SUBMISSION BY THE LAW SOCIETY OF SOUTH AFRICA ON DRAFT TAXATION LAWS AMENDMENT BILL, 2016

Contents

1. INTRODUCTION

The Law Society of South Africa (LSSA) represents more than 24 000 practising attorneys and almost 6 000 candidate attorneys countrywide. It is the umbrella body of the attorneys' profession in South Africa and its constituent members are the Black Lawyers Association (BLA), the National Association of Democratic Lawyers (NADEL) and the four statutory provincial law societies, namely the Cape Law Society (CLS), the KwaZulu-Natal Law Society (KSNLS), the Law Society of the Northern Provinces (LSNP) and the Law Society of the Free State (LSFS).

The LSSA has considered the proposed amendments to the Income Tax Act, 58 of 1962 (the Act), as contained in the Draft Taxation Laws Amendment Bill, 2016 (the Bill) and hereby makes the following submissions and recommendations.

2. PROPOSED AMENDMENT TO SECTION 7C

Proposed amendment

2.1 The "mischief" sought to be addressed involves the Estate Duty sheltering of the growth in value of assets held by discretionary trusts, funded by low/no interest loans.

2.2 Section 31 of the Act would apply in respect of cross-border loans made by a South African resident to a non-resident trust and require a transfer pricing adjustment to the extent that an arm's length interest rate is not charged.

Proposed effective date

2.3 It is proposed for section 7C to come into operation on 1 March 2017 (i.e. with effect from the 2018 year of assessment), but it is not clear whether section 7C will apply in respect of existing funding

or whether same will only apply in respect of loans, advances or credits made to a trust after 1 March 2017.

Submission

2.4 Vested and bewind trusts do not pose the Estate Duty avoidance problem intended to be addressed by the proposed section 7C and accordingly it should be clarified that section 7C will only apply in respect of such loans made to discretionary trusts.

2.5 It is submitted that section 7C should only apply to loans made after 1 March 2017 as it would be prohibitive from a tax cost perspective for taxpayers to unwind historic trust structures and may also be legally impossible to do so due to the terms of existing trust deeds, leaving taxpayers unable to address the punitive implications which may arise in terms of proposed section 7C.

2.6 In order to avoid double tax and absurdities arising should both section 7C and section 31 be applicable, it is submitted that it should be clarified that section 7C will not apply in respect of cross-border loans.

2.7 It is noted that there may be an area of overlap and resulting double taxation in respect of the attribution provisions contained in section 7 of the Act and the proposed section 7C.

2.8 Arguably the mischief intended to be addressed by section 7C (as per the Explanatory Memorandum) has already been addressed by way of the increase in the effective capital gains tax rate applicable to trusts. The effect of this increase is to incentivize distributions of gains by trusts to beneficiaries, thereby completely negating the Estate Duty avoidance as the entire growth in value would be vested in the estate of the beneficiary.

2.9 It is understood that the mischief intended to be addressed by section 7C is the <u>acquisition of an asset</u> by a trust and the sheltering of its growth from Estate Duty, by way of utilising an <u>interest free loan</u>. As currently drafted, section 7C may apply in respect of loans made to a trust in order to, for example, fund trust expenses. No asset is involved and there is no avoidance of Estate Duty or other taxes. It is submitted that the provisions should be limited to loans which directly fund the acquisition of assets.

2.10 The tax suffered as a result of the application of section 7C may in certain circumstances be disproportionate to the mischief intended to be addressed by this provision. In particular, estate duty is triggered on death whereas section 7C would give rise to annual tax implications for the duration of the lifetime of the lender or the natural person connected to such lender. The tax effect over the lender's lifetime may dramatically exceed the potential Estate Duty avoided on the lender's death. On a rough calculation, at an official rate of 10% per annum, the tax liability to the lender will be 4% of the capital amount of the loan (say R100). Over a period of five years this equates to R20 tax. However, assuming the asset has grown over that five year period from R100 to R161 (at 10% compound) the potential estate duty is only 61 x 20% = R12.2. Thus over a short period, section 7C has nearly doubled the tax liability. It is respectfully submitted that this is an excessive solution to the perceived problem – given that it may not be possible to unwind existing trust structures.

