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Dear Ismail

2014 ANNEXURE C: PROPOSALS FOR INCOME TAX LEGISLATIVE AMENDMENTS – DOMESTIC BUSINESS

We refer to your invitation dated 12 November 2013 for proposals for amendments to the current tax legislation and set out below our proposals relating to "income tax – domestic business".

For ease of reference, in this submission the Income Tax Act No. 58 of 1962 is referred to as the "Act" and the Taxation Laws Amendment Bill No. 39 of 2013 is referred to as the "2013 TLAB".

Our submission covers the following topics:

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1. PARAGRAPH (*hh*) OF THE PROVISO TO SECTION 10(1)(*k*)(i)

(i) Legal nature of the problem

GENERAL TAX PRINCIPLES

The exempt nature of local dividends is a fundamental principle of our tax law and has, at its heart, the fact that dividends are paid from after-tax profits. Fundamental principles that ensure the avoidance of double taxation should only be tampered with where specific anti-avoidance is targeted. Thus, any anti-avoidance provisions pulling local dividends into the tax net, should be focussed and should be limited to only the avoidance targeted. Legislation targeting specific leakage in the system should not be so wide so as to impact vast tracts of vanilla business transacted based on sound commercial purpose.

We believe the issue at hand is in essence tax asymmetry between South African taxpayers and non-South African taxpayers, as the risk of loss to the fiscus is only in the event of a South African taxpayer contracting with a non-South African taxpayer. In this regard, transactions between South African taxpayers do not result in a loss to the fiscus, as the deduction in respect of the manufactured payment that is available to the recipient of the exempt dividend, is countered by the taxability of the receipt of the manufactured payment by the South African taxpayer counterparty. Even in the event of the South African counterparties being tax exempt pension funds, the receipt will ultimately be taxed when paid to their pensioners. Thus the leakage that any anti-avoidance legislation should be targeting should be limited to situations where manufactured payments are made to non-South African taxpayers.

SCOPE

The wide scope of paragraph (*hh*) targets not only transactions that shift dividends to the detriment of the South African fiscus, but also covers a multitude of vanilla transactions which form part of standard business practice within the South African financial and equity markets. The wide ambit of paragraph (*hh*) unduly prejudices parties to vanilla equity transactions and threatens not only the South African equity derivatives market, but other equity transactions that form part of standard business practice. We submit that these transactions cannot be argued to constitute tax avoidance arrangements or to create a loss to the South African fiscus.

Given the detrimental impact that the broad-brush approach of the 2013 TLAB will have on the South African equity and derivatives markets, we submit that this proposal be postponed so that in-depth analysis can be conducted in order to address the specific issue while addressing the practical issues which come about unintentionally.

Ultimately, paragraph (*hh*) should be limited to target only situations that result in a loss to the South African fiscus. In this regard, we submit that transactions between South African taxpayers should not result in a loss to the fiscus, as the deductible payment in the hands of the recipient of the dividends should be taxable in the South African counterparty's hands. We are of the view that the following principles should be taken into account in designing a focussed anti-avoidance provision:

- As a loss to the fiscus would occur if the counterparty receiving the manufactured payment were not a South African taxpayer, the scope of paragraph (*hh*) should be limited to transactions between South African taxpayers and counterparties who are not South African taxpayers;

- Synthetic or derivative transactions between two taxpayers should be completely excluded, as there is no loss in terms of the overall fiscus – there is symmetry between the parties;

- All index-related transactions should be excluded completely from (*hh*), as this is the dominant form of hedging for large savings pools and one would want to protect the efficiency of this type of business at all costs. In addition it is difficult to extract extra-normal or contrived dividend yields through index-related transactions given their diversified nature;

- Listed business conducted through a recognised exchange should be excluded, as there is no practical means to determine who the counterparty is at all points in time. In any event, the regulatory frameworks and costs associated with exchange business make it difficult for tax arbitrage to be perpetrated and information is readily available should interrogation ever be required.

(ii) Factual description of the relevant transaction

The wide scope of paragraph (*hh*) targets not only transactions that shift dividends to the detriment of the South African fiscus, but also covers a multitude of vanilla transactions which form part of standard business practice within the South African financial and equity markets. The wide ambit of paragraph (*hh*) unduly prejudices parties to vanilla equity transactions and threatens not only the South African equity derivatives market, but other equity transactions that form part of standard business practice. We submit that these transactions cannot be argued to constitute tax avoidance arrangements or to create a loss to the South African fiscus.

(iii) Nature of the businesses impacted

The South African financial markets, including the equity and equity derivatives markets, the listed derivative market (SAFEX), the OTC equity derivatives market and the ETF market, are all directly impacted by the proposed legislation. These markets are all critical to the functioning of the broader equity market in South Africa. Ultimately, if these markets are impacted negatively, then so is liquidity in the listed physical market, as this is where all hedging is ultimately effected. In due course, this will be reflected in less efficient pricing and increased equity risk premiums, which will affect the cost of capital for the market in general. Furthermore, the significant impact that the proposed legislation will have on liquidity will also impact financial stability.

