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memorandum

to	**Mr. Allen Wicomb (awicomb@parliament.gov.za)**	our ref
cc		your ref
from	ENSafrica	
date	12 September 2016	

TO: THE HONOURABLE MEMBERS, STANDING COMMITTEE ON FINANCE

RE: SUBMISSION TO NATIONAL TREASURY ON THE DRAFT TAXATION LAWS AMENDMENT BILL, 2016

Introduction

We thank you for the opportunity to put forward submissions for consideration by the SCOF in September 2016. Our firm has previously made submissions in this regard to National Treasury. We value the opportunity to participate in the tax law development process. Our submissions are set out below under separate subject headings, followed by the details in each case of the contributors to such submissions.

1. **Clause 12: Insertion of section 7C into the Income Tax Act ("the Act")**

1.1. National Budget Proposal

1.1.1. It is noted that it has been proposed that a person who has made an interest-free loan available to a trust must pay income tax on the amount of interest that would have been levied at the so-called official rate as prescribed in the Seventh Schedule to the Act.

1.1.2. The 2016 Budget Review stated as follows at page 49:

1.1.2.1. 'An important role of the tax system is to reduce inequality. Some taxpayers use trusts to avoid paying estate duty and donations tax. For example, if the founder of a trust sells his or her assets to the trust, and grants the trust an interest-free loan as payment, donations tax is not triggered and the assets are not included in his

or her estate at death. To limit taxpayers' ability to transfer wealth without being taxed, government proposes to ensure that the assets transferred through a loan to a trust are included in the estate of the founder at death, and to categorise interest-free loans to trusts as donations. Further measures to limit the use of discretionary trusts for income-splitting and other tax benefits will also be considered.'

1.1.3. However, the measure contained in Clause 12 is quite different to what was intended above and is far more punitive.

1.1.4. If National Treasury had given effect to the announcement contained in the National Budget the taxpayer's estate would have been increased for estate duty giving rise to payment of 20% of the increased value thereof even though the assets in issue are owned by a trust. The proposal in Clause 12 has the result that the affected taxpayer is subject to tax on interest levied, currently at a rate of 8% on the interest-free loan for as long as the loan is in existence.

1.1.5. It is appropriate to illustrate the effect of the proposal using an example. Assume a taxpayer advanced a loan of R 1 000 000 to a trust which used those funds to acquire shares in listed or unlisted companies and that the taxpayer has a life expectancy of 20 years.

1.1.6. The loan will constitute an asset in the estate of the taxpayer upon their death giving rise to estate duty of R 200 000. If the assets owned by the trust are worth say R 2 100 000 when the taxpayer dies the estate duty would be increased by an amount to R 220 000 if the proposal set out in the National Budget were given effect to. This amounts to a total amount of estate duty payable of R 420 000.

1.1.7. If section 7C is inserted as proposed the taxpayer will be taxed on an amount of income of R 80 000, being 8% of R 1 000 000, per year for the remaining 20 years of his life, which amounts in aggregate to R 1 600 000 and equates to income tax due of R 656 000. In addition, donations tax may be payable thereon as well of a further R 131 200 if the taxpayer does not recover the tax from the trust. The total tax payable amounts to R 787 200 which is significantly higher than the tax payable under the Budget proposal being the increase in estate duty of R 220 000.

1.1.8. Furthermore, the proposed measure is punitive in that the trust will not obtain any relief either for income tax or capital gains tax on the income deemed to be taxable in the hands of the person who sold the assets to the trust.

1.1.9. If the measure to counter the sale of assets to trusts is proceeded with it should be introduced in the manner set out in the 2016 National Budget.

1.2. Davis Tax Committee

1.2.1. In the period between the tabling of the draft Bill, and these submissions, the second report of the Davis Tax Committee has been released for consideration by the Honourable Minister of Finance. It proposes wide ranging changed to the taxation of trusts.

1.2.2. For this reason alone the proposed amendment should be suspended and not introduced until the position of tax and trusts in South Africa has been dealt with holistically.

1.3. General comments on the proposed section 7C

1.3.1. Currently it is provided that the new provision shall come into operation on 1 March 2017 and apply in respect of years of assessment commencing on or after that date. This amendment is clearly retrospective in effect in that it will affect loans made many years prior to the legislation was ever conceived of and is thus repugnant and a violation of the rule of law and thus a violation of the Constitution itself. If anything, the proposal should only take effect in respect of advances or loans made on or after 1 March 2017 and not before that date.

1.3.2. In addition, the proposal as currently drafted could constitute an undue expropriation of taxpayer's property and thus a violation of the constitutionally entrenched right to property on the basis that the amendment is punitive and unreasonable.

1.3.3. Furthermore, the proposal is punitive in that the person who made the loan available to the trust will be liable to tax in the manner specified in the clause without the trust obtaining any relief on the amount payable for either income tax or capital gains tax which amount is effectively included in the affected persons' taxable income.

