Building a better working world

17 August 2014

RE: PUBLIC COMMENTS TO THE TAXATION LAWS AMENDMENT BILL OF 2014

I. INDIVIDUAL, SAVINGS AND EMPLOYMENT

1. Employer-provided residential accommodation (proposed paragraph 9 of the Seventh Schedule)

Policy Comment: Although the proposed amendment is supported, one issue that remains open is apportionment where two or more employees jointly inhabit employer-provided accommodation. This issue applies to many taxpayers and needs to be addressed. A simple division of the rent should probably be the default method.

2. Cross-border retirement saving

Technical Comment: Effective 1 March 2015, all employer contributions to pension funds and provident funds are included in the income of the employee as a taxable benefit. Both "pension fund" and "provident fund" are defined terms in the Income Tax Act and refers to a fund approved by the Commissioner. This creates uncertainty as it is unclear whether contributions to an unapproved foreign fund would be taxed in the hands of the employee. If it is argued that the amount should be included, under which provision of the Act is it included (paragraph (c) of the gross income definition?). Is the intention that the foreign pension fund be approved by the Commissioner? This may not be possible as the foreign pension may never comply with the rules (as set-out in the definitions). If the contribution is taxed, will the employee be allowed to claim a deduction? A deduction is only available for contributions to an approved pension or provident fund. Will the employer be allowed to claim a deduction in respect of a contribution made to a foreign pension?

Policy Comment: South African residents working abroad and foreign residents working within South Africa regularly contribute to local and foreign pension funds. With overall retirement tax reform now in effect, the taxation of cross-border pension issues need to be reconsidered. Given the complexity of the issues involved, it is proposed that the review take place over two years.

3. Tax-free savings accounts (proposed section 12T)

Technical comment: The legislation covers property unit trusts but not real estate investment funds (proposed paragraph (a)(i)(cc) of the "tax free investment" definition

under section 12T(1)). Both forms of property investment should equally be covered as a matter of savings neutrality. As many of you are aware, it should further be noted that real estate investment trusts are now the dominant form of listed property investment with property unit trusts being phased-out.

Overall comment: Although well intended, it is questionable whether the proposed legislation is practical. The features of the legislative structure are best designed for bank accounts and government retail savings bonds. It appears that the main policy goal is to encourage low-income savings as opposed to high-income savings. If so, it would be much easier for SARS, product providers and individual savers to have a generic annual passive savings exemption for all categories of savings income. This exemption could be phased out for wealthier individuals if vertical equity is a consideration.

II. BUSINESS (GENERAL)

1. Third-Party Backed Shares (proposed section 8EA(3)(b)(vii))

Technical comment 1: The proposed relief for third-party backed shares in respect of limited share and loan pledges/guarantees is welcome. We would request that the relief apply to third-party backed shares issued for all permissible "qualifying purposes" – not just for the initial acquisition of equity shares in an operating company. This broader view would be more consistent with section 8EA as a whole.

Technical comment 2: Many third-party backed arrangements are trapped under section 8EA due to impermissible guarantees. The funders of these agreements are often willing to permanently waive these impermissible guarantees in order to eliminate the impact of ordinary revenue under section 8EA (which indirectly assists the issuers because of the funder gross-up clauses in most agreements). However, this unilateral waiver is most likely a GAAR violation even if the waiver is permanent because the waiver will be performed solely for tax reasons. It is requested that a special legislative or interpretative exemption from GAAR be made to allow for the permanent waiver of third-party rights and obligations.

2. Interest limitation in respect of acquisition debt (proposed section 23N(3))

Policy comment: The proposed changes to section 23N are largely welcome, especially the removal of the 10 per cent floor. The new formula should assist most commercially driven private equity acquisitions. Of concern, however, are riskier target company operations mainly funded by the IDC, the DBSA and the DFIs. The debt levels in these circumstances tend to be higher than the general 3:1/4:1 of EBITDA ratio and lack the

aggressive managerial tax motives of certain private equity players occurring before the global economic crisis.