We believe that the proposed legislation will negatively impact local banks in relation to foreign non-South African taxpaying banks. Local banks' primary advantage is their local tax base, which is put to use to create market liquidity and competitive pricing. Under the proposed legislation, this will be reduced to nil. Foreign banks that have 'scale' advantage over local banks, will immediately have an uncompetitive advantage over local banks, which will encourage instability and increased levels of volatility in the South African equities market and ultimately negatively impact market liquidity.

South African institutions need to build and maintain systems and infrastructure substantially similar to those of the non-South African taxpayer banks operating out of Europe, but do not enjoy the benefits of being able to spread the associated costs across many jurisdictions, as is the case with the foreign banks. In addition, South African institutions typically suffer as a result of exchange control regulations versus their international competitors, resulting in a disadvantage relative to the foreigners.

Simply put, South African institutions need to maintain:

- Regulatory standards set by Basel;
- Systems to be able to implement financial reporting of an international standard;
- Systems to be able to report in terms of the applicable regulations; and
- Systems to be able to price and risk manage the resultant positions.

Without having the economies of scale of operating in multiple jurisdictions and with a credit rating capped at that of the sovereign, South African institutions need some support in terms of covering these costs, while being seen to be competitive in the eyes of their local clients who are increasingly being approached by foreign banks.

Should paragraph (*hh*) be implemented as proposed, we predict that South African institutions will slowly disappear from the equities domain in favour of the international banks – just as local independent stock brokers fell away when larger institutions were allowed to own stockbrokers in their own right. The trend will result in more and more business being executed out of London. This will undoubtedly result in the majority of staff executing in the South African markets being located in London while suitcase bankers fly in and out of South Africa to maintain relationships. This will certainly have a detrimental, long-term impact on the fiscus, which we believe will outweigh the anti-avoidance being targeted. In this regard, we believe the impact will be more lasting, significantly larger in pure monetary terms given time, and more far reaching in that other lines of business, which were traditionally owned by South African institutions would be expected to drift abroad.

Other considerations are that the listed equities business of South Africa will, again in our opinion move to those players with the greatest economies of scale and cheapest funding sources and thus out of South African hands.

Finally, South Africa should, from a strategic perspective, be designing a system which puts South Africans and their firms in an advantageous position versus their international counterparts which have no fixed presence in SA. We believe the proposed legislation is in fact achieving the opposite. It is our belief that, while the intention of the proposed legislation may be sound, the consequences in its current form run deep and will negatively impact South Africa and, consequently, the fiscus in ways not anticipated by National Treasury.

2. SECTION 64EB

(i) Legal nature of the problem

BENEFICIAL OWNER FOR PURPOSES OF SECTIONS 64EB(2) AND (3)

Whilst we understand the intention of the proposed amendments to subsections (2) and (3) of section 64EB of the Act as regards the deletion of "beneficial owner" is to avoid unnecessary repetition and circular reference to "beneficial owner", as it is contained in section 64F and section 64F(1), we are concerned that the proposed amendment confuses rather than clarifies the issue. In this regard, the amendment could be interpreted such that the references to persons contemplated in sections 64F and 64F(1) do not necessarily specify that the person needs to be a "beneficial owner", which is what we believe the intention is as regards sections 64EB(2) and (3).

We require clarification that sections 64EB(2) and (3) of the Act require a person to be a beneficial owner of a dividend in order for these sections to apply.

SCOPE OF SECTION 64EB(3)

We previously raised concerns with National Treasury and SARS that the current wording of section 64EB(3) of the Act could be interpreted to cover not only share repos, but also a wide array of other physically settled share derivative and collateral transactions. We were assured that it was always the intention to only include true share repurchase agreements in the ambit and that amendments would be made to clarify the limited nature of this anti-avoidance provision. These amendments entail an inclusion in section 64EB(3) of a reference to "resale agreements" and the inclusion in section 64EB(4) of a definition of "resale agreement".

However, the new definition of "resale agreement" is so wide that it once again includes all manner of vanilla transactions which form part of standard business practice within the South African equity derivatives market that were never the intended target of the anti-avoidance legislation. Consequently, anybody entering into or closing out a normal derivative in the normal course of business during the period between the dividend declaration date and ex-dividend date (which is typically an extremely busy period given that financial reporting updates would have recently been made public) would be prejudiced. We submit that this would result in uneconomical behaviour in terms of market participants avoiding such uncertainty and listed corporates trying to reduce this unnecessary situation.

Including share derivatives and non-cash collateral transactions in the ambit of section 64EB(3) of the Act not only places undue additional pricing on such transactions in a business with small margins, but is not practical to implement in the on-screen listed environment. In this regard, parties to SAFEX-traded derivatives see SAFEX as their counterparty and do not know who their actual counterparties are. Thus, they cannot determine which SAFEX trades are with foreigners and which are with local counterparties.

