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Dear Ms Nkumanda and Ms Collins

Comments on the draft 2014 Taxation Laws Amendment Bill

In response to your request for comments on the draft 2014 Taxation Laws Amendment Bill (2014 TLAB), we set out below the comments of the Banking Association of South Africa's (BASA) Direct Tax Committee on certain aspects of the draft 2014 TLAB. For purposes of this document, the Income Tax Act No 58 of 1962, as amended, will be referred to as the Act. Our submission covers the following topics:

1. DEFINITION OF CONTRIBUTED TAX CAPITAL IN SECTION 1

Problem statement

The proposed introduction of a rule for contributed tax capital (CTC) in respect of conditionally convertible shares creates confusion. In addition, it may result in double counting of CTC.

The intention of the insertion would appear to be to provide clarity on the CTC arising in the event that a share is contingently converted to another class of share. It is unclear why this amendment is considered necessary and, in our view, leads to confusion. It is understood that the legal position upon conversion (contingently, compulsorily, or voluntarily) is that the existing share is redeemed and the new share is subscribed for. The fact that the subscription price and redemption price may be set-off in order to avoid cash flows does not detract from this position. Accordingly, CTC is repaid and new CTC is created through the subscription for the new shares.

The introduction of legislation to achieve what the factual and legal position actually achieves, is confusing and leads to questioning the position regarding shares that are voluntarily, at the option of one party, or in fact compulsorily convertible. We submit that the fact that shares are contingently convertible should not place these shares on a different footing.

In addition, on the above analysis, the wording of sub-section (*aa*) may result in a duplication of the CTC. Generally, what occurs is that the proceeds received by the subscriber upon redemption of the "converted" shares are used to subscribe for the new shares. If one includes both the consideration received by the issuing company for the issue of the new shares and the CTC of the "converted" shares that have been redeemed, one will count the CTC twice.

Proposed solution

We submit that it is unnecessary to include a rule to deal with CTC for conditionally convertible shares. If it were to be retained, then at the very least, sub-section (*aa*) should refer to any additional consideration over and above the CTC of the shares being converted.

2. SECTION 8EA

2.1 Guarantees

Problem statement

The 2014 TLAB proposes that the scope of the exemption guarantees in section 8EA(3)(b) of the Act be broadened to allow for the pledging of the equity shares and associated debt claims in the issuer of preference shares.

This addition of section 8EA(3)(b)(vii), in terms of section 7 of the 2014 TLAB, is very well received. However, the wording in subparagraph (aa) which reads as "that issuer used the funds provided by that person solely for the acquisition by that issuer of equity shares in an operating company", severely limits the application of the section. This is because any transaction where the issuer raised preference shares which funded transaction costs in addition to the direct or indirect acquisition of qualifying shares, would arguably fall foul of the relief.

The word "solely" was previously used with regard to section 8EA of the Act. In this regard, it is worth noting that the original version of section 8EA in the 2012 draft Taxation Laws Amendment Bill (2012 TLAB), required that the consideration received by or accrued to the issuer of preference shares be applied directly or indirectly solely for the purpose of acquiring an equity share in an operating company.

In the Draft Response Document from National Treasury and the South African Revenue Service dated 11 September 2012, a comment to the 2012 TLAB version of section 8EA stated the following:

> as currently drafted, relief from both anti-avoidance provisions is too restrictive because the consideration applied may not be used for purposes other than "solely" for the acquisition of shares. This restriction is unrealistic because consideration of this nature is often applied to transaction costs.

National Treasury and SARS responded as follows to the said comment:

> Response: Accepted. The word "solely" will be removed. The exception will apply as long as the "share is issued" by the issuer for the appropriate purpose, which will include the transaction cost attendant thereto.

We do not believe that the aim of the amendment was to move back to the consequences of the previous draft versions of section 8EA, whereby certain

transactions with an attendant "qualifying purpose" were excluded, merely due to transaction costs being funded from the issued preference shares.

Proposed solution

The addition in subsection 8EA(3)(*b*)(vii)(*aa*) should read as follows: "(*aa*) that issuer used the funds for a qualifying purpose".

2.2 Exploration for natural resources operating company

Problem statement

We welcome the inclusion in the definition of an "operating company" of an exploration company. This does not, however, include start-up operating companies, which are not yet providing goods or services for a consideration.

Proposed solution

We propose that the definition of an "operating company" be extended to include a company that has not yet commenced trading, but that can demonstrate that it intends to commence trading and that the intention is for such company to provide goods and services for a consideration in the reasonable future. An appropriate safeguard should be that, if the company has not commenced trading within 3 months of the issue of the preference shares, such shares should be regarded as third party backed shares.