1.3.4. The clause makes no distinction between loans advanced to domestic trusts and foreign trusts. Clearly, where an interest-free loan is advanced by a SA resident to a non-resident trust that person is subject to the provisions of section 31 which will deem the taxpayer to have received interest at an arm's length basis on the loan so advanced. In such a case, is it intended that section 31 will operate and not the proposed section 7C?

1.3.5. Where funds are loaned to a trust are used to purchase income producing assets, such as rental properties, any interest thereon would be deductible under the general deduction formula contained in the Act and symmetry of tax treatment of the trust's founder or funder and the trust is ensured. However, where the funds are utilised to acquire listed or unlisted shares no deduction for interest is allowed and for capital gains tax purposes only a limited amount of the interest incurred on listed shares may be added to the base cost of the shares. If the amendment is proceeded with the tax symmetry of treatment is disregarded as the trust would not under current provisions be entitled to claim a deduction for interest paid to the founder or funder where the trust acquires shares.

1.3.6. Another concern regarding the enactment of the provision is the adverse cash flow consequences that may arise. The funder or founder of the trust is required to increase their taxable income in the prescribed manner and if the trust does not reimburse the person, donations tax is payable on the tax paid to SARS. Typically the trust will hold shares in private companies which may not pay dividends and thus the trust will not have the cash resources to refund the tax to the founder or funder of the trust. The trust should not be required to realise its assets to place it in cash funds to repay the founder or funder the tax due under the provision.

1.3.7. In many cases a trust will own the home occupied by the founder to protect that asset from financial risks. The founder will normally pay the expenses relating to the maintenance and upkeep of the property. These amounts will result in the trust becoming indebted to the founder. Is it proposed that amounts paid by the founder to maintain the property are also subject to the new section 7C?

1.3.8. Furthermore, the new sections should not apply to vested trusts, that is, where the trust income and capital vests in favour of a beneficiary.

1.3.9. It is unclear in law how the founder will recover the increase in tax from the trust assets as this may violate the provisions of the trust deed or even possibly the provisions of the Trust Property Control Act of 1988.

1.3.10. Trusts are utilised by many people to protect assets from creditors for the benefit of the family and to facilitate ease of succession in law and not primarily to avoid estate duty or income tax. The measure proposed in the clause is extremely draconian and should not be proceeded with without further substantial broad consultation and the possibility of trusts being unwound without adverse tax consequences arising no different to the legislation

introduced to facilitate the transfer of primary residences from trusts to natural persons on two separate occasions.

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2. **Clause 14 and proposed Introduction of section 8CA and amendments to section 8C and 10(1)(k) of the Income Tax Act, 58 of 1962**

2.1. Proposed insertion of section 8CA

2.1.1. Clause14 of the 2016 Draft Taxation Laws Amendment Bill ("**TLAB**") inserts a new section 8CA under the heading "*Deduction of expenditure in respect of restricted equity instrument scheme*". In terms of this section, any expenditure actually incurred and paid by an employer in respect of a restricted equity instrument scheme must be treated as expenditure incurred evenly over the longest period during which an equity instrument can qualify as a restricted equity instrument in terms of that scheme. According to the explanatory memorandum to the TLAB issued on 8 July 2016 ("**EM**"), this amendment seeks to provide more certainty on how the employer should treat the contributions made to the employee share scheme in respect of restricted equity instruments.

2.2. Comments:

2.2.1. Clarification required in the case of indefinite employee share schemes:

2.2.1.1. It is submitted that many incentive schemes operate on an "evergreen" basis where the equity instrument remains restricted for an unknown period (i.e. there is no determinable vesting period.) For example, employee share schemes aimed to promote Black Economic Empowerment ("**BEE**") ownership and comply with BEE legislation generally do not have a determinable vesting period. The indefinite nature of the share scheme is beneficial in these cases as

it ensures a long life of the BEE employee share scheme, which provides certainty to business and also reduces costs related to establishing a new share scheme.

2.2.1.2. As the deduction will be spread over the period during which the restriction in respect of the restricted equity instrument applies, this amendment does not clarify how the deduction should be determined for an employer where there is no specified period for which the restriction will apply. This will be the case where there is no fixed incentive/restriction period.

2.2.2. Clarification that the amendment is limited to a restricted equity instrument in issue at the time at which the relevant expenditure is incurred:

2.2.2.1. Example:

Facts:

2.2.2.1.1. A Ltd establishes an employee incentive plan in terms of which qualifying employees may from time to time and at A Ltd's discretion, be granted a conditional right to receive a specified number of shares at a specified future date. In terms of the plan rules, this specified number of shares and specified future date must be determined in advance by A Ltd at its absolute direction, and communicated to the relevant qualifying employee in a 'grant notice'.

2.2.2.1.2. The plan rules provide that the plan will only terminate when there are no longer any participants in the plan, and A Ltd has resolved that the plan should be terminated.

