Webber Wentzel submission - draft Taxation Laws Amendment Bill, 2016

Clause 12: insertion of new section 7C - "Loan or credit advanced to trust by connected person"

Proposed amendment

The new provision seeks to discourage the use of interest-free loans to trusts by founders, which have been identified as a means by which Estate Duty is avoided by such persons (or rather, by their estate at death). The new provision will deem interest to be charged on these loans at the official rate, and further deem a donation to have occurred if the tax on the interest is not recovered from the trust. Finally, it seeks to prevent the annual donations tax exemption from being used to pay down such loans.

As presently drafted, the provision appears to apply only to loans and credit advanced after 1 March 2017, as would be fair and expected, however this should be clarified in the final EM.

Problems identified and proposed solutions

Benevolent trusts

Most trusts are established for reasons other than the avoidance of income tax and Estate Duty. This fact is not recognised in the proposal. Trusts established for charitable purposes, the protection of assets for the benefit of minors or the elderly, the maintenance of former spouses and children, and many other benevolent trusts, will be fatally impacted by this proposal. Many of these trusts will not earn the official rate of interest (currently 8%) and will be unable to pay the required interest, nor pay the lender the tax due on the interest. The trust would quickly become insolvent and be unable to achieve its benevolent objectives. Furthermore, the trustees of such trusts would find themselves in the position of having to find a return of at least 8% on trust assets in order to ensure the survival of the trust, forcing them to take investment risks that put the trust in further jeopardy. Tax rules should not drive these outcomes.

Solution

It is admitted that a carve-out or exemption for benevolent purpose trusts would be difficult to define. Consequently, it is submitted that a less punitive proposal be put forward to discourage Estate Duty avoidance, and that this proposal be removed in its entirety until a solution is found.

Commercial trusts

The proposal is clearly aimed at family trusts funded by individuals, or by their family companies. However, the scope of the provision is so far reaching that it could easily impact many commercial arrangements where a company loans funds to a trust, including BEE empowerment trusts, employee share trusts, and asset protection trusts. The trigger is merely that the company be connected to an individual who is connected to the trust. The definition of "connected person" in section 1 is notoriously wide, so that even large companies could find that certain individuals are connected to the company and the trust, for example because they are beneficiaries of the same trust or partners of the same partnership.

Solution

The trigger should be narrowed to ensure that only family trusts are targeted. Perhaps consider using a narrower version of the "connected person" definition.

Attribution rules and CGT

A low or interest-free loan is considered an "other disposition" for the purposes of the attribution rules (i.e. section 7, and Part X of the Eighth Schedule), in terms of the common law. Therefore, failure to charge interest on the loan already triggers these "tax back" rules. The lender will consequently pay income tax and capital gains tax on any income and gains generated in the trust by funds from the interest-free and low-interest loan. This is fair and proper, and it is suggested that SARS should enforce these provisions more vigorously, in order to discourage the abuse of trusts in this way.

There is nothing in the proposal which would prevent both section 7C and the attribution rules from applying to the same loan. An interest-free loan remains an "other disposition" even if section 7C deems interest to be taxable on it. This will result in double taxation.

Furthermore, the disposal of assets into a trust on loan account will trigger CGT, as would be the case for any asset disposed of by an individual. Such tax is not avoided by the use of an interest-free loan to fund the transfer.

Solution

Interest-free loans do not achieve income tax or CGT avoidance, if the attribution rules are properly enforced. Although transfer of assets diminishes the estate of the disposer, CGT is paid thereon, so there is no avoidance. Furthermore, the loan is an asset in the estate of the lender, on which Estate Duty will be paid at death. The only loss to the *fiscus* is Estate Duty on the subsequent growth, if any, of the asset sold into the trust. If this is the sole concern, then section 3(3)(d) of the Estate Duty

Act provides ample ammunition for SARS to attack trusts being used to avoid Estate Duty. If section 3(3)(d) does not apply, then it is submitted that the deceased did not enjoy the benefit of the assets in the trust, and therefore no Estate Duty has been avoided (i.e. the trust property is correctly treated as outside the deceased's dutiable estate).

It does not seem reasonable to create double taxation (section 7C plus attribution) in order to discourage the use of trusts for Estate Duty purposes, when the transfer of assets is subject to CGT (and often Transfer Duty) and the loan remains subject to Estate Duty. As noted above, trusts are used for many legitimate purposes other than estate duty in any case.