2.3 Qualifying purpose

Problem statement

The expansion of the qualifying purpose relating to the issuer in section 8EA(3)(b)(ii) of the Act has been proposed in clause 7(1)(b)(ii) of the 2014 TLAB to permit a holder of a preference share to have an "enforcement right" or an "enforcement obligation" against an issuer of a preference share in circumstances where the issuer has used the proceeds for a qualifying purpose. However, it permits an "enforcement right" or "enforcement obligation" to exist only in circumstances where the issuer uses the proceeds to acquire or redeem a preference share issued for a qualifying purpose. We submit that it should be extended to include the settlement of debt that was incurred for a "qualifying purpose".

Proposed solution

The above proposed amendment may be achieved by adding paragraph (cc) to the proposed amendment to refer to the use of the proceeds to settle debt. However, in order to simplify what is already an extremely complex section, it is suggested that the above extension be achieved by simply amending section 8EA(3)(b)(ii) to read: "any issuer of a preference share if the proceeds from the issue of that preference share are utilised by that issuer for a qualifying purpose;".

3. PARAGRAPH (i) OF THE FURTHER PROVISO TO SECTION 9D(2A)

Problem statement

The high-tax exemption in section 9D of the Act seeks to eliminate the onerous administrative burden involved in establishing whether the high-tax exemption applies

by allowing for the foreign business establishment (FBE) exemption to be utilised *as an alternative* to the high-tax test. However, the high-tax test *still* requires an onerous exercise to be performed should reliance be placed on the exemption, plus there is *still* an onerous burden of proof required to satisfy SARS that no "net income" has to be taken into account in terms of section 9D(9A). Therefore, the new provision does not really assist in relieving the onerous burden of proving that section 9D does not apply in cases where the controlled foreign company in question is located in a high tax jurisdiction, is subject to high amounts of tax, and has an FBE (but earns the type of income which has to be analysed and exempted in terms of section 9D(9A)).

Further, although the new amendment seeks to clarify which taxes are included in the test, the exercise is even further complicated as it would take into account the provisions of all applicable income tax legislation, including double tax agreements, tax credits, rebates, and other rights of recovery of tax from a foreign government after disregarding any tax losses from other tax years or from other foreign companies.

It is submitted that, whilst the current and proposed new provision of the high tax exemption does not eliminate countries which by default have a high-tax rate, it would be far easier for taxpayers to administer this exemption if National Treasury would consider narrowing the exemption to exclude specific high-tax countries, either based on a % of the South African corporate tax rate and/or in terms of an approved list of excluded countries.

In addition, although welcomed, the new foreign business establishment exemption in paragraph (bb) does not address tax losses and whether the losses would be allowed to be carried forward, if claimed, to the following year in which the taxpayer proves that there is no net income to be taken into account in terms of section 9D(9A).

Proposed solution

We request that National Treasury consider the implementation of a less onerous way of determining whether the high tax exemption applies. We furthermore request that National Treasury clarify the position with regard to tax losses being claimed and carried forward within the ambit of the new FBE exemption (which has been offered as an alternative to the high tax exemption).

4. PARAGRAPH (*ff*) OF THE PROVISO TO SECTION 10(1)(*k*)(i)(*gg*)

Problem statement

While we support the amendment to exclude from the ambit of paragraph (*gg*), dividends that are received or accrued on borrowed stock that are treated as taxable under paragraph (*ff*), we question the relevance of paragraph (*gg*) and the rationale for denying the exemption on dividends that are received or accrued on shares that are of similar kind and quality, as the borrower still has full economic interest in similar shares held long. This view is shared by National Treasury, as stated in the EM in respect of clause 13 of the 2014 TLAB, which categorically confirms on page 81 by the example given that the borrower retains full economic interest in the shares owned that are of similar kind and quality, and that the dividends in respect of those shares should not be deemed to be income. Furthermore, we question how the manufactured payment on borrowed stock and the dividend received on similar long share positions can be seen to be connected: The manufactured dividend payment is as a result of a short position concluded to earn taxable trading income and the long position, which is entirely unrelated to the short position, and should remain exempt.

Proposed solution

We propose the deletion of paragraph (*gg*), as dividends received or accrued on positions where the holder does not retain full economic ownership is sufficiently covered in paragraphs (*ff*) and (*ee*)(A).

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

Problem statement

As per the draft Explanatory Memorandum (EM) with regard to section 13(1)(*h*) of the 2014 TLAB, the proposed amendment is intended to be grammatical only and provides no further clarity on what is meant by an amount of expenditure that is determined [wholly or partly] with reference to dividends received by or accrued to that company. We submit that the current wording is too wide and covers an unintended multitude of vanilla derivative transactions.

Proposed solution

Clarity is required on how the wording should be interpreted and whether the expenditure referred to in the provision is limited (only) to the amount of manufactured dividend paid under an equity derivative written over equity positions held by that company. We refer to the draft EM on the TLAB 2013, which sets out the intention of National Treasury as requiring the provision to operate in a similar fashion as the dividend mismatches involving securities lending schemes, in that the exemption for dividends received or accrued will be denied if the company incurs obligations to pay dividends.

