities lending arrangement. The source of these gains will presently follow form (as a sale of an asset, followed by a repurchase – see section 22(9)).

4.2 Foreign Tax Credits
(Bill reference: Clause 11; section 6quat)

Comment:The choice of deducting foreign taxes (as opposed to utilising a tax credit) should be retained. The deduction is especially useful if the foreign tax results in a net economic loss in respect of an activity after other costs are taken into account.

Response: Accepted. The choice to deduct foreign taxes was deleted with the understanding that the deduction would be superfluous in light of the new credit for foreign taxes on management fees. The deduction will be retained given the continued utility for taxpayers.

4.3 Special Foreign Tax Credit for Management Fees
(Bill reference: Clause 12; section 6quin)

Comment:The proposed "South African sourced" tax credit fails to take into account foreign withholding taxes imposed on the basis of accrued payments as opposed to cash payments. This failure will cause an unintended mismatch of credits vis-à-vis the timing of the foreign taxes imposed.

*Response:*Accepted: The proposed "South African sourced" credit will be adjusted to account for taxes imposed in respect of payments or accruals. The change matches the South African system of taxing receipts or accruals (and the matching system of the basic foreign tax credit).

4.4 Incentive: Headquarter Company Adjustment
(Bill reference: Clause 29; section 9I)

Comment:The pre-approval process for obtaining headquarter company relief is unwieldy and creates uncertainty. Successful systems utilising headquarter company relief make the relief seamless without pre-approval systems. The proposal will accordingly undermine the attractiveness of the regime and shift foreign investor focus to other countries.

> *Response:*Accepted. Thepre–approval requirement will be withdrawn. Taxpayers must simply elect into the regime by submitting a form to notify SARS of the election as well as an annual reporting to measure the success of the regime. Reporting requirements will be as simple and short as practical.

Comment:The exclusion of break-even financial instruments in the asset test should apply only to the 80 per cent denominator. Otherwise loans to foreign subsidiaries will not apply in favour of taxpayers for purposes of the 80 per cent calculation.

> *Response:*Accepted: The break-even rule will be narrowed. The exclusion will now be limited to "cash or bank deposits payable on demand." This change should eliminate the concern.

Comment: The 80 per cent income test will give rise to practical problems going forward. The strictness of the test will cause unintended violations during the start-up phase when little revenue is generated from foreign subsidiaries or during periods of economic difficulty. It is also questionable whether the 80 per cent income test is necessary in light of the 80 per cent asset test.

> *Response:*Partially accepted. The 80 per cent income test operates as a backstop to the 80 per cent asset test so that foreign subsidiary income bears some relationship to assets. However, as backstop test, this test can be relaxed. The 80 per cent threshold is accordingly dropped to 50 per cent. In addition, a safe harbour will exist for small headquarter operations with total receipts and accruals up to R5 million.The R5 million exclusion should provide the desired flexibility during the start-up phase.

Comment:The 80 per cent income test accounts for dividends, interest, royalties and fees from foreign subsidiaries as a positive factor (falling within the numerator). However, this test fails to provide similar favourable treatment for lease payments from these foreign subsidiaries.

> *Response:* Accepted. Lease payments from foreign subsidiaries will be treated the same as dividends, interest, royalties and fees. All amounts receive or accrued by the headquarter company from a foreign subsidiary should theoretically be treated as a positive factor.

Comment:The reference to "receipts and accruals" as a benchmark for the income test is too broad and inadvertently covers share subscriptions. This broad test means that certain non-taxable income items unintentionally fall within the formula.

Response: Accepted: The reference to "receipts and accruals" will be substituted for taxable "income" in line with the conceptual intention. Receipts and accruals outside the tax net will be ignored.

Comment:Foreign exchange gains should not be viewed as income that automatically counts against headquarter company status. These gains are often part and parcel of operating foreign operations.

Response: Accepted: A specific exclusion for foreign exchange gains will be added so that taxable exchange gains and losses are not issue for headquarter companies.

Comment:The proposed headquarter relief treats foreign subsidiaries as qualifying entities if the headquarter company owns a minimum percentage of 20 per cent. This minimum percentage should be reduced to 10 per cent in line with proposed changes to the participation exemption.