2.11 In addition, depending on the nature of income derived by the trust – there may be distortion should the official interest rate be charged in respect of loans made to the trust. For example, should the loan obtained by the trust be used to acquire property which derives rental income, any interest paid by the trust in respect of such loan would be deductible in the hands of the trust and subject

to income tax in the hands of the lender. In contrast, should the loan obtained by the trust have been used to acquire shares which generate exempt dividend returns, the trust would not be entitled to deduct any interest paid to the lender and the lender would be subject to income tax in respect of such interest. Accordingly, the imputed interest in effect targets those trusts which have acquired assets which are unproductive of taxable income, and not those which produce taxable income. There is no equitable reason for this effect.

2.12 In certain circumstances it may not be possible for the trust to make payment of a cash amount to the relevant natural person to settle the additional tax charge arising in terms of section 7C – for example where the trust does not have liquid assets and/or does not earn income. It appears on the basis of the current proposed wording of section 7C that should the natural person fail to recover such additional tax charge from the trust – such would give rise to a donation on the part of such natural person notwithstanding that, for a variety of commercial reasons not motivated by gratuity, the natural person may be unable have to recover such amount from the trust. This compounds the tax liability described in paragraph 2.10 above.

2.13 In addition, the proposed section 7C does not deal with the mechanism in terms of which the natural person may legally recover the tax incurred in terms of section 7C from the trust. (It may be that such natural person is not the actual lender (for example: where a company which is a connected person in relation to such natural person made the loan to the trust) or the natural person/lender is not a beneficiary of the trust concerned.) Should the relevant trust deed not make provision for the payment of such tax incurred to the natural person, the trustees of such trust may not have the necessary authority to effect payment thereof.

2.14 It is not clear how the proposed section 7C interacts with the recently released second Davis Tax Committee Report and the proposals made therein as relates to the taxation of trusts. In particular, we note the following extract from this report:

> *"There would be numerous complexities associated with implementing a form of transfer pricing adjustment to deem a return on interest-free loans between SA registered trusts and SA taxpayers. The DTC concurs with the recommendations of the Katz Commission that this be avoided."*

This appears to be at odds with the proposed section 7C. The Report makes recommendations for sweeping changes to the taxation of trusts for income tax and estate duty purposes. We submit that the proposed section 7C requires further consideration in the context of the Report.

We respectfully submit that the proposed section 7C should be held back until the Minister has had the opportunity to consider the Report and its recommendations.

Recommendation

2.15 We respectfully recommend that the proposed section 7C should be held back until it may be further considered in the context of the DTC report.

2.16 We welcome the opportunity for further discussion around fine tuning this proposal so as to achieve the desired effects in a fair and equitable manner.

3 PROPOSED AMENDMENT TO SECTION 8CA(2)

Proposed amendment

3.1 It is submitted that the proposed new section 8CA(2) should be amended to clarify that the reference to 'the longest period during which an equity instrument can qualify as a restricted equity instrument in terms of the relevant scheme' is limited to restricted equity instruments in issue at the time at which the relevant expenditure is incurred.

Submission

Example:

Facts:

3.2 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'.

3.3 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.

3.4 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.

3.5 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:

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

3.6.1 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.

3.6.2 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).

3.6.3 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.

3.7 It is submitted that neither option 1 nor option 3 would produce equitable results. Option 2 may be more equitable in the circumstances.

3.8 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.

4 PROPOSED AMENDMENT TO SECTION 8CA(3)

Proposed amendment

4.1 The section of the explanatory memorandum to the Bill 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'.

Submission

4.2 It is submitted that this reference should be expanded upon to clarify, or provide examples of, the various sorts of expenditure would be deductible in terms of this proposed new section 8CA(3). For example, would employers be entitled to deduction in respect of the amount of any dividend paid to an employee which constitutes "remuneration" as defined?

4.3 It is submitted that the underlying premise that all amounts should be treated as remuneration, supports the case for deductibility of the proposed taxable dividends.

4.4 We submit further 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, 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. We submit that this should be allowed. (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.)