If it is National Treasury's intention to limit the application of the provision to manufactured dividends paid, we propose an amendment to the existing wording to deny the exemption on dividends received on equity positions to the extent that the amount of that dividend does not exceed any deductible amount incurred that is determined wholly with reference to those dividends received. We believe that this will be achieved by amending the provision to read as follows:

> "to any dividends received by or accrued to a company other than dividends taken into account for purposes of paragraph (gg) to the extent that —
>
> (A) the aggregate of those dividends does not exceed an amount equal to the aggregate of any amounts incurred by that company as compensation for any distributions in respect of any share held [any deductible expenditure incurred by that company] and;
>
> (B) the amount of that expenditure is determined wholly [or partly] with reference to those dividends received by or accrued to that company."

In addition, we respectfully request you to reconsider the concerns raised by BASA in their submission to National Treasury on the 29th of November 2013 on the 2013 DTLAB (Refer to Annexure A (para 3)) which sets out the impact of section 10(1)(k)(hh) of the Act on the equity derivative markets.

6. SECTION 11D

Problem statement

The proposal is that the definition of "research and development" be revised to re-instate the innovation requirement of a functional design. There are various interpretations for the innovation requirement, with the Department of Science and Technology (DST) and taxpayers having different views on what innovation means for purposes of the Research and Development incentive. The DST adopts a higher level meaning of the term, whereas taxpayers give the term its ordinary meaning. The Oxford Dictionary defines innovative as "featuring new methods/ideas; advanced; creative in thinking; original".

Proposed solution

There is currently no definition of the term "innovative" in either section 1 or section 11D of the Act. It is proposed that a definition of innovative be included in section 11D of the Act. This will provide greater clarity to taxpayers in ensuring the term is universally applied and interpreted.

7. SECTION 12T

While we applaud the proposed introduction of the tax free savings account, we are concerned that the ambit of the tax free investments and the administrative requirements of the issuers/administrators/service providers are not clear.

7.1 Ambit

Problem statement

The ambit of the tax free investments is not clear. Firstly, it is not clear whether paragraphs (*a*)(i), (*a*)(ii), (*b*) and (*c*) of the proposed definition of "tax free investment" in section 12T(1) must *all* be met for a product to constitute a "tax free investment".

If this is the case, the requirements of paragraph (a)(ii) and paragraph (c) would have the effect that many of the products contemplated in paragraph (a)(i) would not fall within the ambit of tax free investments. For instance, many financial instruments issued by a bank (as contemplated in paragraph (a)(i)(aa)) would not be administered by either a broker or a LISP (as contemplated by paragraph (a)(ii)(bb)), as they would be administered by the bank *itself*, nor would they constitute products that meet the requirements of the Policyholder Protection Rules or CISCA. In this event, a fixed deposit held at a regulated bank would not comply, which could surely not have been the intention.

We can only assume that the statement in the Explanatory Memorandum that institutions that will be permitted to provide products to clients are "JSE, authorised users [ie brokers], banks and long term insurers", means that qualifying products administered directly by these entities, should be included.

Proposed solution

We require clarification as to whether paragraphs (a)(i), (a)(ii), (b) and (c) must ***all*** be met in order for section 12T to apply. If this is the case, the administrators per paragraph (a)(ii) and the product list per paragraph (c) need to be expanded. In

particular, paragraph (a)(ii) needs to include banks, the JSE and the National Government, and paragraph (c) needs to include interest-bearing deposits with a regulated bank and any other products to be allowed in addition to CIS long term insurance investments.

7.2 Tax implications of excess investments

Problem statement

It appears that, in the event that an individual exceeds his maximum allowable annual contribution to his tax free savings accounts, he will be taxed at a rate of 40% on such excess investment, and that such excess investment will then be treated as a tax free investment for all future returns — thus, any interest, dividends, other income, or gains in respect of such excess investment would be exempt from tax.

Proposed solution

We would appreciate your confirmation that, while excess investments will be subject to tax at a rate of 40%, all returns from such excess investments (albeit, dividends, other income, interest or gains) will be exempt from tax.

7.3 Administrative requirements of issuers/administrators/service providers

Problem statement

As individuals are entitled to open multiple tax free savings accounts with different administrators or even with the same administrator, it will not be possible for individual administrators/issuers/service providers to track whether an individual has exceeded his R30,000 annual or R500,000 life-time limit, or to track the impact of withdrawals and/or transfers on these limits.

Proposed solution

We submit that it should remain the responsibility of the individual to track his annual and life-time limits and declare any excess investments in his income tax return. Administrators/issuers/service providers should not be required to involve themselves in any individual account holders' tax affairs, other than applying the Dividends Tax exemption applicable to tax free savings accounts in respect of all investments allocated by the individual account holder to such account.