It is suggest that the final Davis Tax Committee (DTC) report on Estate Duty be considered before this proposal is introduced, so that the issue can be resolved in a holistic way.

Non-resident trusts

Section 31 (transfer pricing) already applies to loans between a non-resident trust and a resident beneficiary of that trust (or a resident relative of a beneficiary, which would typically include the founder), as they are connected persons. Consequently, such loans must be at arm's length, meaning market-related interest must be charged. Section 7C will compare the interest charged on such loans to the official rate, rather than to the arm's length rate. Typically, an arm's length rate would be higher than the official rate for foreign loans in any case, so section 7C would not find application. However, where it did apply there is nothing to prevent both section 7C and section 31 from applying to the same loan, which could lead to an adjustment under both provisions, and a deemed donation under both provisions. This is far too punitive. Failure to apply an arm's length rate of interest on a foreign loan should be dealt with exclusively in terms of section 31.

Solution

Loans to foreign trusts should be excluded from section 7C, and remain subject to section 31. Section 7C would consequently be a domestic transfer pricing rule for local trusts, as seems to be the intention.

Clause 13: replacement of section 8C(1A) - Amounts received in respect of restricted equity instruments

Proposed amendment

The current section 8C(1A) seeks to include in income any return of capital in respect of a restricted equity instrument ("**REI**"). Such a return of capital is considered to constitute an effective vesting of that REI, as some or all of the economic value has been extracted therefrom.

The replacement provision both narrows and extends the provision. It narrows the return of capital inclusion by carving out returns in the form of REIs (which will fall to be taxed in terms of section 8C in any case). It extends the provision by including any amounts received in respect of a REI in income, except (a) the aforementioned returns in the form of REIs, (b) dividends dealt with elsewhere in the Act, and (c) gains or losses dealt with elsewhere in section 8C.

Problems identified

Disincentive to employee share ownership

Section 8C has always sought to tax employee equity as remuneration. It has never sought to provide a tax incentive to reward employees with equity. The only 'concession' that it provides is that it taxes such equity at vesting rather than at acquisition, however this is simply an extension of the normal accrual principle of taxation, it is submitted. Such deferral generally results in more tax being paid (i.e. on the share growth) than would otherwise be the case, and results in more tax collected, not less.

The new section 8C(1A) prompts us to pause and reflect as to why the taxation of employee equity should be targeted with such punitive treatment. The alignment of employees with other shareholders in a common goal of shared growth is a positive objective that should be encouraged, not punished. Rewarding employees with a share of that growth should be applauded. Empowering previously disadvantaged workers to becoming part-owners of their employers is a laudable goal and actively encouraged by BB-BEE legislation, but not by tax legislation.

Yet more complex and retroactive amendments to section 8C merely serve to highlight that it is time this legislation was revisited in its entirety, not only with the goal of preventing tax avoidance but of encouraging employee equity participation and alignment with transformation goals.

Solution

The present amendment should be held over pending a root-and-branch review of section 8C and related provisions. Further complexity introduced ahead of such a review would introduce unnecessary uncertainty.

Repayment of capital contributed

The existing section 8C(1A), and also the proposed replacement, simply includes a return of capital in income. No relief is given for any consideration paid for the share on which capital is being returned, i.e. unlike the rest of section 8C, the gross proceeds rather than the gain is included in income.

Solution

Only the amount returned in excess of the amount contributed should be included in income, i.e. the gain.

Retroactive effect

The provision will apply to amounts received after 1 March 2017, but in respect of REIs acquired before or after that date. The provision therefore seeks to tax amounts received in respect of existing REIs, which were acquired in terms of the current (and historic) rules.

There are two objections to this retroactive effect.

Firstly, taxpayers are under no obligation to arrange their affairs so as to create the largest possible tax burden for themselves. Consequently, employee share schemes have been designed to comply with the law in such a way that the correct amount of tax is paid, but no more. If Treasury and SARS are of the view that taxpayers should pay more tax on certain arrangements then that is their prerogative, however they should exercise such prerogative in a prospective manner and not retrospectively. When the REIs in question were acquired by the relevant taxpayers, such taxpayers knew and understood the tax consequences and were locked into those consequences by section 8C and related provisions. To now change the rules such that those consequences are different is unfair and unreasonable. Of course, all taxpayers know that the law may change and need to accept that possibility. However, section 8C is designed in such a way that the consequences are locked in from the time of acquisition until the time of vesting. The taxpayer cannot now stop holding a REI. It is, was and will remain an REI until it vests. It is only fair and reasonable that the tax treatment of that REI during its vesting period should remain constant.