"Resale agreements" appear to cover not only share repurchase transactions, but also certain security transactions as well as physically settled vanilla share derivatives issued in exchange for the underlying reference shares. The following are examples of such affected transactions:

- Provision of collateral by way of the outright transfer of shares;

- Physically settled OTC derivatives issued in lieu of the reference shares;
- Physically settled SAFEX-traded equity futures issued in lieu of the reference shares; and
- *In specie* creations and redemptions of exchange traded funds (ETFs).

In order to limit the scope of section 64EB(3) of the Act to the intended target – being repos entered into after declaration date with non-South African taxpayers – we propose that the definition of "resale agreement" be amended as follows:

> *"(4) For the purposes of this section,* ***'resale agreement'*** *means the acquisition of a share by any person subject to an agreement in terms of which that person undertakes to dispose of that share or any other share of the same kind and of the same or equivalent quality at a future date* <u>*to the person, or any other company forming part of the same group of companies as that person, from whom the share was originally acquired, excluding—*</u>
>
> <u>*(i)*</u> <u>*any collateral arrangement; or*</u>
>
> <u>*(ii)*</u> <u>*any resale agreement listed on a recognised exchange."*</u>

EFFECTIVE DATE

It is proposed that the proposed amendments to section 64EB(3) and (4) of the Act be effective from 1 September 2012. Given the uncertainty regarding the ambit of section 64EB(3) and the fact that Dividends Tax needs to be withheld prior to payment of the deemed dividend and reported to SARS in the month following payment of the deemed dividend, it is not practical nor acceptable to apply these changes retrospectively.

The effective date of any amendments to section 64EB of the Act simply cannot have retrospective effect. Consequently, we propose that the effective date be amended to 1 January 2014.

(ii) Factual description of the relevant transaction

Section 64EB affects all cessions of dividends and manufactured payments relating to scrip loans and repurchase agreements to non-residents transacted after dividend declaration date. The beneficial owner requirement and the effective date of the amendments are essential to all these transactions. The wide ambit of the wording of section 64EB(3) of the Act could be interpreted to cover not only share repos, but also a wide array of other physically settled share derivative and collateral transactions, which cannot be argued to constitute any form of tax avoidance.

(iii) Nature of the businesses impacted

The definition of "resale agreement" in section 64EB(4) is so wide that it includes all manner of vanilla transactions which form part of standard business practice within the South African equity derivatives market in the anti-avoidance Dividends Tax net, which could never have been the intention. Consequently, anybody entering into or closing out a normal derivative in the normal course of business during the period between the dividend declaration date and ex-dividend date (which is typically an extremely busy period given that financial reporting updates would have recently been made public) would be prejudiced. We submit that this would result in uneconomical

behaviour in terms of market participants avoiding such uncertainty and listed corporates trying to reduce this unnecessary situation.

3. SECURITIES LENDING OF BONDS

(i) Legal nature of the problem

While security lending arrangements falling within the definition of "lending arrangement" in the Securities Transfer Tax Act No. 25 of 2007 (the "STT Act") are effectively taken out of the ambit of the Income Tax Act and the STT Act, this treatment is not extended to loans of bonds or other fixed income instruments. Consequently, as securities lending transactions in respect of bonds and the like constitute the legal transfer of the bonds (both on loan and return), the transactions result in income tax disposals with the attendant income tax or CGT consequences, dependant on the intention of the particular taxpayer. There is no justification for securities lending of bonds and other fixed income instruments to be treated on a different basis to that of shares or depository receipts.

The same reasoning justifying the beneficial tax treatment of scrip loans, applies to bonds – i.e. bond lending also improves liquidity, encourages investment and increases pricing efficiency. Consequently, we submit that the same exclusions as are afforded to lending arrangements in respect of shares and depository receipts in the Income Tax Act, be afforded to securities lending arrangements in respect of bonds and other fixed income instruments. To this end, bond loans should not be treated as disposals for the purposes of section 9C, section 22 or the Eighth Schedule.

(ii) Factual description of the relevant transaction

Affected transactions are securities lending arrangements in respect of bonds and other fixed income instruments.

(iii) Nature of the businesses impacted

Affected transactions are securities lending arrangements in respect of bonds and other fixed income instruments.

4. OUTRIGHT TRANSFER OF COLLATERAL

(i) Legal nature of the problem

BACKGROUND

During the 2012 Annexure C process, The Banking Association of South Africa (BASA) and the South African Securities Lending Association (SASLA) submitted a proposal with regard to collateral arrangements in respect of securities lending transactions. In particular, it was requested that, where collateral is posted in respect of a securities lending transaction by way of an outright transfer (as opposed to a pledge), the same tax exemptions as apply to scrip loans should apply – thus the transaction should be exempt from securities transfer tax ("STT") and should not be treated as a disposal for purposes of sections 9C, 22 and the 8th Schedule.

On 10 December 2012, BASA and SASLA met with National Treasury, represented by Keith Engel, Nhlanhla Radebe and Susan Nieuwoudt, and SARS, represented by Gerrie Swart and Johan de la Rey, regarding the submission, where Keith Engel undertook to address the problem in consultation with the FSB. While the need to address this issue was then confirmed in the 2013 Budget, it has not yet been dealt with.