7.4 Requirement to obtain Dividends Tax Declarations and Undertakings

Problem statement

The Dividends Tax exemption for dividends resulting from tax free savings accounts has been proposed to be included as a new section 64F(o). As no exclusion from the requirement to obtain declarations and undertakings in terms of sections 64F(2), 64G(2)(a), and 64H(2)(a) has been proposed, it would appear that issuers or regulated intermediaries are expected to obtain Dividends Tax Declarations and Undertakings from all holders of tax free savings accounts. We submit that the sheer volumes of natural persons expected to avail themselves of the tax free savings account regime will place a prohibitive administrative burden on issuers/regulated intermediaries.

Proposed solution

We submit that the issuer/regulated intermediary should be allowed to rely on their Know Your Client (KYC) processes to identify natural persons, deceased and insolvent estates that invest in these products and apply the exemption automatically to such parties' tax free savings accounts.

7.5 Deemed normal tax on excess contributions

Problem statement

We submit that the deemed normal tax of 40% to be levied for excess contributions by the taxpayer is unnecessarily harsh. As the contributions will be made with post-tax funds, the penalty provision essentially creates double taxation of the same amount at the marginal tax rate. As the excess amount does not constitute gross income and does not fall into the calculation of taxable income, it is unclear on what basis this amount is to be taxed.

As much as the "tax" on excess contributions will deter taxpayers from exceeding the limits, the punitive nature of the "tax" is overly harsh.

Proposed solution

We urge National Treasury to reconsider the rate at which the deemed tax on excess contributions is to be levied. At the very least, the rate should not be the highest marginal rate of income tax for individuals (as if the excess amount is question is being regarded as income). The rate should rather acknowledge the "after tax" nature of the funds in question and the fact that they are being invested on a long term basis, in which case the CGT rate of taxation would be more appropriate, ie tax 33.3% of the excess contribution at the taxpayer's marginal rate, alternatively simply make the penalty rate equal to the CGT inclusion rate multiplied by the highest marginal rate tax for individuals of 40%, which means that the excess should be taxed at 13.32%, rather than 40%.

7.6. Quantum of the annual allowable contribution

Problem statement

We submit that the proposed annual allowable contribution of R30 000 may not be appropriate in order to incentivise taxpayers to invest in the tax free investments. Given that the current annual interest exemption available to individual taxpayers is R23 800; offering tax free returns on an annual capital amount, which is capped at R30 000, may be too low, especially if National Treasury is contemplating revoking the annual interest exemption at a future date.

Proposed solution

Even if the annual interest exemption is retained, in addition to the tax free investments incentive, it may be more of an incentive to taxpayers to invest in such products if the annual allowable contribution is increased to R50 000, for example.

8. SECTION 23M

8.1 Need for section 23M

Problem statement

We submit that the objectives of section 23M of the Act, ie the scrutiny and restriction of interest deductions, are already adequately addressed by the transfer pricing and thin capitalisation rules in section 31 of the Act in relation to cross-border debt-funding, and the interest restriction rules in section 23N of the Act in relation to domestic funding arrangements.

In relation to cross-border debt, we submit that there does not appear to be any abusive tax avoidance arrangement that is targeted by section 23M which is not already targeted by section 31. The two provisions appear to address exactly the same issues. In fact, we confirm that the co-existence of the two provisions is cause for substantial uncertainty and confusion, both in South Arica and abroad, possibly even transfer pricing penalties in foreign jurisdictions. For example, any limitation imposed by section 23M to an acceptable arm's length interest rate may have the further adverse tax implication that if the actual interest payments were to be limited to that allowed for SA tax purposes (i.e. an amount less than arm's length), this may have adverse tax implications in the foreign country, since it is an accepted OECD principle that the interest payment will be at an arm's length rate (as opposed to a reduced rate for SA domestic tax purposes).

As regards domestic debt, we recognise that section 23N only becomes applicable in the context of so-called *reorganisation* or *acquisition* transactions. However, it is our understanding that the potentially abusive debt arrangements that National Treasury and SARS wish to target are precisely those that typically arise through reorganisation and/or acquisition deals. Thus, the debts targeted by section 23M (in the domestic SA environment) are essentially the same debts that are in any event caught by section 23N.

Proposed solution

Therefore, we believe that section 23M should be deleted, especially since the level of scrutiny required for normal commercial transactions, which potentially fall foul of section 23M, is not warranted since there is no mischief involved and therefore no anti-avoidance criteria to be achieved . Alternatively, we believe that it should be delayed until 1 January 2016, to allow for substantial amendments, in line with the proposals outlined in SAICA's submission document dated 5 June 2014 (attached, for ease of reference as Annexure B), and the proposals contained below.

With regard to the current proposed amendments, we comment thereon below. However, such comments do not detract from our belief that section 23M should simply be deleted.

8.2 Repo rate adjustment

Problem statement

With regard to the repo rate adjustment per "C" of the formula in section 23M(3)(*b*) of the Act, National Treasury appears to consider the adjustable taxable income limitation to be appropriate in a low repo rate environment. In the current environment, if one were to calculate the interest limitation based on the average

repo rate of 5.75%, the attendant interest deduction is limited to 39% of a debtor's adjusted taxable income. Whilst we welcome the change to linking the percentage adjustment relating to adjusted taxable income to the average repo rate, in certain instances this would lead to interest deductibility limitations for entities in a start-up scenario or a capital intensive business where large initial capital expenditure is required to establish the business, before profits may be generated therefrom.