2.2.2.1.3. In year one of the plan's operation, qualifying employee B acquires a conditional right to receive 50 shares in year five of the plan's operation.

2.2.2.1.4. In year three of the plan's operation, A Ltd incurs and actually pays expenditure of R100 in connection with the plan. During the same year, qualifying employee C acquires a conditional right

to receive 50 shares in year six of the plan's operation.

Result:

2.2.2.1.5. In terms of the current proposed wording of section 8CA(2), it is unclear which of the following is correct:

2.2.2.1.5.1. A Ltd will be entitled to deduct an amount of R20 per year over a five year period commencing from the date on which it incurred the R100 expenditure, on the basis that, in terms of the plan rules, the longest possible period during which an instrument can qualify as a "restricted equity instrument" in terms of the plan rules is the five year vesting period commencing from the award of the conditional rights to employee B, and ending in year five of the operation of the plan.

2.2.2.1.5.2. A Ltd will be entitled to deduct an amount of R33.33 per year over a period of three years commencing from the date on which it incurred the R100 expenditure, on the basis that the longest possible period during which an instrument can qualify as a "restricted equity instrument" in terms of the plan rules, calculated from the date on which the expenditure was incurred, is the three year vesting period of employee C's conditional rights, expiring in year six of the plan's operation (as opposed to the remaining two years of the five

year vesting period in applicable to employee B's shares).

2.2.2.1.5.3. A Ltd will effectively not be entitled to a deduction, as the longest possible period during which an instrument can qualify as a "restricted equity instrument" in terms of the plan is infinite, the plan having a no specified termination date (i.e. the plan may operate in perpetuity) and A Ltd having absolute discretion to determine the vesting period in respect of awards.

2.2.2.1.6. It is submitted that the option set out in 2.2.2.1.5.2 above would produce the most equitable results.

2.2.3. Consideration of a cross reference to section 23H:

Consideration may also be given to the inclusion in the proposed new section 8CA(2) of a cross reference to section 23H of the Act, clarifying that section 8CA(2) will apply notwithstanding the provisions of section 23H.

2.2.4. Comment on the insertion of section 8CA(3):

The section of the EM to the 2016 TLAB dealing with the proposed new section 8CA(3) currently refers to '*historic costs actually incurred and paid by the employer to provide its employees with restricted equity instruments scheme*'. It is submitted that this reference should be expanded to clarify, or provide examples of, the various sorts of expenditure which would be deductible in terms of this proposed new section 8CA(3). A specific aspect is whether employers will be entitled to a deduction in respect of the amount of any dividend paid to an employee which constitutes "remuneration" as defined?

Some of our clients have also raised the suggestion that affording a deduction for employers in respect of amounts which constitute "remuneration" for tax purposes, is likely to assist with the avoidance of economic double taxation. However, they have highlighted that consideration should be given to the fact that, in many instances the group structures of companies may include a holding company which holds all of the shares of its operating subsidiaries. The

holding company would generally only earn exempt dividend income and would be the entity making the distributions in respect of the restricted equity shares. Such company would, firstly, not be the employer and would accordingly not qualify for the deduction in the current proposed section 8CA(3) and, secondly, would not have any taxable income against which to utilise a deduction. The distributions to employees in respect of the restricted equity instruments would still, however, be funded by operating income from the underlying subsidiaries which was subject to corporate income tax in their hands. The deduction would accordingly be most appropriate at the employer company level. Even in this scenario, however, the deduction would reduce the tax burden of the entire company, but shareholders who are employees would only receive a dividend pro rata to their shareholding. As such there would be a mismatch in the sense that all shareholders would receive the "benefit" of the deduction, but employees would be taxed on the full dividend they receive. This would result in the impractical need to create different classes of shares in order to create parity. Appropriate amendments to section 8CA(3) should therefore be given careful consideration.

3. **Clause 24: Proposed amendment of section 10(1)(k)**

3.1. Clause 24(d) of the TLAB deletes paragraph (dd) of the proviso to section 10(1)(k)(i).

3.2. Clause 24(e) of the TLAB amends section 10(1)(k)(i)(ii) by the substitution of the section with the following:

"*(ii) to any dividend received by or accrued to a person in respect of services rendered or to be rendered or in respect of or by virtue of employment or the holding of any office, other than a dividend that accrued in respect of-*

(A) an equity instrument as defined in section 8C after that equity instrument vested in that person as contemplated in that section; or

(B) a marketable security contemplated in section 8A held by that person;"

3.3. With regard to dividends received in respect of restricted equity instruments, the EM states that the current requirements regarding dividends in respect of restricted equity instruments that are exempt from normal tax do not deal adequately with dividends consisting of or derived from –

3.3.1. The proceeds from the disposal or redemption of -

3.3.1.1. The underlying equity shares; or

3.3.1.2. Shares from which those equity shares derive their value; or

3.3.2. The liquidation of a company from which those equity shares derive their value.

3.4. Comments:

3.4.1. Treatment of ordinary dividends:

3.4.1.1. The effect of the proposed amendments is to treat **all** dividends received in respect of a restricted equity instrument scheme as ordinary revenue and to clarify that dividends will only be exempt after the restriction falls away and the equity instrument vests in the employee in terms of section 8C or when a marketable security is held by an employee in terms of section 8A.