One option would be to allow for an increased level of debt if the IDC and/or DBSA represent more than 50 per cent of the funding for the acquisition. Given that this request is likely to be rejected, section 23N should at least be softer in impact so that section 23N no longer eliminates the excess interest deduction but merely operates as a deferral mechanism like section 23M (as in section 23M(4)). The use of the same rule for both sections 23M and 23N will have the further benefit of improving the co-ordination between the two sections.

3. Interest limitation in respect of interest paid to exempt persons (proposed section 23M)

Policy comment #1 (guarantees): The rules relating to guarantees by controlling (i.e. connected) persons are creating a variety of anomalies. Many shareholders with significant share interests in companies provide commercial guarantees unrelated to (taxable and exempt) lenders without any tax avoidance motive. In fact, commercially driven guarantees are the norm. None of these commercially driven guarantees operate as disguised lending from the controlling (i.e. connected) person.

> Example (parent versus subsidiary): South African parent company owns all the shares of South African subsidiary. Further assume that the group is seeking debt finance from various unrelated lenders – some of which are foreign persons and pension funds. Under this scenario, section 23M will never apply if the borrowing is directly incurred by the South African parent company. However, if the South African subsidiary borrows the same funds from the same creditors, section 23M potentially applies if the South African parent company guarantees the debt. Surely, the potential for avoidance is not greater in the latter circumstance?

We note that the guarantee rule of the United States (i.e. section 163(j)) applies only to guarantees made by "exempt persons" – not by all persons. We also note that the U.S. rule has similarly caused unintended difficulties despite the even narrower scope.

The impact of the section 23M rules against guarantees is a real problem because of the frequent use of guarantees as security by various (taxable and tax-exempt) lenders within the domestic market. . Guarantees by themselves do not equate to indirect funding from the guarantor unless there is ring-fenced (indirectly pledged) passive funds backing the guarantee. This form of special purpose guarantee is very rare.

Therefore, it is recommended that section 23M(2)(b)(ii) be removed from the bill (or at least delayed for further consideration). We note that this request is not "technically" outside the Bill because wording is fully within clause 34(1)(b) of the Bill.

Policy comment #2 (threshold): Although technically outside the Bill, we repeat that the connected person threshold for triggering section 23M is far too low. In the initial Bill, the threshold was 70 per cent and concerns were raised at that time that the 70 per cent threshold was too low because the test failed to take into account the use of debt to minimise net equity in the case of carrying Black Economic Empowerment shareholdings (i.e. 26 per cent plus). This anti-avoidance rule is a major concern for many foreign investors, especially the mining sector. Due to a cleaning of wording in the final draft, the threshold was dropped even lower to a connected person standard, thereby exacerbating the problem.

In theory, section 23M is merely intended to protect government against tax avoidance when the creditor and debtor are economically indifferent as to whether the financing between the two parties is equity or debt. In these cases, there is a strong tendency for tax motives to prevail. The "connected person" test is far too low for the creditor and debtor to be viewed as a single economic unit (with a mere 20 per cent connection often triggering a connection when no majority shareholder exists). The U.S. rule of section 163(j) at least requires a more than 50 percent connection.

Admittedly, this issue has been raised before and seemingly disregarded. Taxpayers are just now waking up to this reality. Again, section 23M was enacted for a legitimate policy reason, the rule just needs to be narrowed. It should be remembered that this rule is enacted in combination with the transfer pricing, the latter of which will undoubtedly operate as a second level of defence.

4. REIT unbundlings (proposed section 46(6A))

Policy comment: The removal of tax-free unbundlings in the case of REITs and their controlled subsidiaries is not supported. This change was never announced in the Budget Review (either in the main chapter or in Annexure C) and cannot be viewed as a technical correction. REIT unbundlings have the same policy purpose as any other unbundling.

Admittedly, one issue does exist. This form of unbundling should not be treated as a "qualifying (i.e. deductible) distribution" under section 25BB. Otherwise, a deduction results on the one end and potentially exempt receipts and accruals occur on the other.