Proposed solution

We propose that the number 40 per "B" of the formula in section 23M(3)(*b*) be increased to 50 to cater for the scenarios described above. This would alleviate financial strain on capital intensive start-up companies whilst not resulting in significant leakage for the fiscus.

8.3 Provisional tax

Problem statement

In terms of the application of section 23M, the deductibility of interest can only be determined at year-end once the company's 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.

Proposed solution

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. 3 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.

8.4 Financial credit protection

Problem statement

In the ordinary course of business, financial institutions buy credit protection as part of a prudent credit risk mitigation strategy. These trades would include the direct syndication of risk.

The current wording of section 23M is ambiguous and could be interpreted to place the onus on the borrower to know at any point in time what the ultimate source of funding is. In other words, if a financial institution lends money to its client and chooses to mitigate its own credit risk in relation to that client by "selling down" its exposure to a tax exempt entity, which is in a controlling relationship with the client, then the client is at risk without any knowledge of the implications in relation to his interest deductibility. It is onerous to expect lenders to obtain the permission of their clients every time they decide to mitigate their credit exposure by "selling down" portions of their book. In addition, it is not practical for the issuers to know at all times who the ultimate holders of their bonds are in the secondary market when this could change on a daily or hourly basis.

Proposed solution

We request that South African tax exempt entities be removed from the ambit of the section.

9. SECTION 24JB

9.1. Effective date

Problem statement

While we would like to express our appreciation for the inclusion of "an interest in a partnership" in the exclusions contained in section 24JB(2)(a) of the Act, we note that the effective date of years of assessment ending on or after 1 January 2014 (which is the effective date of section 24JB), has been limited to paragraphs (a) and (b) of section 40(1) of the 2014 TLAB. This limitation has the effect that paragraphs (c)-(g) of section 40(1) of the 2014 TLAB will only be effective upon promulgation of the draft 2014 Taxation Laws Amendment Act.

We submit that it could never have been the intention that the entire section 40 of the 2014 TLAB would not be effective from the effective date of section 24JB. Insofar as paragraph (e) is concerned, its omission from the original version of section 24JB was clearly an oversight and, if the effective date for its inclusion in the ambit of section 24JB were not aligned with the effective date of section 24JB, we would find ourselves in the untenable situation where certain partnerships fall within the ambit of section 24JB once section 24JB is effective, and then fall outside the ambit of section 24JB from the date of promulgation of the 2014 Taxation Laws Amendment Act. Insofar as the remainder of the paragraphs of section 40(1) of the 2014 TLAB are concerned, we note that they are all merely textual in nature and are intended to improve the flow of section 24JB. We submit that their effective dates should be aligned with the effective date of section 24JB.

As the EM (page 34) states that "the proposed amendment is deemed to have come into operation on 1 January 2014 and applies in respect of years of assessment commencing on and after that date", it therefore would appear that the wording of section 40(2) of the 2014 TLAB is merely an oversight.

Proposed solution

Section 40(2) of the 2014 TLAB should be amended to apply the proposed effective date to the entire section 40(1) of the 2014 TLAB, ie from 1 January 2014 and applies in respect of years of assessment ending on or after that date.

9.2. Insurance groups to be excluded from the "covered person" definition in section 24JB(1)

Problem statement

The proposed amendments to section 24JB of the Act do not address the issue previously raised by BASA in their submission to National Treasury on the 5th of August 2013 with regard to insurance groups. The introduction of section 24JB was ostensibly a result of the combined efforts and negotiation between National Treasury and BASA without any involvement from the Insurance industry as the intention was not for section 24JB to impact the Insurance industry. The "covered person" definition was drafted with this design principle in mind and was accepted by National Treasury. 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.

A "controlling insurance group", which means a holding company that is a listed company whose only business is the acquiring, holding and managing of another controlling company or other controlling companies, and its subsidiaries, which include an insurance group.

An insurance group is defined as a company as contemplated in subparagraph (i) and (ii), which directly or indirectly holds more than 50% of the shares in another company or companies.

Proposed solution

Notwithstanding the exclusion in section 24JB(2) of the Act, it is proposed 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.

9.3. Section 24JB(3) and its interaction with other sections of the Act

Problem statement

Section 24JB(2) of the Act requires the inclusion or deduction from income of any covered person, all amounts recognised in profit or loss in the statement of comprehensive income (i.e. a reference to the accounting recognition in profit or loss) in respect of financial assets and financial liabilities of that covered person that are recognised at fair value through profit or loss (i.e. a reference to the category selection) in terms of International Accounting Standards (IAS 39).