A similarity can be drawn to the addition of para. (c) of the definition of equity instrument from 21 October 2008. From that date, contractual rights which derived their value from shares were subject to the provisions of section 8C. However, because section 8C only applies if a right was an equity instrument at acquisition, the amendment was not retrospective (i.e. it did not bring all such existing contractual rights into section 8C, only newly acquired ones). This was, it is submitted, the fair and correct outcome. A similar outcome should transpire with the current proposal.

Secondly, employee share schemes are carefully crafted arrangements and taxation is just one part of the design process. Taxation is, however, crucial to the financial funding model of share schemes. Employee share schemes are commercial arrangements, and must be funded like anything else in business. Often, the schemes are funded with ongoing dividends or occasional disposal proceeds. Funding models require certain assumptions, some of which (rate of return etc) can be adjusted for within a range, and others cannot be. It can never have been expected by plan designers in the past that all amounts accruing in terms of REIs would be subject to income tax, particularly on existing REIs. The net-of-tax basis for the funding model has therefore changed dramatically. It has effectively become more expensive and less attractive to offer equity to employees.

Solution

The amendment should apply only to REIs acquired on or after 1 March 2017.

Interaction with CGT

The new section 8C(1A) seeks to include any amount received in respect of REIs in income, excluding certain amounts, but not excluding capital gains. Where holders of REIs participle in capital gains as beneficiaries of a trust or partners in a partnership, it is possible that such amounts would fall to be taxed in terms of section 8C(1A). Should this occur, it is unclear how double taxation would be eliminated. The same problem already exists in relation to trusts since the introduction of the amended para. 80(1) and new para. 80(2A) and the latest change merely exacerbates the problem

For example, a trust may dispose of some but not all its shares and the resulting capital gain is vested in the beneficiaries, who hold Units in the trust (the Units being REIs for the purpose of section 8C). For each share disposed of and resulting gain vested in each beneficiary, one Unit is cancelled. This will trigger paragraph 80(2A), and section 8C(1A), such that the capital gain made by the trust is subject to CGT in the trust (at 32.8%) and the vested amount is included in the income of the beneficiary (at up to 41%). The same amount is therefore subject to a combined tax rate of 73.8%. Furthermore, no tax deduction is available to the employer for the amount taxed as

remuneration in the hands of the employee (i.e. there is no matching corporate tax offset), even in terms of the proposed section 8CA.

Solution

Section 8C(1A) should exclude capital gains dealt with in terms of the Eighth Schedule, in the same way that it excludes dividends dealt with in terms of the Act.

Overly-wide application

Many of the problems identified herein are a result of the overly-wide application of the provision. It can be understood from the EM that the provision is largely targeted at arrangements whereby value is extracted from REIs in a form that would not otherwise trigger section 8C, e.g. share buy-backs. The opportunities to do this are extremely limited in the ordinary course of events.

Solution

The provision should be aimed more directly at combatting the specific mischief which has been identified.

If share buy-backs, which generate a dividend, pose a threat to the operation of section 8C, then a specific provision to include the proceeds of such a transaction in the income of the REI holder would solve that problem, with none of the unintended consequences noted above.

Clause 17: Section 8F of the Income Tax Act

Proposed amendment

Hybrid debt instruments subject to subordination agreements: it is proposed to exclude debt instruments that are subject to subordination agreements from the application of section 8F to the extent that the issuer is not able to pass the solvency and liquidity test in terms of the Companies Act and the holder of the instrument is a company in the same section 41 group of companies.

Objection / Problem identified

The above exclusion is welcomed because the subordination of a loan should not in itself cause a debt instrument to be treated as equity in nature. The subordination is normally triggered by the poor financial performance of a company/borrower that leads it to require its lender (normally a group company) to subordinate loan funding to the company so that the company can obtain an unqualified audit opinion - a qualified audit opinion could have various adverse consequences for the company.