Response: Accepted:The minimum shareholding of qualifying subsidiaries in a headquarter company will be reduced to 10 per cent. Failure to reduce the percentage was an oversight.

4.5 Overhaul of the controlled foreign company regime
(Bill reference: Clause 27: Section 9D)

Comment:Theproposed rules treating "de facto" South African managed foreign companies as controlled foreign companies are too broad. For instance, even a relatively small shareholder of a listed company could inadvertently fall within these anti-avoidance rules.

*Response:*Accepted. The main concern is the use of discretionary trusts to artificially break the ownership link so as to undermine the controlled foreign company rules. Legislation in this area will accordingly be reconsidered. However, closure of these schemes remains a top priority.

Comment: The proposal to treat cell companies as "mini" controlled foreign companies based on each cell or aggregated accounts is understood. However, the proposal has the unintended effect of treating many offshore unit trusts as controlled foreign companies because all of these investments operate as segregated accounts.

*Response:*Accepted. The proposal is not intended to cover standard offshore unit trusts. It is accordingly proposed that cell company treatment be reserved for entities primarily engaged in insurance. Mainly at issue is the use of cells to avoid captive insurance treatment with the proposal to be changed accordingly.

Comment: The proposed treatment in the controlled foreign company rules of a headquarter company as a foreign company is misplaced. The proposed change creates the unintended effect of treating a headquarter company as a controlled foreign company even though a headquarter company is a South African tax resident.

> *Response:* Accepted:The proposed changes will be deleted as superfluous. Direct or indirect ownership by headquarter companies do not count towards controlled foreign company status (as drafted under current law). However, South African tax residents can look-through a headquarter company (as with all companies). More specifically, assume a South African parent company owns all the shares of a headquarter company, which in turn owns all the shares of a foreign company. Under these circumstances, the foreign company is viewed as a controlled foreign company due to the indirect ownership of the South African parent company. No proposed amendments are required. This treatment ensures that the use of a headquarter company does not undermine the existence of pre-existing controlled foreign companies.

Comment:The current diversionary rules should be retained for imported sales and services. The proposed “permanent establishment requirement is overly restrictive and will hinder many non-tax motivated structures.

> *Response:*Partiallyaccepted. The proposed rules for imported goods will remain. These rules are not overly restrictive because these rules are only intended to apply if the controlled foreign company is both: (i)subject to an effective tax rate of less than 50 per cent of the South African rate, (ii) and the activity lacks any connection to a foreign permanent establishment. However, the proposed rules for imported services will be dropped in favour of the current system for imported services. Insufficient analysis has been dedicated to the impact of permanent establishment concept as a tool for determining diversionary service activities.

Comment:The calculation of the moderate level of tax (i.e. the 50 per cent) escape hatch for diversionary sales is too complex for compliance purposes. Unlike the high tax exemption, thisescape hatch applies solely to potential diversionary income streams as opposed to the foreign company as a whole. The calculation would be simpler if applied to the controlled foreign company as a whole.

> *Response*:Accepted.The 50 per cent calculation will mirror the high tax exemption. The calculation will focus on the entity as a whole (as opposed to the current focus on specific income streams).

Comment:Taxing all South African deductible payments to a controlled foreign company as per se tainted incomediscourages the use of inter-group services. The proposal also adversely impacts royalties of controlled companies, even if the royalties predate the foreign company’s position as a controlled foreign company (i.e. predating the South African multinational's acquisition of that foreign company).

> *Response*: Accepted.The controlled foreign company anti-round tripping provision will be limited to financial instrument income. Hence, per se tainted income treatment for deductible payments by South African companies to controlled foreign companies will apply to the main object of concern – interest and other deductible payments in respect of financial instruments.

Comment:The tainted income rules fail to provide relief for exchange gains and losses. Exchange gains and losses are part and parcel of foreign operations and should be excluded if arising in the normal course. This exclusion would match current law.

> *Response*: Accepted.The deletion of foreign exchange gains and losses from per se tainted treatment was unintended. These exchange gains and losses should be ignored if arising in the normal course of business (unless attributable to a treasury operation or a captive insurer).

Comment: The rules targeting Treasury operations are confusing. Are the deemed rules the exclusive category of impermissible treasury operations or do the proposed amendments target something more?