3.4.1.2. It is accepted that National Treasury wishes to tax the "redemption" of the restricted equity instruments, as opposed to the existing practice whereby these transactions attract dividends tax of 15% only. The proposed amendment achieves what the EM sets out to explain what is intended to be achieved, **however, as the proposed amendment currently reads, all dividends received by a person will be taxable until such time as the shares becomes unrestricted**.

3.4.1.3. National Treasury is advised that if the amendment extends to ordinary dividends, which is what the current proposed changes appear to do, it will have a negative impact on the objectives of BEE legislation and the Mining Charter. In this regard we note the following:

3.4.1.3.1. Companies implement BEE share schemes to comply with BEE legislation and the Mining Charter, which involve a broad based workforce.

3.4.1.3.2. Most of the share schemes are implemented through a trust. In fact, in terms of the Draft Reviewed Broad Based Black-Economic Empowerment Charter for the South African Mining and Minerals Industry, 2016 (the "**Draft Mining Charter**"), it will become a requirement for mining companies that at least 5% of the required 26% BEE shareholding must be held by employees and communities through a trust and the employees

specifically through an Employee Share Ownership Plan ("**ESOP**").

3.4.1.3.3. These ESOPs are normally structured that the employees each receive an equal portion of the dividends declared in respect of the equity shares held by the trust.

3.4.1.3.4. Currently, the dividend tax of 15% is withheld on dividends declared to the trust and all employees receive an equal amount of dividends. However, if this change is effected, each employee will be taxed according to their marginal tax rate; it will increase the UIF and SDL contribution; which all impact the take home amount for the respective employees. The additional amount of dividends to be included in remuneration may also push an employee into a higher bracket which may result in an overall lower take home pay for the year. This will have a dire financial impact on lower income earning employees.

3.4.1.3.5. Based on our experience and dealings with the Human Resources departments and Union representatives in relation to ESOPs this will cause tension and possibly negatively impact the employees financially. Our mining clients have indicated that they would probably have to gross up the dividend amounts with the respective taxes to be paid in order to provide the same benefit it used to provide and to make the distributions equal amongst the workers. This will be an additional cost to an already economically impaired industry, the consequences which are likely to be catastrophic.

3.4.1.3.6. We believe that applying a dividend tax to ordinary dividends is more efficient and easier for the South African Revenue Service to administer and audit, as opposed to including ordinary dividends in income of individuals.

3.4.1.3.7. It is thus submitted that the proposed amendment should be redrafted to tax only the "redemption" of the restricted equity instruments, which is what the amendment is focused on, with an appropriate carve-out / exemption where dividends are distributed by a company to its shareholders on a pari passu basis. Put differently, the scope of the proposed amendments should be limited to dividends declared in respect of restricted equity instruments prior to the date of their vesting in terms of section 8C, which has the effect of diminishing the value of those restricted equity instruments upon the date of their vesting for purposes of section 8C. This should adequately address the mischief identified, without unduly prejudicing employees *inter alia* in the manner illustrated in the example provided below.

3.4.1.4. We note that, as mentioned above, the draft Mining Charter sets out that the 26% BEE shareholding should also include communities, black entrepreneurs etc. Normally the shares acquired by the BEE shareholder and the employees have the same restrictions relating to the transferability of the share for purposes of locking in BEE and therefore making it a restricted equity instrument. However, based on the proposed change, the tax treatment in respect of the BEE shareholders will be different in that BEE shareholders that are employees are taxed on dividends as income and other BEE shareholders are taxed as shareholders. This treatment is inconsistent and counterproductive to the objective that the Mining Charter and BEE legislation in South Africa is seeking to achieve with regard to broad-based ownership opportunities for workers of businesses.

4. Clause 13: Proposed amendment to section 8C(1A)

4.1. Clause 13 of the TLAB proposes to amend section 8C(1A) by deleting the section and replacing it with the following:

"(1A) A taxpayer must include in his or her income any amount received by or accrued to him or her in respect of a restricted equity instrument for the year of assessment during which that amount is received or accrues if that amount is not-

(a) Distributed to him or her as a return of capital or foreign return of capital by way of a distribution of a restricted equity instrument;

(b) Subject to the provisions of this Act with respect to a dividend of that restricted equity instrument; or

(c) Taken into account in terms of this section in determining the gain or loss in respect of that restricted equity instrument."