5. Small business funding entity (proposed sections 10(1)(cQ) and 30C)

Technical comment: The rules relating to small business funding entities seemingly contain a technical anomaly. In order to obtain this relief, the funding by the entity must be "widely accessible to all small, medium and micro-sized enterprises." The problem with the word "all" is that any legitimate funder will have criteria for distinguishing when and when not to provide a grant. For instance, if the funding organisation limits funding to organisations with a turnover below R500 000, this funding entity would seemingly fail the incentive scheme because the grants would no longer be widely accessible to "all" small, medium or micro-sized enterprises. Other criteria for geographies, population groups and business sectors can also be expected.

Policy comment: The relief does not match the relief for other non-profits even though these entities are essentially funding entities – much like a funding public benefit organisation. More specifically, the relief for passive income (as well as capital gains) is noticeably absent. It is unclear why business profits are favoured when this type of profits raises competitive concerns vis-à-vis domestic taxable entities. The rules also limit recurring fundraising so an internal need exists to grow the limited fundraising via reinvestment (all of which should be completely exempt).

6. *Small Business Relief*

Policy comment: While this issue is not a core issue for our firm given our client base, we expect that many small businesses will object to the change. Stated relief will probably be viewed as a significant tax increase for many. The refundable credit of R15 000 will be viewed as only partial compensation for the administrative compliance burden of most small businesses. Any small business of significance faces a much higher direct and indirect burden. We also doubt whether SARS is comfortable with its new role as "refund" agent (on top of the employment incentive).

However, if a refund mechanism is to be employed, we note that the nature of the relief has so fundamentally changed that the base definition of small business must also be reconsidered because the regime no longer has an incentive flavour. For instance, small businesses involving services should probably be added to the definition because these small businesses face the same administrative tax burdens.

III. BUSINESS (FINANCIAL INSTITUTIONS AND PRODUCTS)

1. Insurance – Definition of risk policies (section 29A(1))

Policy comment: The definition of risk policy is too broad and outside the stated objective. Risk policies with profits economically favouring the insurer (as opposed to

the insured) in the case of long-term insurance can only involve death, disability and severe illness. The definition instead covers "any amount payable [that] is dependent on any future event of which the occurrence is uncertain". As a result, the definition seemingly includes all of the various forms of "smooth bonus" and other complex investment plans. These pure investment products were the core reason for the four fund policy system and should accordingly remain within the policyholder funds unless a decision is made to abandon the four fund system altogether.

IV. BUSINESS INCENTIVES

1. Further adjustments to the R&D incentive (section 11D)

Administrative comment: The amendments offered are supported (including the associated regulations). The main issue is the slowness and unwieldiness of the application process. Unlike the few applications required for incentives like the IPP, the potential number of R&D applications is simply too large for a small number of staff from multi-departments to process. Yet, given the potential for the uncontrolled loss of revenue due to the nature of the incentive, we understand the multi-department approach.

In order to remedy the above, we would suggest that the National Treasury provide a specific allocation of maximum expenditure permitted that can be spent on R&D. In this way, the tax expenditure can be better controlled like an indirect grant. Under this approach, the multi-departmental approach could be dropped with the DST being fully in control. A SARS team member would only be needed to verify that the project proposed technically falls within the potential parameters of section 11D and that the estimate of the tax expenditure is properly calculated.

2. *Industrial policy projects (proposed proviso to the "manufacturing asset" definition" of section 12(1))*

Technical comment: The need for the deeming in section 12I in respect of section 13 and 13*quat* is not entirely clear given the existence of section 12N. One can only presume that the intention is to cover leased property owned by lessors outside the list of lessors contained in section 12N. If so, this deeming is insufficient because the additional allowance will only be available in respect of section 12I but not in respect the basic allowance under section 13 and 13*quat* (because section 12N does not apply). It makes no sense to provide the additional incentive without the basic allowance.

What is probably intended is that manufacturing and UDZ buildings that are part of an industrial project be treated as owned for all purposes of the Income Tax Act (thereby

covering both additional and basic additional depreciation). If so, this provision needs to be redrafted.

