OLDMUTUAL INVESTMENT GROUP

ALTERNATIVE INVESTMENTS

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Dear Mr Allen Wicomb,

Comments on Clause 34 of the Draft Taxation Laws Amendment Bill ("TLAB")

We represent the R9.15bn Housing Impact Fund of South Africa (HIFSA) and the R1.2bn Schools and Education Investment Impact Fund of South Africa (SEIIFSA). HIFSA focusses on the lower income market attempting to deliver and fund houses for sale and for rent to those who qualify primarily in terms of the Financial Sector Charter. In SEIIFSA the Fund focusses on stimulating affordable independent schools that deliver quality education.

The investors in these Funds are largely pension funds, the Government Employees Pension Fund, the Eskom Pension Fund, Old Mutual Life Assurance Company South Africa and the Development Bank of Southern Africa as the one exception. Almost all of these bodies have tax exempt status for their core funds. The Funds are managed by the Development Impact Funds team of the Old Mutual Investment Group.

The investments are large, an average size in excess of R400m, and utilise implementing agencies that are on average the smaller construction or property management companies. In order to secure our funding the investments are structured in separate terminating ring-fenced Special Purpose Vehicles where the Fund seeks control in order to be able to step in should there be management failure in the project. The Funds will normally seek to hold 50% of the equity and takes most of the mezzanine and senior debt. In this way we seek to secure the outcome.

The Funds' investments consequently consist of a combination of shares, loan capital and guarantees. Where funding is provided to a Special Purpose Vehicle set up to hold a housing or school project, HIFSA and SEIIFSA will take an equity stake as security for the funding provided. The projects that we invest in take between eight and fifteen years to complete and repay the bulk of the debt. This is a very long investment horizon when one is dealing with partners who might not in and of themselves be investment grade. Many experience some form of management stress during the course of the project and we step in to support or replace management during such events. In our experience it has always been critical for us to be able to take rapid action to secure our investment. Pricing cannot replace the security we gain through maintaining a controlling interest in the project.

Most of the projects that we invest in cannot access meaningful scale debt from any other source at this point in time.

In most of these terminating ring-fenced SPVs we charge interest but the SPV receives its cash in the form of either rental or the sale of houses. We estimate that as a consequence of the new proposed section 23M of the Income Tax Act the cost of producing these houses will now escalate, exacerbating the current affordability problems that low income people experience even more.

Clause 34 of the Draft TLAB contains amendments to section 23M of the Income Tax Act. However, these amendments do not appear to ameliorate what we perceive as possible unintended consequences of this section of the Act on project finance type structures.

This mix of equity and debt can create a problem under section 23M because the creditor (or guarantor) can potentially be viewed as connected persons with the Funders where the shareholder interests are as low as 20 per cent, and in our Funds' case we will normally strive for 50% for security. The result is that the interest charged in the housing or school SPV would not be deductible.

We are concerned over what is possibly an unintended consequence of section 23M.

To the best of our knowledge, section 23M is intended to prevent the loss of revenue caused by excessive interest deductions paid to connected exempt persons. It is aimed primarily at foreign taxpayers who do not pay tax on interest received via domestic law (or via tax treaty). As tax-exempt persons are treated equally to prevent the anti-avoidance rule from being viewed as discriminatory against foreign persons, project finance SPVs have become swept into the ambit of section 23M.

Unfortunately, the current version of section 23M negatively impacts the abovementioned special purpose vehicles holding housing or schools projects because domestic tax-exempt parties are the key investors. These exempt persons include pension funds, untaxed policyholder funds of long-term insurers and the Development Bank of Southern Africa.

We do not believe that it is Government's intention to increase the cost of housing or schooling to families that qualify in terms of the Financial Sector Charter income bands. HIFSA will be delivering around 60,000 housing units into the affordable market over the next five to eight years. Currently with building costs escalating faster than inflation, interest rates rising, Basel III reducing available mortgages and the over indebted status of most of our target market, the impact of both direct (VAT) and indirect (23M) taxation makes purchasing a house out of the range of many within the FSC income bands.

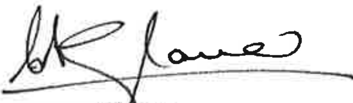
Denial of interest deductions effectively raises the cost of capital so as to create a barrier for significant investment into housing developments thus making Financial Sector Charter type development funds unlikely under the auspices of exempt pension funds.

From the perspective of developmentally focussed funds that invest by way of terminating ring-fenced SPVs what is most critical is:

- The definition of connected party. Since control is an important aspect of our security we often structure the projects such that the Funds maintain 100% control until the debt has been paid off at which stage our counterparty has a call on 50% of the shares. For tax efficiency we need to give up a material part of our security and put exempt pension funds in a position where they are forced to take on a significantly higher credit risk. This again will drive the cost of capital up.

We hope that the above discussion convinces you of the importance of this matter and the urgent need for change. Please contact Christine Glover on (021) 509 5977 should you wish to discuss this matter further.

Yours sincerely



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