4.2. According to the EM, the reason for the change is to give effect to the implicit assumption that the full value of the equity shares underlying a restricted equity instrument will vest and accordingly, be included in the income of an employee when the restriction fall away.

4.3. Comments:

4.3.1. Deduction of costs incurred in acquisition of restricted equity instrument:

4.3.1.1. In respect of the changes proposed to section 8C(1A), we note that currently it states that "A taxpayer must include in his or her income **<u>any amount received by or accrued</u>** to him or her in respect of a restricted equity instrument " (our emphasis).

4.3.1.2. This change does not deal with the situation if the employee incurred expenditure to acquire the restricted equity instrument. Will the cost incurred to acquire the restricted equity instrument be allowed to be deducted from the amount received or accrued and must it be included in his or her income? Surely, the cost incurred to acquire the restricted equity instrument should be available to set-off against the amount received or accrued and must be included in income.

4.3.2. Commercial disparity:

4.3.2.1. The commercial disparity created by the insertion of section 8C(1A), together with the proposed amendment to section 10(1)(k) is illustrated below:

Facts:

X (Pty) Ltd operates an employee share incentive plan in terms of which qualifying employees of X (Pty) Ltd are offered the opportunity to purchase shares in X (Pty) Ltd at market value. The

only restriction on the shareholding of these qualifying employees is that these shares may be forfeited for an amount equal to or the lesser of: i) their market value, or ii) the consideration paid by for those shares, if they leave the employ of X (Pty) Ltd under certain specified circumstances. This restriction falls away after a period of five years. Commercially, this plan is intended to align the interests of the qualifying employees of X (Pty) Ltd with the interests of its shareholders, and to encourage the retention of qualifying employees.

In January of year 1 of the plan's operation, Y purchases shares in X (Pty) Ltd to the value of R100 in terms of the plan. In May of year 1 of the plan, Z purchases shares in X (Pty) Ltd worth R100 in terms of the plan. These shares constitute "restricted equity instruments" for purposes of section 8C, as a result of the abovementioned restriction, which will remain in place until year 5 of the plan's operation.

In May of year 1 of the plan, a third party individual investor purchases shares in X (Pty) Ltd for an open market value of R100.

Over the next five years, in the ordinary course of its business, X (Pty) Ltd distributes an agreed percentage of its profits to its shareholders as an annual dividend, which it pays in June each year. These dividends do not reduce the value of the issued shares in X (Pty) Ltd. A, Y and Z each receive an aggregate amount of R10 in this regard, over the five year period.

X (Pty) Ltd declares an additional dividend in April of year 5 of the operation of the plan, which reduces the value of the shares in X (Pty) Ltd by 10%. A, Y and Z each receive an amount of R10 in this regard.

Y and Z are still in the employ of X (Pty) Ltd at the vesting date of their respective shares in X (Pty) Ltd. X (Pty) Ltd shares increased in value by 10% from year 1 to year 5 of the operation of the plan.

Result:

Over the five year period contemplated above, A (an ordinary, third party shareholder in X (Pty) Ltd) pays dividend withholding tax at a rate of 15% on all dividends declared by X (Pty) Ltd, being R3 (15%

of the R10 annual dividends received by A from X (Pty) Ltd plus 15% of the R10 additional dividend received by A from X (Pty) Ltd in April of year 5).

If the proposed amendments are introduced subject to the amendments we have suggested, Y and Z each will pay dividends withholding tax at a rate of 15% on the R10 ordinary dividends received in respect of their shares in X (Pty) Ltd, being a total of R1.50 each. Y and Z will also pay income tax at a maximum effective rate of 41% on the market value of their shares in X (Pty) Ltd as at the date of vesting, less the consideration paid by them for same. This will amount to R4.10 - 41% of R10 (R110 – R100 = R10) - in the case of Y, and R0 - 41% of R0 (R100 – R100 = R0) - in the case of Z (the value of Z's shares as at the date of vesting having been reduced by 10% as a result of the special dividend declared by X (Pty) Ltd in April). In addition, Z will pay income tax at a maximum effective rate of 41% on the amount of the special dividend which reduced the value of Z's shares in X (Pty) Ltd, being R4.10 (41% of R10). Y will pay dividends withholding tax on this additional dividend at a rate of 15%, being R1.50.

If, however, no changes are made to the proposed amendments, Y and Z will pay income tax at a maximum effective rate of 41% on all dividends received in respect of their shares in X (Pty) Ltd prior to the vesting of their shares, being R8.20 each (41% of the R10 annual dividends paid by X (Pty) Ltd plus 41% of the R10 additional dividend paid by X (Pty) Ltd in April of year 5). Y and Z will also pay income tax at a maximum effective rate of 41% on the market value of their shares in X (Pty) Ltd as at the date of vesting, less the consideration paid by them for same. This will amount to R4.10 - 41% of R10 (R110 – R100 = R10) - in the case of Y, and R0 - 41% of R0 (R100 – R100 = R0) - in the case of Z (the value of Z's shares as at the date of vesting having been reduced by 10% as a result of the special dividend declared by X (Pty) Ltd in April).