REQUEST

Upon further consideration, it has become clear that the tax treatment of all forms of outright transfer of collateral is problematic, not merely the outright transfer of collateral in respect of scrip loans.

Collateral placed by way of pledge or cession in security has no income tax or STT implications due to the fact that it does not involve the transfer of beneficial ownership in the collateral. Pledge of collateral is, however, not always practical or preferable. As an alternative, collateral may be posted by way of outright transfer, which results in the transfer of beneficial ownership in the collateral both upon its posting and its return. However, in the absence of specific legislative intervention, each transfer constitutes a disposal with attendant tax implications.

Pledged collateral is problematic since, under South African common law, a secured party holding pledged collateral is extremely limited in the ways that it can use the collateral (if at all). Furthermore, South African common law does not recognise rehypothecation (or onward pledging) of collateral, with the result that collateral in back-to-back transactions can only be posted by way of outright transfer. This problem becomes apparent in the securities lending environment, where banks' securities lending desks (in their role as intermediary) often interpose themselves as principal between lenders and borrowers, which requires them to onward post the collateral they receive from borrowers with lenders, which cannot effectively be done by way of pledge and onward pledge. The recently introduced Regulation 28 highlights this problem in that it requires any collateral that is posted to a pension fund to be held in the name of the pension fund. This necessitates outright transfer from the borrower, or requires the securities lending desk to source proprietary assets or cash to place as collateral, thereby increasing the cost of the transaction to the detriment of a liquid and efficient market.

Outright transfer of collateral furthermore facilitates netting and has an additional benefit in that it allows the holder of the collateral to use the collateral, subject only to an obligation to return equivalent collateral on discharge of the borrower's obligations. By taking collateral by way of outright transfer, banks are able to pool same resulting in pricing efficiency, transaction flow and liquidity. Outright transfers of collateral are more effective risk mitigants than pledges and thus allow for a more efficient deployment of capital in respect of these risks, which is important particularly in the context of companies with strengthened regulatory capital requirements (e.g. banks and insurers). The international norm is for collateral to be provided by way of outright transfer.

Collateral arrangements are, by their nature, not intended to create tax consequences. Consequently, it should be irrelevant whether collateral is posted by way of pledge or by way of outright transfer and both scenarios should result in tax neutrality. While pledged collateral achieves tax neutrality due to the fact that there is

no legal transfer of beneficial ownership, outright transfer of collateral requires legislative intervention to attain tax neutrality.

Consequently, we request that the posting or return of all forms of collateral by way of outright transfer (albeit equities, fixed income instruments, cash or other assets), be disregarded as disposals for purposes of sections 9C, 22 or the Eighth Schedule of the Act and (if applicable) the STT Act. We note that this request is supported by SASLA and STRATE.

(ii) Factual description of the relevant transaction

This issue impacts all transactions where collateral (albeit cash, equities, fixed income instruments or other assets) is posted or returned by way of outright transfer. The types of transactions that could give rise to the risk to be covered by this collateral include, amongst others, securities lending transactions, funding, repurchase agreements and share derivatives.

(iii) Nature of the businesses impacted

The businesses and taxpayers that could be impacted include lenders and borrowers in securities lending transactions, lenders and borrowers in funding arrangements, participants in repurchase agreements, issuers, traders and investors in financial transactions such as derivatives, futures and options.

The lack of an efficient and economic collateral facility will severely impact the banks in terms of Basel III and also force trade offshore, thereby impacting the liquidity of the South African financial markets.

5. TAXATION OF HEDGE FUNDS

(i) Legal nature of the problem

The 2013 TLAB introduces a new tax regime for certain hedge funds with effect from 1 January 2014. This is done by way of section 25BA of the Act, paragraph 61 of the Eighth Schedule to the Act and section 9C of the Act, read with the definition of "portfolio of a hedge fund collective investment scheme" in section 1 of the Act. Effectively, a "portfolio of a hedge fund collective investment scheme" and its investors will enjoy the same tax treatment as collective investment schemes.

A "portfolio of a hedge fund collective investment scheme" is defined to mean "any portfolio held by any hedge fund business that qualifies as a declared collective investment scheme in terms of section 63 of the Collective Investment Schemes Control Act [CISCA]". Section 63 of CISCA, in turn, provides that the Minister of Finance may, by notice in the Government Gazette, declare a specific type of business to be a collective investment scheme to which the provisions of CISCA apply.

No declaration as envisaged in section 63 of CISCA has been made with regard to hedge fund businesses and we understand from discussions with the Financial Services Board and National Treasury that it is no longer anticipated that such a declaration will be made. Instead, an application process outside the scope of section 63 is being considered.

As the taxation amendments contained in the 2013 TLAB relating to hedge funds only apply to hedge funds that are the subject of a section 63 CISCA declaration, the legislation will be ineffectual so long as no section 63 declarations have been made. It is essential that the tax legislation be brought in line with the CISCA legislation and regulations.