> *Response*: Accepted. The proposed amendments relating to Treasury operations are arguably ambiguous. The legislation will be changed to reflect the fact that Treasury operations are tainted "including" those activities deemed to constitute Treasury operations. This anti-avoidance rule accordingly entails a two-fold analysis. First, at issue is whether the operations constitute Treasury operations using a general facts and circumstances analysis. Secondly, at issue is whether the activities fall into any of the listed deeming criteria. If either set of circumstances exist, the income at issue is subject to taintedincome treatment under the controlled foreign company regime.

Comment:Insurers lack the same relief mechanisms as banks. Insurers generate substantial passive investment income to support both risk insurance liabilities as well as maintaining client investments. No reason exists to provide insurers with automatic tainted activity treatment when the banks are receiving relief in respect of roughly the same categories of investments.

> *Response*: Accepted: Financial instrument income received in the ordinary course of insurance business will be excluded for tainted passive income treatment. However, this relief will not apply in respect of captive insurers. Captive insurance should be viewed on par with tainted Treasury operations.

***Comment*:**Tainted income relief for leasing operations is too narrow. Firstly, the exclusion of financial lease income is unrealistic. Secondly, the 12-month limit is unreasonable.

Response: Partially accepted. As a general matter, finance lease income should be viewed as interest income from financial instruments. Financial lease income should accordingly be subject to the same potential financial instrument income provisions within the controlled foreign company regime. Therefore, the diversionary rental provision will specifically exclude leases that constitute financial instruments with those leases falling under the tainting rules for financial instrument income. The 12-month limit can remain because the 12-month rule typically becomes an issue in the case of financial leases.

Comment: Foreign dividends received by a CFC from a non-CFC foreign company situated in the same country will be subject to multiple taxes without corresponding tax credit. The unintended result occurs mainly where the shareholding in the non-CFC foreign company is below the participation exemption threshold of 10 per cent. In this case, there is a potential mismatch between the foreign and the South African tax treatment of the dividend. South Africa will thus impose tax without the corresponding credit for the underlying profits.

Response: Accepted. The participation exemption will be relaxed in respect of dividends received by a CFC from another foreign company resident in the same country as the CFC. This relief matches standard domestic tax treatment of company-to-company dividends found internationally (i.e. in-country dividends between companies is mainly exempt). As a result, a CFC will be able to claim the participation exemption without regard to the 10 per cent participation requirement if the foreign dividends are between foreign companies within the same country.

***Comment*:** The high-tax exemption has the inadvertent effect of denying the indirect foreign tax credit claimed under the previously taxed foreign income exemption where the taxpayer holds between 10 and 19.99 per cent participation in the foreign company. This situation would generally arise where the taxpayer elects for that foreign company to be treated as a controlled foreign company without the application of the foreign business establishment exemption.

*Response:*Accepted. The election to qualify as a fully taxable controlled foreign company will include controlled foreign companies subject to the high-tax exception. It should be noted that this change will have a limited shelf-life given the pending elimination of the election.

4.6 CFC restructuring

(Bill reference: (Clauses 72, 73, 74, 76, 77 and 124); sections 41, 42, 44, 46 and 47)

Comment:The proposed limitations for offshore section 42 share-for-share reorganisation rules are too restrictive. No need exists for the transferor to hold shares in the transferee as long as both entities are controlled foreign companies within the same group. The 95 per cent restriction for offshore mergers is also questionable.

Response: Accepted. The provisions will be redrafted to capture the underlying purpose (that the transferee company must remain in the South African group and within the same controlled foreign company net). The revised rules will effectively match the participation exemption limitations.

Comment: The exclusion of section 45 offshore reorganisations no longer makes sense in light of the proposal to lift the section 45 suspension. This exclusion will unduly restrict offshore reorganisations given the proposed narrowing of the participation exemption.

Response: Partially accepted. It is agreed that offshore section 45 reorganisations should be added as part of the offshore restructuring package, but this addition is impractical given current time limits. It is accordingly proposed that the participation exemption be fully retained in this arena for another year so that offshore section 45 relief can be properly prepared in the interim.

Comment: The effective date for foreign reorganisation rollover relief should be brought forward to include restructurings that take place earlier than 1 January 2012.

Response: Not accepted. Moving effective dates forward creates unintended consequences. Given the delayed promulgation of the Bill, the timing difference will be insignificant in any event.