A complexity arises where an upfront investment amount received by the issuer is not an amount included in the income statement. Only subsequent fair value movements are recognised in the statement of comprehensive income. With regards to the upfront investment amount, such amount will not meet the requirement of being "recognised in profit or loss in the statement of comprehensive income".

In terms of section 24JB(3) of the Act as it currently reads, it appears that the amount must first fall within section 24JB(2) of the Act, before section 24JB(3) of the Act can be applied. Based on the above, it is questionable whether the upfront investment amount will qualify, given that the initial amount is not recognised in the statement of comprehensive income and therefore not an "amount contemplated in subsection 2" as currently required in section 24JB(3) of the Act.

Based on consultations with National Treasury and SARS, we understand that the wording of section 24JB(3) of the Act is intended to override all other sections of the Act with regards to qualifying financial instruments. The EM confirms that financial instruments that are taxed in terms of section 24JB of the Act, will not be taken into account for purposes of gross income and section 11(*a*) of the Act.

In addition to the above, the current wording of section 24JB(3) of the Act reads that, any amount taken into account in respect of the financial instrument must only be taken into account in terms of that subsection. This wording is in contrast with the wording in other sections of the Act, such as section 24I(6) of the Act, where it reads that "any inclusion in or deduction from income in terms of this section shall apply in lieu of any deduction or inclusion which may otherwise be allowed or included under any other provision of this Act", questions whether the current wording does in fact achieve the override for the rest of the Act, as intended.

This principle is best illustrated by means an example:

A covered person issues an exchange traded note (ETN) whereby the investor makes an upfront investment of R100. The capital investment is not guaranteed and the return on the note references that of a basket of equities. Following the year of assessment in which the instrument is issued, the instrument is redeemed. At maturity, shortly after year end, the note realises with cumulative market movements since inception amounting of R20, in favour of the issuer (assume that all fair value movements occurred within the first year of issue). The redemption amount is calculated at R80.

Under IAS 39, the covered person recognises a financial liability at fair value, either by virtue of the held for trading or designated at fair value through profit or loss category selection. At initial recognition, the initial investment amount of R100 is recognised in the Balance Sheet. In year 1, cumulative market movements of R20 are subsequently measured at fair value in the statement of comprehensive income as a fair value gain to the issuer. On redemption, the financial liability of R80 is derecognised from the Balance Sheet.

The tax position of the covered person is as follows:

Column A indicates the tax position, applying the wording of section 24JB(3) as it currently reads to override all provisions of the Act with regards to fair value movements only on qualifying financial instruments.

Column B indicates the tax position that will apply if section 24JB overrides all provisions of the Act with regards to the fair value movements and the upfront investment that is recognised in the Balance Sheet on day 1.

Year 1	**A**	**B**
Taxation of FV gain – s24JB(2)	20	20
Gross income	100	0
Taxable profit	**120**	**20**

Year 2	**A**	
11(a)	(80)	0
Tax loss	**(80)**	
Cumulative position over two years	**40**	**20**

Column A does not result in the correct tax position as it leads to double taxation i.e. the fair value gain is taxed over and above the difference in gross income and the deduction on redemption, which economically, is the amount of the fair value gain that has already been taxed under section 24JB.

In Column B, the position is rectified by virtue of the legislative override applying to all fair value amounts in respect of qualifying financial instruments, including those fair value amounts recognised in the Balance Sheet on day 1 in addition to the fair value movement recognised in the statement of comprehensive income.

Proposed solution

We propose an amendment to the current wording of Section 24JB(3) of the Act to read "In determining taxable income or assessed capital loss of a covered person, any financial asset or financial liability of a covered person that is contemplated in subsection (2) [or (5) to be excluded] must only be taken into account for purposes of this Act in terms of that subsection" .

10. SECTION 31(3)

10.1 Effective date

Problem statement

The proposed revision of the current form of the secondary adjustment relevant to TP, in terms of which the amount of the secondary adjustment will be deemed to be a dividend in specie paid by a South African taxpayer to the non-resident connected person, is welcomed. Certain practical issues do, however, require clarification, namely:

- The treatment of "secondary adjustments" for the period up to 1 January 2015, taking into account that it is impossible to give effect to the deemed loan secondary adjustment current applicable (as acknowledged on p68 of the Explanatory Memorandum (EM)); and

- The application of the proposed secondary adjustment to a section 31 primary adjustment between a South African resident holding company and its foreign subsidiary. Say, for example, the South African resident holding company received R50 million for services rendered to its foreign subsidiary, whereas the arm's length price for the services is R80 million. Since the foreign subsidiary does not have any interest in the South African holding company, no deemed dividend in specie declaration is practically possible.

Proposed solution

Clarification is required in respect of the —

- "deemed loan" secondary adjustment, taking into account that it was/is not practically possible to apply this legislation. We understand that retrospective

legislation should only be entertained in exceptional circumstances, but given the administrative difficulty in applying the deemed loan regime, it is suggested that this legislation be repealed retrospectively, to apply in relation to years of assessment commencing on or after 1 January 2012, to effectively replace the deemed loan regime. It is further recommended that, where a deemed loan has been imposed, the taxpayer have the option to convert such deemed loan to a deemed dividend;

- application of the deemed dividend in specie secondary adjustment where less than an arm's length amount was received by a South African resident holding company from its foreign subsidiary (i.e. interest held in the foreign subsidiary and not vice versa).