The former result is more closely aligned with commercial reality that, having paid market value for their shares in X (Pty) Ltd, Y and Z are, aside from the special restriction placed on their shares in terms of the plan, effectively ordinary shareholders in X (Pty) Ltd.

4.3.3. General comments:

4.3.3.1. In addition to the comments listed above, we note that the proposed amendments as currently formulated:

4.3.3.1.1. may result in economic double taxation (the relevant employer company being taxed on its income at 28%, and the employee being taxed on distributions of this income at a maximum effective rate of 41%, resulting in a total tax burden of 69%; and

4.3.3.1.2. could result in the already onerous tax costs of share incentive arrangements becoming intolerable for employers and employees, with the result that these arrangements will no longer be implemented.

4.3.3.2. This is likely to impact upon employer's abilities to effectively and efficiently facilitate BEE ownership arrangements, align the interests of its employees with its shareholders and encourage employee retention through share ownership. It is also likely to discourage the economic growth opportunities afforded by share ownership plans, which currently allow employees to save by investing in shares, which grow in value over time.

4.3.3.3. Furthermore, there does not appear to be any policy reason to tax share based incentive plans in a manner which would be more punitive than any other salary or bonus scheme, particularly since capital growth is already taxed as income in these plans, for the duration that the relevant instrument is "restricted" for purposes of section 8C.

5. Proposals to National Treasury

5.1. It is submitted that:

5.1.1. A significant number of employees are currently locked into incentive arrangements which may be affected by the proposed amendments.

5.1.2. The proposed amendments will effectively reduce the benefits participants will receive under affected plans, and if the relevant amounts are regarded as remuneration, will effectively reduce the remuneration they receive.

5.1.3. The majority of significantly impacted employees are likely to be beneficiaries of BEE incentive plans, given the qualifying scoring criteria applicable to BEE plans, which require actual ownership interests and the payment of dividends. In light of the fact that these employees may be locked into plans, and that their remuneration could effectively be reduced, the proposed amendments are essentially anti-BEE in their effect.

5.1.4. From an employers' perspective, the reduction in benefits to employees with no corresponding deduction or reduction in the cost of providing the plan, effectively increases the costs of providing employees with these benefits.

5.2. Given the complex, specialised nature of these provisions, as well as the significant commercial and economic impact which the proposed amendments, if implemented as currently proposed, would have on employers and employees respectively in relation to *inter alia* BEE ownership plans, existing share-based plans and the entire share-based employee incentive space going forward, **an opportunity for further interaction with National Treasury would be greatly appreciated before amendments are effected**. It is recommended that the following groups be afforded the opportunity to be represented in such interactions:

5.2.1. BEE advisors who specialise in the implementation of employee ownership plans;

5.2.2. financial modelling companies who calculate the economic outcomes for employers and employees of incentive arrangements;

5.2.3. employers with existing plans in place, whose employees would be adversely affected by these proposed amendments; and

5.2.4. the trade unions representing potentially affected.

5.3. To the extent that the above proposal is not accepted:

5.3.1. Firstly, for the reasons set out above we strongly submit that, at least:

5.3.1.1. the scope of the proposed amendments should be limited to dividends declared in respect of restricted equity instruments prior to the date of their vesting in terms of section 8C, which will have the effect of diminishing the value of those restricted equity

instruments upon the date of their vesting for purposes of section 8C; and

5.3.1.2. where amounts are taxable in the hands of participants in an incentive scheme, the employer company be afforded a deduction, similar to a remuneration payment.

5.3.2. Secondly, we propose that **section 8B** of the Income Tax Act should be reconsidered, especially in light of the BEE legislation and the Mining Charter. The uptake of section 8B is very limited due to the restrictions and the value ceiling in section 8B. We highlight a few of these and would appreciate the opportunity to discuss this in more detail with National Treasury:

5.3.2.1. The limitation on the value i.e. R50 000 for 5 preceding years could be problematic especially in the current economic environment, such as the mining industry, where the share price is volatile.

5.3.2.2. The requirement that more than 80% of employees must participate but those employees cannot also participate in other equity schemes – most mining companies have other share schemes in place to promote e.g. talented management staff, women staff etc.

5.3.2.3. Furthermore, the requirement of 80% is very high in some cases. Mining companies need to empower black employees as required in the BEE legislation and Mining Charter. Thus, the company would set out to establish a trust for black employees. In some cases, less than 80% of the staff would be black or would participate in this scheme. This will then throw out the particular mining company from using section 8B.

5.3.2.4. Albeit the intention, there is no explicit requirement for “black employees” and thus may still fall foul of draft Mining Charter requirements especially if the majority of employees are not “black employees”.