(ii) Factual description of the relevant transaction

This issue affects the taxation of hedge funds regulated under CISCA as well as investors in these hedge funds.

(iii) Nature of the businesses impacted

This issue affects the taxation of hedge funds regulated under CISCA as well as investors in these hedge funds.

6. HYBRID DEBT

6.1. Section 8F

(i) The legal nature of the problem

SECTION 8F(3)(b) – REFERENCE TO GOVERNMENT GAZETTE

In order to describe Tier 1 and Tier 2 capital instruments, section 8F(3)(b) refers to "Government Notice No. R.1029 published in Government Gazette No. 35950 of 12 December 2012". As this regulation may be replaced in future, there is a risk that section 8F(3)(*b*) of the Act could become ineffective should it not be amended simultaneously with the issuance of a replacement Government Notice. Consequently we propose that the phrase "or any Government Notice which may replace it from time to time" be included prior to the closing bracket.

RETROSPECTIVE APPLICATION

Section 8F applies in respect of amounts incurred or accrued on or after 1 April 2014. This will result in existing transactions entered into prior to the effective date being included within the ambit of the amended section 8F of the Act.

As companies and their shareholders made commercial decisions based on the tax law in existence at the time when the relevant instrument was issued, the retrospective application of the new section 8F will negatively impact past commercial decisions and shareholder returns and/or the credit position of companies. Furthermore, the restructuring of existing transactions could result in penalties being imposed by the holders of the instruments, further worsening the position for issuers.

These instruments would have been priced on the basis that the yield constituted deductible debt. Accordingly, while the deeming of such interest as a dividend in the hands of the holder enhances the return to the holder, it increases the cost to the issuer in that the issuer now has an "equity" instrument which has been priced as debt. In addition, the issuer may be liable for Dividends Tax depending on who the holder is. This will result in these transactions being non-commercial and will require

the instruments to be redeemed prior to 1 April 2014, which may not be possible in the circumstances.

We propose that section 8F should apply to transactions entered into on or after 1 April 2014.

THREE YEAR SAFE HARBOUR

Previously, the inclusion of a three year restriction for convertible instruments in terms of section 8F resulted in the ability for entities to raise funding through instruments which will now constitute hybrid debt instruments in terms of paragraph (*b*) of the definition of "hybrid debt instruments". The previous three year safe harbour allowed entities the flexibility to raise funds by means of instruments which included an option by the issuer to convert such instruments to shares after three years in the event of downside, without suffering the adverse consequences of limiting an interest deduction in terms of section 8F of the Act.

The new wording of section 8F provides no flexibility in this regard and will inevitably deny the taxpayer an interest deduction, even if the debt never converts to shares during such a transaction.

Without such flexibility, the cost of funding will increase significantly. The commercial impact of such an increased cost of funding would be a significant increase in the cost of acquisitions for shareholders. We believe this would adversely affect the South African economy due to the fact that it would limit foreign investment, given that similar restrictions do not exist in the rest of Africa. The South African economic growth rate and foreign investment are already lower than other African countries and the proposed limitations may further hamper growth and investment in South African companies.

In order to accommodate the three year safe harbour, we propose that paragraph (b) of the definition of "hybrid debt instrument" in section 8F(1) of the Act be amended as follows (underlining indicates new text and brackets indicates deletions):

> "(a) the company is **[in that year of assessment]**, within three years from the date of issue of the instrument, entitled to—
> (i) convert that amount (or any part thereof) **[in any year of assessment]** to; or
> (ii) exchange that amount (or any part thereof) **[in any year of assessment]** for,
> shares ...;"

LISTED INSTRUMENTS

Section 8F of the Act currently includes listed instruments within its ambit. In our view this will unduly add to the administrative burden and complexities that already exist in the current Dividends Tax regime.

In this regard, we refer to recent discussions with SARS where the industry highlighted the extreme difficulty (near impossibility) of identifying the beneficial owners of listed debt instruments – listed debt instruments are frequently traded, with interest generally flowing amongst several Central Securities Depository Participants

(CSDPs) before it is finally paid to a beneficial owner. Due to the crucial role performed by the various CSDPs, it is not practically possible for the issuer company to identify the beneficial owner of such dividends in specie (i.e. interest as envisaged in section 8F).

In light of the above and in order to avoid market disruption and encourage capital market investment, we submit that listed instruments should be specifically excluded from the ambit of section 8F, failing which, that further consultation between SARS, National Treasury, the JSE and the industry be held before including listed debt instruments within the scope of section 8F of the Act.

WRITE DOWN / CONVERSION

In order to prevent undue tax consequences on the write down / conversion of Tier I and II capital instruments, we propose that a specific exclusion be inserted into section 8F (read with sections 19 and paragraph 12A of the Act) relating to Tier I and Tier II instruments. The gist of the exclusions in this regard adopted in foreign jurisdictions of late (e.g. by the HMRC in the UK) is as follows:

- If the accounting treatment adopted in the event of a write-down / conversion results in a credit to the income statement or reserves, this credit will not be taxable. Conversely, any debits arising on a subsequent write-back will not be deductible.