10.2 Potential double taxation

Problem statement

There is a concern that double taxation may arise in relation to withholding taxes paid on royalties, interest (from 1 January 2015) and services (from 1 January 2016). If one assumes that in 2015 a SA subsidiary receives a loan amounting to R100m from its foreign parent company, which charges 10% interest on the loan amount. However, an arm's-length interest rate would be 8%. The SA subsidiary would already have paid interest withholding tax on the full 10% interest paid. Thereafter, the secondary adjustment would require an additional 15% withholding tax to be withheld by the SA subsidiary on the deemed dividend in specie (the excessive interest paid). That 2% differential would be subject to double tax, i.e. both as interest and as a deemed dividend. The position regarding SA withholding tax paid on services (when introduced) and royalties may be similar.

In addition, where a SA resident holding company receives less than an arm's length amount from its non-resident subsidiary, whether the amount in question is interest, fees or royalties, also needs to be addressed. In this scenario, the amount received may have already been subject to withholding tax in the foreign jurisdiction, in which case the non-arm's length component thereof will be subject again to dividends withholding tax in SA, since it will be regarded as a deemed dividend in specie.

Proposed solution

National Treasury needs to ensure that the non-arm's-length portion of the interest paid is not subject to the dividends withholding tax, where such interest has already been subject to withholding tax, whether in SA or offshore. The same principle would need to be adhered to in relation to fees and royalties paid to non-residents.

Alternatively, the rate of the "penalty" withholding tax should be reduced to 10%.

11. SECTION 37D

Problem statement

This proposed new section provides for a 4% allowance in respect of land declared as a nature reserve or national park based on:

- the cost of acquisition of the land and any improvements thereon; or

- the lower of the market or municipal value if the amount exceeds the cost over a period of 25 years.

It is proposed that this section comes into operation on 1 March 2015 and applies in respect of years of assessment commencing on or after that date.

It is unclear whether the section will apply to existing land declared as a nature reserve or national park, or only to land declared as such in years of assessment commencing on or after 1 March 2015.

The EM specifically states that "land declared as a nature reserve or national park should no longer be treated as a section 18A donation. This seems to imply that existing land that has been declared as a nature reserve or national part prior to the effective date may qualify for a deduction in terms of this section.

Proposed solution

We propose that clarity be provided in terms of the effective date and application of the provision to "declared land" currently on hand.

12. SECTION 49D(1)(A)(II)

Problem statement

Clause 56(1)(*b*) of the 2014 TLAB proposes amending section 49D(1)(*a*)(ii) of the Act by adding the additional requirement for a foreign person to be "registered as a taxpayer" in order for the exemption to apply. The wording does not align with that of the other withholding tax exemptions available to foreign persons with regard to permanent establishments in South Africa. In this regard, sections 50D(3)(*b*) and 51D(1)(*b*) of the Act refer to the exemptions applying if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act, ie not registered as a taxpayer in terms of the Act.

Proposed solution

It is recommended that the wording contained in the proposed section 56(1)(*b*) of the 2014 TLAB be aligned to that of sections 50D(3)(*b*) and 51D(1)(b) of the Act — ie "registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act", (not the Act).

13. SECTION 64EB

13.1 Amount subject to Dividends Tax

Problem statement

We applaud the attempt to simplify the anti-avoidance provision of section 64EB(2) of the Act by deeming the manufactured dividend that is paid to the lender to be a dividend subject to Dividends Tax under certain circumstances, instead of deeming the actual dividend to be paid to the lender. While it would appear that it was the intention that the taxable dividend remain the same in terms of both constructs, this is not in fact the case.

In terms of the current construct of section 64EB(2)(b) of the Act, any Dividends Tax due is calculated on the value of the dividend paid on the reference shares. However,

in terms of the proposed revised subsection (2), the amount on which Dividends Tax will be calculated has been substantially increased. This is because the ambit is no longer limited to the value of the actual dividend paid on the reference shares. Instead, the ambit is "any amount paid by [the borrower] to [the lender] in respect of that borrowed share".

The amount subject to Dividends Tax could now include not only the manufactured dividend in respect of the borrowed share, but also scrip lending fees. Furthermore, the manufactured dividend may itself exceed the amount of the actual dividend paid on the borrowed shares due to the application of standard gross-up provisions. In this regard, the Global Master Securities Lending Agreement (GMSLA), which is the standard agreement which applies to all scrip loans, contains a gross-up provision, with the effect that, in addition to the quantum of the actual dividend paid on the borrowed shares, the borrower is required to pay to the lender:

> "an additional amount as is necessary to ensure that the amount actually received by [the lender] (after taking account of such withholding [for or on account of any tax]) will equal the amount [the lender] would have received had not such withholding been required".