5.3.2.5. The deduction for the employer may not match the grant and thus could have a financial accounts impact for the employer.

5.3.2.6. Section 8B only applies to permanent employees – in the mining industry the companies often make use of contractors, section 8B would be more useful if extended to contractors as well.

5.3.2.7. The administrative burden on employer companies when employees leave the employment to identify the recoupment etc. is great. It needs to be appreciated by National Treasury that mining companies' have thousands of employees and the staff turnover is very high.

5.3.3. Again, we emphasize that interaction with role-players on section 8B and its application would assist.

6. **Clauses 15 and 16: Proposed amendment to section 8E and 8EA of the definition of "Hybrid Equity Instrument" and "Preference Share"**

Comment:

6.1. According to the EM, National Treasury has proposed to include within the ambit of section 8E and 8EA schemes involving the issue of preference shares whereby *inter alia* trusts are utilised as a holding mechanism in which investors acquire "participation rights" in trusts whilst the underlying investment of such trusts are preference shares. This amendment has been proposed to be effected through the amendment of the term "hybrid equity instrument" in section 8E and "preference share" in section 8EA to include any right or interest where the value of that right or interest is directly or indirectly determined by the underlying share that is either an equity share or a share other than an equity share.

6.2. It is proposed that this amendment will come into operation on 1 January 2017, and will apply in respect of years of assessment ending on or after this date.

6.3. Due to the widespread use of trusts as a vehicle to facilitate large-scale preference share portfolios, particularly in the banking sector, this proposed amendment is likely to have significant tax implications to the investors into these schemes, which in essence are the public at large. In the absence of any forewarning of this amendment, it would not be possible to reorganise non-compliance structures within delayed until 1 January 2018.

7. **Clauses 17 and 18: Proposed amendment to section 8F and 8FA**

Comment:

7.1. It is proposed to insert a subparagraph *(e)* to section 8F(3) and 8FA(3) to exempt any instrument that constitutes a "*third-party backed instrument*" from section 8F and 8FA.

7.2. According to the EM, the proposed amendment of excluding third-party backed instruments from the application of these sections is to ensure that the recharacterisation rules available in section 8EA that recharacterise dividends to income applies to all instruments that meet the definition of third-party instruments, despite any attempt by a taxpayer to avoid such

recharacterisation by using the provisions of section 8F to retain dividends treatment for the yield of third-party backed instruments as a result of recharacterisation rule of section 8F that recharacterises interest into dividends *in specie*.

7.3. It is submitted that the reference to "third-party backed instrument" in section 8EA(1) alone is not a correct alignment with the principles applied when section 8EA(1) was introduced (as well as the subsequent amendments thereto). It is requested that the same principles be applied as that in section 8EA, i.e. that certain "qualifying persons" be permitted to provide security, and that the same category of persons be included for purposes of section 8F.

8. **Clause 53: Proposed amendment to section 42**

8.1. It is proposed that in order to clarify the conditions under which "asset-for-share transactions" between a natural person and a company will qualify for roll-over relief, that only transactions where the employee is engaged on a full-time basis in personal liability companies should qualify. This is intended to be achieved through the insertion of the phrase "*as contemplated in section 8(2)(c) of the Companies Act*" in subparagraph (*a*)(i)(B) of the definition to "*asset-for-share transaction*"

8.2. According to the EM this amendment is proposed to come into effect in relation to transactions entered into after the promulgation of the Taxation Laws Amendment Act, 2016.

8.3. Notwithstanding the effective date, it is unclear whether, in relation to "asset-for-share transactions" that take place prior to the effective date, where the additional requirement that the employee render services for personal liability companies is not met, whether the provisions under section 42(6)(*a*)(ii) of the Act will be triggered if the prescribed eighteen-month period from the date that the "asset-for-share transaction" took place has not lapsed.

8.4. Clarity is therefore sought that section 42(6)(*a*)(ii) will not be triggered for transactions which take place prior to the effective date of the proposed amendment.

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9. **Clause 21: Amendments to Section 9D(2A) of the Income Tax Act**

9.1. The stated purpose of the so-called "high tax exemption" is to disregard tainted Controlled Foreign Company ("CFC") income, if little or no South African tax was at stake after taking into account the South African tax rebates. In this context the "high-tax exemption" is based on a calculation of a hypothetical amount of the global level foreign taxes imposed by all foreign spheres of government. Currently, the global foreign tax is calculated after disregarding foreign tax carryover and carry-back losses, as well as group losses.

9.2. In the Budget Speech delivered by the Minister of Finance in February 2016 it was announced that the "high tax exemption" for CFCs would be revisited and in particular that the adjustment for foreign group losses in the calculation in the high tax exemption would be deleted.

9.3. The EM to the TLAB reiterates the above by providing that "it is proposed that the adjustment for foreign group losses be withdrawn in the determination of foreign tax for high tax exemption purposes".