- If any convertibility feature is classified for financial accounting purposes as an embedded derivative which is accounted for separately at fair value, any resulting debits / credits to the income statement or reserves will be ignored for tax purposes.

(ii) Description of the relevant transaction

Existing hybrid debt transactions will be affected by the retrospective application of section 8F. Hybrid debt instruments aimed at raising funds which include an option by the issuer to convert such instruments to shares in the event of downside, will no longer enjoy a three year safe harbour.

(iii) The nature of the businesses impacted by the problem

Commercial decisions are based on the tax laws in existence at the time when the relevant instrument was issued. As such, retrospective applications to transactions already in place will result in these transactions being non-commercial and will require the instruments to be redeemed prior to 1 April 2014, which may not be possible in the circumstances.

In addition, the previous three year safe harbour allowed entities the flexibility to raise funds by means of instruments which included an option by the issuer to convert such instruments to shares after three years in the event of downside, without suffering the adverse consequences of limiting an interest deduction in terms of section 8F. The current proposal does not provide any flexibility which will result in the cost of funding increasing.

6.2. Section 8FA

(i) The legal nature of the problem

SECTION 8FA(3)(b) – REFERENCE TO GOVERNMENT GAZETTE

In order to describe Tier 1 and Tier 2 capital instruments, section 8FA(3)(b) refers to "Government Notice No. R.1029 published in Government Gazette No. 35950 of 12 December 2012". As this regulation may be replaced in future, there is a risk that section 8FA(3)(b) of the Act could become ineffective should it not be amended simultaneously with the issuance of a replacement Government Notice. Consequently we propose that the phrase "or any Government Notice which may replace it from time to time" be included prior to the closing bracket.

RETROSPECTIVE APPLICATION

Section 8FA applies in respect of amounts incurred or accrued on or after 1 April 2014. This will result in existing transactions entered into prior to the effective date being included within the ambit of the amended section 8FA of the Act.

As companies and their shareholders made commercial decisions based on the tax law in existence at the time when the relevant instrument was issued, the retrospective application of the new section 8FA will negatively impact past commercial decisions and shareholder returns and/or the credit position of companies. Furthermore, the restructuring of existing transactions could result in penalties being imposed by the holders of the instruments, further worsening the position for issuers.

These instruments would have been priced on the basis that the yield constituted deductible debt. Accordingly, while the deeming of such interest as a dividend in the hands of the holder enhances the return to the holder, it increases the cost to the issuer in that the issuer now has an "equity" instrument which has been priced as debt. In addition, the issuer may be liable for Dividends Tax depending on who the holder is. This will result in these transactions being non-commercial and will require the instruments to be redeemed prior to 1 April 2014, which may not be possible in the circumstances.

We propose that section 8FA should apply to transactions entered into on or after 1 April 2014.

LISTED INSTRUMENTS

Section 8FA of the Act currently includes listed instruments within its ambit. In our view this will unduly add to the administrative burden and complexities that already exist in the current Dividends Tax regime.

In this regard, we refer to recent discussions with SARS where the industry highlighted the extreme difficulty (near impossibility) of identifying the beneficial owners of listed debt instruments – listed debt instruments are frequently traded, with interest generally flowing amongst several Central Securities Depository Participants (CSDPs) before it is finally paid to a beneficial owner. Due to the crucial role performed by the various CSDPs, it is not practically possible for the issuer company to identify the beneficial owner of such dividends in specie (i.e. interest as envisaged in section 8FA).

In light of the above and in order to avoid market disruption and encourage capital market investment, we submit that listed instruments should be specifically excluded from the ambit of section 8FA, failing which, that further consultation between SARS, National Treasury, the JSE and the industry be held before including listed debt instruments within the scope of section 8FA of the Act.

WRITE DOWN / CONVERSION

In order to prevent undue tax consequences on the write down / conversion of Tier I and II capital instruments, we propose that a specific exclusion be inserted into section 8FA (read with sections 19 and paragraph 12A of the Act) relating to Tier I and Tier II instruments. The gist of the exclusions in this regard adopted in foreign jurisdictions of late (e.g. by the HMRC in the UK) is as follows:

- If the accounting treatment adopted in the event of a write-down / conversion results in a credit to the income statement or reserves, this credit will not be taxable. Conversely, any debits arising on a subsequent write-back will not be deductible.

- If any convertibility feature is classified for financial accounting purposes as an embedded derivative which is accounted for separately at fair value, any resulting debits / credits to the income statement or reserves will be ignored for tax purposes.

(ii) Description of the relevant transaction

The retrospective application of section 8FA will affect existing hybrid debt transactions.

(iii) The nature of the businesses impacted by the problem

Commercial decisions are based on the tax laws in existence at the time when the relevant instrument was issued. As such, retrospective applications to transactions already in existence will result in those transactions being non-commercial and will require the instruments to be redeemed prior to 1 April 2014, which may not be possible in the circumstances.