Policy comment: Lessee created "plant" under section 12C is a major omission to the relief intended. Unlike machinery, "plant" constructed on a lessor's property is no longer "owned" by the lessee if constructed on lessor land (like the underlying structure of section 13 and 13quat). The cost of "plant" is substantial and the real "value-addition" for industrial projects. Therefore, section 12C should be brought within the relief for plant constructed on leased property to the same extent as sections 13 and 13*quat*. We also note that section 12C plant should be added to section 12N.

3. *PPP improvements (proposed section 12NA)*

Technical comment: The need for a new section in regards to leased improvements or buildings pursuant to a lessor obligation is unclear. The main distinction between this section and section 11(gA) appears to be the existence of a national or provincial government lessor. Rather than create confusion with the creation of yet another section in this area, provision (vi) of section 11(1)(g) should be redrafted so as not apply if the lessor is national or provincial government operating as part of a PPP project. The net result is to bring the rules back within the standard subset of section 11(1)(g) rather than create confusion of another section. If double dipping under section 10(1)(zI) is a concern (as indicated in section 12NA(3)), section 10(1)(zI) grants should be added to the anti-double dipping rules of section 12P.

V. INTERNATIONAL

1. Transfer pricing (proposed section 31(3))

Technical comment: While the proposed amendment is widely supported, concerns exist about the transition from the current rule to the proposed rule. In particular, even though the adjustment is proposed to take effect from 1 January 2015, it is unclear how interim adjustments will be treated going forward that stem from the pre-1 January 2015 period. For example, will the deemed loan that arose due to non-arm's length transactions entered into before 1 January 2015 continue to exist or will this pre-existing deemed loan be converted to a dividend on 1 January 2015?

Policy comment: Deemed dividend treatment is generally correct for a correlative adjustment. However, what if the under-pricing benefits a foreign subsidiary? In this case, the deemed downward transfer from a South African company to a foreign subsidiary is more akin to a tax-free contribution than to a deemed dividend.

VI. VALUE-ADDED TAX

1. Electronic commerce (section 1 "enterprise definition" of the VAT Act)

Technical comment: This paragraph should be amended by the deletion of the words "where a tax invoice will be delivered". If this amendment is not undertaken, a person will not be carrying on an "enterprise" if that person supplies electronic services from an export country to a non-resident in South Africa and payment originates from a South African Bank but that non-resident elects that the tax invoice is delivered outside of the Republic.

Policy comment 1: It is concerning that after the new legislation has been implemented; there are already suggested changes to the legislation. These changes have an impact on the registration liability of e-commerce companies that have already registered under the current definition. In the first set of amendments, there was a requirement that the electronic services should be made either to a recipient being a South African resident OR where any payment for those services originate from a South African bank account. Now the suggested changes requires at least two circumstances to be present, which would imply that some of the original companies who were liable to register under the initial amendments would not have been required to register under these new requirements. The concerning question is whether these companies who have already registered are now required to deregister for VAT.

Policy comment 2: Further with regards to the paragraph (cc) requirement, taking into account that electronic services are a service rendered via the internet, it is highly unlikely that any recipient of these services would receive a tax invoice delivered at an address in the Republic. They would more likely receive these invoices via email with an email address as the address on the invoice. Does government specifically require a physical letter or does government envision that tax invoices emailed to an email address which is accessed in South Africa also be included?

2. Deletion of the zero rating for agricultural products (proposed deletion of section 11(1)(g) of the VAT)

Policy comment: The wholesale deletion of the zero rating for agriculture products on the grounds of avoidance cannot be justified. We are indirectly aware of the few schemes involved and the stated avoidance is far from widespread. While we understand that discussions are underway and accelerated refunds are a stated option, we doubt these accelerated refunds will ever occur in practice. If a specific avoidance is a stated concern, a narrow anti-avoidance rule should suffice. Farmers will also be losing the 4-monthly Category D so as to further add to their burdens.