It follows that, in the event that a scrip loan is entered into with a foreign lender after declaration date:

- In terms of the GMSLA, the borrower is required to gross-up the payment to the foreign lender by an amount equal to any South African Dividends tax withheld;

- In terms of section 64EB(2) of the Act, the borrower will be required to withhold Dividends Tax from the payment to the foreign lender, which Dividends Tax will be calculated as 15% (or the applicable reduced rate in terms of a DTA) of the grossed-up manufactured dividend plus any scrip lending fees paid.

Consequently, in terms of the current wording of section 64EB(2), if the actual dividend paid on the borrowed shares was R100, Dividends Tax (at a rate of 15%) of R15 would be withheld. In terms of the proposed revised wording, Dividends Tax would be withheld on the grossed-up manufactured dividend (R117.64) plus Dividends Tax on any scrip lending fee (eg R10), resulting in total Dividends Tax of R19.15.

As section 64EB(2) is an anti-avoidance provision aimed at recovering Dividends Tax that would have been due by foreign lenders if they held their shares instead of lending them out, it could never have been the intention to subject any amount in excess of the actual dividend that would have been subject to Dividends Tax, to Dividends Tax.

Proposed solution

In order to ensure that the amount subject to Dividends Tax is limited to the amount of the dividend on the borrowed shares, we propose that the words "as does not exceed an amount equal to the amount of dividends paid on the borrowed shares" be inserted after the phrase "in respect of that borrowed share" in the proposed revised section 64EB(2)(b) of the Act.

13.2 Retrospectivity

Problem statement

We note that it is intended that the amendments to section 64EB(2) of the Act come into operation with retrospective effect on 4 July 2013. This retrospective application would place an undue financial burden on local borrowers, as the proposed amendment, if promulgated in its current form, would result in an increased withholding obligation effective from 4 July 2013, which local borrowers are unlikely to be able to recover from the foreign lenders.

Not only would local borrowers be out of pocket, they would also face the administrative burden of correcting their Dividends Tax reporting since 4 July 2013.

Proposed solution

We submit that legislation should only be effective with retrospective effect in exceptional circumstances. As the quantum of Dividends Tax withholding would be the same pre and post the proposed amendment, provided the above limitation is included, there would appear to be no exceptional circumstances warranting retrospective application of the amendment.

14. SECTION 64F(1)(*p*)

Problem statement

The 2014 TLAB proposes an additional exemption (p) from Dividends Tax for any person if the amount of Dividends Tax that would be payable, but for the proposed paragraph, would be less than R100. Under the assumption that the *de minimis* rule has been proposed to ease the administrative burden of imposing and collecting withholding taxes on amounts of Dividends Tax that are less than R100, we submit that this is not achieved if the requirement to obtain a Dividends Tax Declaration and Undertaking form prevails. As per sections 64G(2) and 64H(2) of the Act, an exemption declaration form is required for all exemptions listed in section 64F of the Act.

Proposed solution

We propose that sections 64G and section 64H of the Act be amended, by including an additional paragraph in subsection 2 of each section as follows:

Section 64G(2): "A company must not withhold any dividends tax from the payment of a dividend contemplated in subsection (1) if the amount of the dividend tax that would, but for the application of this paragraph, be payable in respect of that dividend, is less than R100."

Section 64H(2): "A regulated intermediary must not withhold any dividends tax from the payment of a dividend contemplated in subsection (1) if the amount of dividend tax that would, but for the application of this paragraph, be payable in respect of that dividend, is less than R100."

15. THE OUTRIGHT TRANSFER OF COLLATERAL AND THE TAXATION OF SECURITIES LENDING ARRANGEMENTS

Problem statement

The proposed amendments to the 2014 TLAB do not address the concerns raised by BASA in their submission to National Treasury on the 29th of November 2013 on the 2013 DTLAB with regards to the following sections of the Act –

- Sections 64EB(2) and 64EB(3) of the Act: Whether the persons contemplated in sections 64F and 64F(1) of the Act are required to be the "beneficial owner" of the dividend announced or declared;
- Section 64EB(3) of the Act: Definition of a "resale agreement";
- Definition of "lending arrangement" in the Securities Transfer Tax Act No. 25 of 2007 (STT Act) and section 9C, section 22 and the Eighth Schedule of the Act within the context of security lending on bonds; and
- Section 9C, section 22 and the Eighth Schedule of the Act and if applicable, the STT Act in the context of the outright transfer of collateral.

These matters were noted in the 2013 National Budget Speech, however were not addressed during the 2013 legislative cycle.

Proposed solution

It is respectfully requested that the prior concerns raised be addressed. The submission made by BASA to National Treasury has been attached as Appendix A (paras 7 to 9).

* * *

We thank you for the opportunity to provide you with our comments.

Yours faithfully

Leon Coetzee
Chairman: The Banking Association Direct Tax Committee