7. LIMITATION OF EXCESSIVE INTEREST DEDUCTIONS

7.1. Section 23M

(i) The legal nature of the problem

REPO RATE ADJUSTMENT

With regard to the repo rate adjustment per "D" of the formula in section 23M(5)(d), National Treasury appears to consider the 40% adjustable taxable income limitation to be appropriate in a 5% repo rate environment. In light thereof, we submit that the adjustment of the percentage per section 23M(5)(d) of the Act where the average repo rate exceeds 10% during a specific year of assessment, is not only arbitrary, but excessive.

We submit that, in section 23M(5) of the Act, the percentage adjustment relating to adjustable taxable income with respect to the repo rate, should be incrementally adjusted from the current 5% repo rate, as opposed to from a 10% repo rate position.

PROVISIONAL TAX

In terms of the application of section 23M, the deductibility of interest can only be determined at year-end once the audit has been completed and adjusted taxable income for the year has been determined. As a result, a company's provisional tax could unintentionally be understated at year-end, when the second provisional tax payment is due, which could result in penalties being imposed by SARS.

Consequently, we propose that the provisional tax legislation be amended in order to allow companies to make a further provisional tax payment shortly after a year-end has been concluded (e.g. 2 months after year-end). This proposal not only addresses the issues experienced in relation to section 23M of the Act, but also addresses issues currently experienced by large listed companies (and their subsidiaries) where a best estimate of taxable income is exceptionally difficult to determine on the last trading day of the year, as a more accurate estimate can practically only be determined once the year-end audit has been concluded.

(ii) Description of the relevant transaction

This affects transactions that are subject to section 23M of the Act.

(iii) The nature of the businesses impacted by the problem

This affects all transactions that are subject to section 23M of the Act.

7.2. Section 23N

(i) The legal nature of the problem

FIVE YEAR CARRY-FORWARD

We submit that the existing restrictions on the carry-forward of assessed losses, as contained in section 20 of the Act, provides sufficient protection against potential abuse. Consequently, no additional limitation should be imposed on the carry-forward of non-deductible interest.

Moreover, section 23N does not cater for the carry-forward of interest in excess of the formula limitation, during the 5 year term following the year of acquisition. Consequently, any excess interest will constitute a permanent difference for income tax purposes, as opposed to a temporary difference as was contemplated in the Media Statement issued by SARS and National Treasury during April 2013.

This approach is contradictory to section 23M, which does allow the carry-forward of losses. We submit that this anti-avoidance provision should not apply to South African taxpayers, as there would be no loss to the fiscus, and that general tax principles should prevail.

REPO RATE ADJUSTMENT

With regard to the repo rate adjustment per "D" of the formula in section 23N(4)(d), National Treasury appears to consider the 40% adjustable taxable income limitation to be appropriate in a 5% repo rate environment. In light thereof, we submit that the adjustment of the percentage per section 23N(4)(d) of the Act where the average repo rate exceeds 10% during a specific year of assessment, is not only arbitrary, but excessive.

We submit that, in section 23N(4) of the Act, the percentage adjustment relating to adjustable taxable income with respect to the repo rate, should be incrementally adjusted from the current 5% repo rate, as opposed to from a 10% repo rate position.

PROVISIONAL TAX

In terms of the application of section 23N, the deductibility of interest can only be determined at year-end once the audit has been completed and adjusted taxable income for the year has been determined. As a result, a company's provisional tax could unintentionally be understated at year-end, when the second provisional tax payment is due, which could result in penalties being imposed by SARS.

Consequently, we propose that the provisional tax legislation be amended in order to allow companies to make a further provisional tax payment shortly after a year-end has been concluded (e.g. 2 months after year-end). This proposal not only addresses the issues experienced in relation to section 23N of the Act, but also addresses issues currently experienced by large listed companies (and their subsidiaries) where a best estimate of taxable income is exceptionally difficult to determine on the last trading day of the year, as a more accurate estimate can practically only be determined once the year-end audit has been concluded.

SECTION 24O IN THE CONTEXT OF 23N

Subsequent to previous proposals to National Treasury, section 23N of the Act was amended to refer to the taxable income of the acquiring company as opposed to the acquired company when calculating the amount of interest allowed to be deducted.

However, in the case of share acquisitions, lenders will analyse, inter alia, both the borrower and the target group's earnings and free cash flow.

Consequently, we recommend that, in the case of section 24O transactions, the "adjusted taxable income" of both the acquiring company, and the acquired "group of companies" (as defined in section 41) be used for measurement purposes, with the 40% excessive interest test being calculated on a "greater of" basis.

Furthermore, given the recent amendments to the treatment of foreign dividends, we suggest that section 24O should apply not only to the acquisition of local group companies, but also foreign group companies.

(ii) Description of the relevant transaction

This affects transactions that are subject to section 23N of the Act.

(iii) The nature of the businesses impacted by the problem

This affects transactions that are subject to section 23N of the Act. The legislation will have a significant impact on South African resident companies as a result of excess losses being permanently lost.

8. Section 8EA

(i) Legal nature of the problem

Clause 11(1)(d) of the 2013 TLAB inserts a new subsection (3)(a) into section 8EA of the Act, which, in essence, simply replaces the proviso to the definition of "third party backed share".