5 GENERAL COMMENTS RE: TAXATION OF SHARE-BASED EMPLOYEE INCENTIVE ARRANGEMENTS

5.1 To the extent that any of the above comments are not taken into account, in addition to the comments raised above, the following should be noted:

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

5.1.2 These proposed amendments will effectively reduce the benefits participants will receive under affected plans, and if the relevant amounts are to be taxed as remuneration, will effectively reduce the benefits 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 our experience, share based schemes are increasingly used for BEE purposes whilst pure incentive plans make less use of actual shares and dividends). In light of the fact that these employees and employers may be contractually locked into plans, and that their benefits could effectively be reduced, the proposed amendments are essentially anti-BEE in their effect.

5.1.4 From 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.

Recommendation

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 and we would welcome the opportunity to participate.

6 PROPOSED AMENDMENT TO SECTION 10(1)(k)

Proposed amendment

6.1 We understand that the proposed amendments to paragraph (ii) of the proviso to the exemption from the 10(1)(k) exemption in respect of dividends are intended to target 'dividend stripping' and other similar arrangements in terms of which value may be extracted from a 'restricted equity instrument' in the form of dividends declared prior to that instrument 'vesting' for purposes of section 8C, without that value being subject to income tax. In other words, the rationale for the proposed amendment appears to be concerned with distributions that reduce the capital value of restricted equity instruments.

Submission

6.2 It is submitted that the proposed amendments, which have the effect of subjecting all dividends declared in respect of a restricted equity instruments prior to that instrument's vesting to income tax, are unnecessarily broad. 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 have the effect of diminishing the value of those restricted equity instruments upon the date of their vesting for purposes of section 8C.

6.3 This should adequately address the mischief identified, without unduly prejudicing employees *inter alia* in the manner illustrated in the example provided below.

6.4 This comment is also applicable to the proposed amendment to section 8C(1A).

6.5 In addition to the comments listed above, the proposed amendments as currently formulated:

6.5.1 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

6.5.2 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.

6.6 This may well impact upon the costs of employers' 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 their employers shares, which grow in value over time.

Recommendation

6.7 It is submitted that 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 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.

7 PROPOSED AMENDMENT TO SECTION 12E

7.1 We refer to the Bill and the amendment therein proposed in respect of section 12E of the Act. As the statutory body responsible for the administration and regulation of the attorneys' profession in South Africa, we welcome the proposed amendment but would be grateful if you would consider the following further submission, on behalf of our members, in relation to such amendment.

Proposed amendment

7.2 In terms of clause 30(1) of the Bill it is proposed that the definition of "small business corporation" in section 12E(4) be amended to include a personal liability company as contemplated in section 8(2)(c) of the Companies Act, 71 of 2008 ("Companies Act").

Proposed effective date

7.3 In terms of clause 30(2) of the Bill it is proposed that the above amendment be deemed to have come into operation on 1 March 2016 and apply in respect of years of assessment ending on or after that date.

Recommendation

7.4 It is noted at paragraph 2.3.II of the Explanatory Memorandum to the Bill that the amendment is proposed in response to the unintended exclusion of personal liability companies from the

definition of "small business corporation" as a result of changes to that definition in 2011 relating to the Companies Act.

7.5 It is our understanding that, given its unintended nature, the above exclusion went largely unnoticed by personal liability companies, their auditors and the South African Revenue Service ("SARS"). Taxpayers have therefore acted on the assumption that such companies qualified as small business corporations. We further understand that prior to 2016, at which stage we assume it became aware of the unintended exclusion, it was never the policy or practice of SARS to assess such companies on any basis other than as small business corporations.

7.6 We note that the currently proposed effective date of 1 March 2016, in respect of years of assessment ending on or after that date, gives the proposed amendment retrospective effect.

7.7 In light of the above observations, we submit that the proposed amendment should be given further retrospective effect to the date at which the reference in section 12E(4) to the Companies Act, 61 of 1973 was effectively replaced by a reference to the Companies Act, 71 of 2008. In terms of section 23(2) of the Taxation Laws Amendment Act, 7 of 2010, this date was 1 January 2011.

Proposal

7.8 We therefore propose that clause 30(2) of the Bill be amended to reflect that clause 30(1) is deemed to have come into effect on 1 January 2011.

Please contact Kris Devan at kris@lssa.org.za if there is any further information that you require in relation to the above proposal.