4.8 Transfer pricing: Correlative adjustments
(Bill reference: Clause 61; section 31)

Comment: The proposed treatment of correlative adjustments is too discretionary. The tax treatment of these adjustments as solely within the discretion of SARS should be narrowed.

Response: Accepted. Correlative adjustments will effectively be treated as per se zero-interest bearing loans. The zero-interest rate nature of these loans will give rise to deemed interest under standard transfer principles until the deemed amount is repaid to the South African entity making the deemed loan.

4.9 Foreign currency issues
(Bill reference: Clause 56; section 24I):

Comment: Currency gains realised by non-trading trusts should be excluded from the ambit of section 24I where the trust holds a foreign bank account used for travelling abroad. Travel funds in a trust fund raise the same complications as travel funds in the hands of natural persons.

Response: Accepted. The proposed extension of section 24I to non-trading trusts will be dropped. The use of foreign currency and foreign loans by trusts will remain outside of section 24I.

Comment:Exchange differences arising from non-monetary items should be deferred until assets are brought into use. The proposed complete exemption of this exchange differences creates permanent differences between the tax and accounting treatment of these gains.

Response: Partially accepted. The proposed deletion of subsections (7) and (11) of section 24I will be dropped. The taxation aspects of currency gains arising from non-monetary will be reviewed in the subsequent legislative cycle.

4.10 Foreign dividends
(Bill reference: Clause 32; section 10B)

Comment: The denial of the participation exemption for foreign dividends derived from financial instrument holding companies is administratively burdensome. The net result will be reduction of foreign dividends back to South Africa.

Response: Accepted. The foreign financial instrument holding company restriction in respect of the foreign participation exemption for dividends will be dropped. This test has been largely ineffective to prevent the avoidance schemes of concern. Ordinary treatment for hybrid instruments should presumably resolve the issue, thereby rendering the financial instrument holding company test for foreign dividends unnecessary.

4.11 Single charge for emigration
(Bill reference: Clause 28; section 9H)

Comment:The exit charge for emigrating companies could potentially be overridden by double tax agreements. The proposal is unclear in respect of the timing of the deemed disposal versus the change of residence, thereby giving rise to problems that do not exist in the current exit charge.

Response: Accepted. The rules need to be clarified as to the timing of the exit charge. As under pre-existing law, the timing of the disposal will be deemed to take place on the date immediately before the date of the change of residence.

5. VALUE ADDED TAX (VAT)

5.1 Temporary relief for developers
(Bill reference: Clause 146; section 18B)

Comment:The proposed relief for developers being forced to use the property as rental in lieu of sales should apply retrospectively. The problem for developers began in 2008 at the inception of the economic crisisand the amendment should recognise this reality.

> *Response:* Partially accepted: The legislation will only cater for prospective relief. Taxpayers must accept that their actions will be subject to the law in existence at the time of their actions. However, SARS will deal with each issue administratively (on a developer by developer basis), recognising the issues of economic hardship (as permitted under current law).

***Comment*:** The proposed relief should also be extended to cover speculators and financiers of fixed property. Speculators are also in the situation of being forced to rent unsold property.

> *Response:* Not accepted: The relief was designed to specifically aid developers from going into bankruptcy based on the VAT rules pertaining to the renting of residential fixed property. These developers are being caught with a large-scale set of properties built simultaneously. Speculators acquire and sell fixed property speculatively over time, thereby having much more control over their cash-flows. Speculators have also been a common subject of VAT compliance concern and a special exemption will undoubtedly add to these concerns.

5.2 Minimum threshold exemption for imported goods and services
(Bill reference: Clauses 144 & 149 (1)(a); section 14 (5) & Schedule 1)

***Comment*:** The local book publishing and retail industry claim their business are at risk if the proposed R500 exemption is added for goods and services. The net result will mean that small books can be imported without VAT while domestic sales remain subject to VAT. This difference can be substantial in the case of medium and high-priced purchases.

> *Response*: Partially accepted: The R500 proposed threshold for hard copy books and other printed matters imported into South Africa will be dropped with the current R100 threshold remaining. However, as a matter of parity, a comparable R100 minimum threshold exemption will be added for services (e.g. soft copy books) imported into South Africa. Further work to effectively subject all e-commerce transactions to VAT will be explored.