9.4. However, in terms of section 21(1)(b) of the TLAB, the deletion of paragraph (ii)(bb) of the further proviso to subsection (2A) of the Act is proposed. Paragraph (ii)(bb) provides that the aggregate amount of tax payable by a CFC in respect of a foreign tax year must be determined "*after disregarding any loss in respect of a year other than that foreign tax year or from a company other than the controlled foreign company".*

9.5. By deleting paragraph (ii)(bb) in its entirety, not only the adjustment for foreign group losses, but also the adjustment for prior year losses will be deleted from the "high tax exemption". This proposed deletion does not appear in line with the stated intention, which appears to take issue only with the allocation of foreign group losses, and not the disregarding of the losses of the relevant CFC itself from a prior year.

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10. **Hedge funds**

10.1. Annexure C of the 2016 Budget Review noted the following under the heading "Transitional tax issues resulting from regulation of hedge funds":

"There are certain scenarios where the tax relief provided in the Taxation Laws Amendment Act (2015) to assist the hedge fund industry's transition to a new regulated regime is limited and inapplicable to certain hedge fund's trust structures. This is the case with the tax relief for asset-for-share and amalgamation transactions. It is proposed that provision be made to address these scenarios."

10.2. The proposed amendments contained in the draft Taxation Laws Amendment Bill ("draft TLAB") do not address the above.

10.3. In addition, we note the following in relation to hedge funds:

10.3.1. The current transitionary relief available to hedge funds is not sufficient to provide relief for exchange gains/losses triggered in terms of section 24I of the Income Tax Act (the "Act") upon the transfer of the assets to the regulated hedge fund collective investment scheme. Specific provision in sections 42 and 44 should be made to address this unintended consequence of the regulation of hedge funds.

10.3.2. The provisions of section 41(4) deals with companies and sets out the steps to be taken by a company to be deemed to have taken steps to liquidate, wind up or be deregistered. Section 41(4)(a) – (c) set out the steps to be taken by a company to be deemed to have taken steps to liquidate, wind up or be deregistered. Section 44(13) provides that the provisions of section 44 do not apply if the amalgamated company has not taken the steps referred to in section 41(4). For purposes of, *inter alia*, section 44, a portfolio of a hedge fund collective investment scheme is a company (see the definition of a "company" in section 41). Legally a portfolio of a hedge fund collective investment scheme would not constitute a company as its legal form would be either a trust or a partnership. As such although the intention is that a portfolio of a hedge fund collective investment scheme may qualify for section 44 in instances where it intends to amalgamate with another portfolio of a hedge fund collective investment scheme, it cannot comply with section 41(4) as it does not constitute a company and therefore cannot take the specific steps applicable to companies in subparagraphs (a) – (c). If a portfolio of a hedge fund collective investment scheme cannot comply with section 41(4), then it cannot rely on the relief in section 44 as a result of section 44(13). On this basis section 41(4) should be amended to include a reference to the steps to be taken by a portfolio of a hedge fund collective investment scheme on the basis that it is constituted as a trust or partnership and cannot take the steps applicable to a company.

10.4. Furthermore, it is noted that the proviso to the "connected person" definition in section 1 of the Income Tax Act (the "Act") should be amended to either refer to a "portfolio of a

collective investment scheme" or to include a reference to a "portfolio of a hedge fund collective investment scheme". This is so because the definition of a connected person in relation to a trust in paragraph (b) excludes a "portfolio of a collective investment scheme". Furthermore, consideration should be given to excluding a partner in a "portfolio of a hedge fund collective investment scheme" from the connected person definition in relation to a partnership (paragraph (c)) in the light of the fact that a "portfolio of a hedge fund collective investment scheme" may be constituted as a partnership.

10.5. Section 9D

10.5.1. The introduction of paragraph (D) to the proviso to section 9D(2) as proposed by section 21(1)(a) of the TLAB should include the participation rights held by a "portfolio of a hedge fund collective investment scheme" that is a resident as there is no basis to limit the exclusion to a portfolio of a collective investment scheme in securities only.

10.5.2. We note that local collective investments schemes may hold shares in foreign companies that do not constitute foreign collective investment schemes. The proposed amendment should be expanded to refer to all controlled foreign entities and not only foreign companies that constitute foreign collective investment schemes.

10.6. Section 8F

10.6.1. Section 8F and 8FA are proposed to be amended to include a definition of a "third-party backed instrument" which will result in the provisions of sections 8F/8FA not applying to such a third party backed instrument.

10.6.2. The concept of a "qualifying purpose" should be included in sections 8F and 8FA in order to disregard enforcement rights/obligations enforceable against certain persons in determining whether an instrument qualifies as a third-party backed instrument on a similar basis than section 8E/8EA.

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11. Conclusion

We wish to thank you for the opportunity to submit comments on the 2016 TLAB.

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Per B.J. Croome