Subsection (3)(a) is different to the subsection (3)(a) of the Draft 2013 TLAB commented on by the general public and presented to Parliament. In this regard, it now excludes subsection (bb) from subsection (3)(b)(iii), which previously read "that person" and now only includes, as it now reads:

> "(aa) the operating company contemplated in subparagraph (i);
> (bb) the issuer contemplated in subparagraph (ii);"

As previously stated, it now excludes the previous (bb) "that person;".

Furthermore, subsection (3)(iv)(bb) substitutes the words "the issuer contemplated in subparagraph (ii)" for the words "that person", whilst subsection (3)(iv)(cc) includes the words "the other person that directly or indirectly holds at least 20 per cent of the equity shares in the operating company contemplated in subparagraph (i) or the issuer contemplated in subparagraph (ii)".

The effect of the exclusion in subsection (3)(b)(iii) and the amendments effected by way of subsection (3)(b)(iv) is that it now excludes as a party from whom a subscriber of preference shares was previously able to obtain an "enforcement right" or "enforcement obligation", a person that holds more than 20% of the equity shares in an Issuer of a preference share, or which issuer constitutes a group company in relation to a person, in a situation where such Issuer refinances preference shares or debt that was previously issued to fund the acquisition of equity shares.

The refinancing of debt or preference shares that were previously used to fund the acquisition of equity shares is clearly contemplated by virtue of its inclusion in "qualifying purpose". In addition, that a subscriber for a preference share may obtain an "enforcement right" or" enforcement obligation" against certain acceptable parties is also clear.

The Clause by Clause Explanation of the TLAB indicates that the amendments to section 8EA are merely designed to clarify the exceptions to the anti-avoidance rule. It is thus apparent that there was no intention to amend the section in any way.

If indeed this result is intended, it has retrospective effect, since the amendment is essentially with effect from the date of introduction of section 8EA, meaning that refinancing transactions that previously relied on "enforcement rights" or

"enforcement obligations" from these parties are now in breach of section 8EA with the result that dividends that were previously exempt are now retrospectively taxable.

We suggest that the amendment to section to exclude subparagraph (bb) from the subsection (3)(b)(iii), be deleted and further that the amendments effected by way of subsection (3)(b)(iv) also be deleted.

(ii) Description of the relevant transaction

Affected transactions are the re-financing of debt or preference shares, specifically the party from whom a subscriber of preference shares was previously able to obtain an "enforcement right" or "enforcement obligation".

(iii) The nature of the businesses impacted by the problem

Affected transactions are the re-financing of debt or preference shares, specifically the party from whom a subscriber of preference shares was previously able to obtain an "enforcement right" or "enforcement obligation".

9. SECTION 24JB

(i) Legal nature of the problem

In the definition of "covered person" in section 24JB(1) of the Act, the conceptual exclusion has already been made with reference to a company that is a long-term insurer as defined in section 1 of the Long-term Insurance Act. Unfortunately, this exclusion does not go far enough, as it does not extend to subsidiaries of an insurance company. An insurance group is not predominantly engaged in banking or any associated activities per se.

Insurance groups are, by virtue of the definition of covered persons, included within the ambit of section 24JB, notwithstanding the fact that they hold investments on capital account and are not engaged in banking activities.

Furthermore, insurance groups have separately undertaken organisational restructures in anticipation of the implementation of Solvency II in South Africa to avoid any negative impact the Regulations may have on the amount of capital that they must hold. In this regard, the insurance group and other related group subsidiaries would be held directly by a controlling company. The insurance group would typically not hold any other subsidiaries.

A "controlling company" is defined in the Long-term Insurance Act Amendment Bill and means a holding company that is a public company whose only business is the acquiring, holding and managing of another company or other companies, including an insurance group. The controlling company and the insurance group will also be subject to the supervision of the Registrar of Long-term Insurance.

Notwithstanding the exclusion in section 24JB(2), we propose that the current exclusion of a long-term insurer be extended so as to refer to a controlling company, as defined in the Long-term Insurance Act Amendment Bill, and any company that is held directly or indirectly by the controlling company. A covered person should therefore not extend to the insurance group that is governed separately in terms of

the Long-term insurance Act and should consequently be specifically excluded from the definition of covered person in section 24JB(1) of the Act.

(ii) Description of the relevant transaction

The transaction affected are all transaction that fall within the ambit of section 24JB that relate to insurance companies and their subsidiaries.

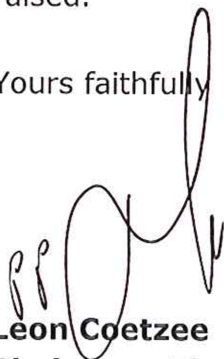
(iii) The nature of the businesses impacted by the problem

The business impacted is that of insurance companies and their subsidiaries.

* * *

Please do not hesitate to contact me should you wish to discuss any of the issues raised.

Yours faithfully



Leon Coetzee
Chairman: The Banking Association Direct Tax Committee