We are concerned, however, that the exclusion has been limited to section 41 group scenarios, i.e. that it will only apply to loans from a SA resident group company to a SA group company. The relief should also apply to loans from non-resident persons who are willing to keep insolvent South African companies afloat by their subordinating loans to such companies.

The reason for limiting the exclusion to section 41 groups can certainly not be to counter BEPS, because there are various provisions in the Income Tax Act that already serve this purpose, e.g. transfer pricing (section 31), section 23M and section 23N. Accordingly, we see no reason to discriminate between resident and non-resident lenders who subordinate debt.

Suggested solution / Alternative proposal

We would therefore suggest that the requirement of a section 41 group be replaced by a section 1 group of companies test or a connected person test to enable the exclusion to also apply to non-resident lenders in the relevant circumstances.

Clause 17: insertion of "third-party backed instrument" definition in section 8F and section 8FA

Proposed amendment

It is proposed to insert a definition of "third-party backed instrument" in section 8F. The exclusions from the operation of sections 8F and 8FA will then be extended to also apply to a "third-party backed instrument" as defined in section 8F. In other words, interest will not be recharacterised as a dividend in specie in terms of section 8F or section 8FA if the instrument concerned is a "third-party backed instrument".

Problem identified

The proposed definition of "third-party backed instrument" to be included in section 8F will mean any form of interest-bearing arrangement or debt in respect of which an "enforcement obligation" or "enforcement right" as defined in section 8EA(1) is enforceable or exercisable by the holder of that instrument as a result of any amount relating to that instrument not being received by or accruing to any person entitled thereto.

The definitions of "enforcement obligation" and "enforcement right" that are referred to in section 8EA both apply with reference to a <u>share</u>. For example, "enforcement obligation" is defined as meaning, "in relation to a <u>share</u> any obligation…"

However, section 8F and section 8FA both apply with respect to interest on a <u>debt instrument</u>.

This is because sections 8E and 8EA are hybrid equity provisions whilst sections 8F and 8FA are hybrid debt provisions.

As such, it is not possible to reconcile the application of a definition that refers to a share with a debt instrument.

Suggested solution

Given that the reference to "enforcement obligation" or "enforcement right" as defined in section 8EA(1) creates confusion, please consider inserting an independent definition into section 8F, as opposed to referencing section 8EA in the definition. Further, the newly inserted definition in section 8F should not be with reference to a share but rather with reference to a debt instrument.

Clause 21: Further *proviso* to subsection 2A of section 9D of ITA - proposed change to "high tax exemption" for CFCs

Proposed amendment

Clause 21(1)(b) of the 2016 Draft TLAB proposes an amendment to the existing CFC legislation in section 9D of the Income Tax Act relating to the calculation of the "high tax exemption".

Change to this exemption was anticipated as a result of the statement in Annexure C to the 2016 Budget Review document that "*it is proposed the adjustment for foreign group losses in the calculation for high-tax exemption is deleted*". The Explanatory Memorandum to the Draft TLAB 2016 also refers to the deletion of the foreign group losses exemption, illustrating this with examples, and explains that Treasury's reason for this proposed change is that in the examples given, the CFCs are able to shelter their taxable income with losses made available by other group companies, thus effectively eliminating any foreign tax payable by the CFC themselves.

Objection / Problem identified

The proposed amendment, which deletes paragraph (ii)(bb) of the further proviso to subsection 2A of section 9D of the Act, goes beyond a denial of relief where a CFC makes use of group losses. If enacted in its current form, the amendment will mean not only that the CFC will not be treated as having paid foreign tax to the extent that it makes use of foreign group losses, but also that a CFC cannot treat the utilisation of its own broughtforward loss as foreign tax paid for the purposes of the high tax exemption. As discussed below, this will have unduly harsh consequences. No reasons have been advanced by Treasury or SARS to justify rendering the high tax exemption inapplicable where a CFC in a high tax location makes use of its own brought forward loss.

In the Explanatory Memorandum, Treasury has focused on the availability of foreign tax credits and argued that if cash tax is not being paid, no foreign tax credits would be available and hence there would be more SA tax to collect if the income of these companies was imputed to SA. This approach ignores the underlying reason why paragraph (ii)(bb) of the further proviso to subsection 2A of section 9D was included in the first place, namely to prevent taxation of income in SA where that income has already been subjected to tax at a high rate in another country.

The purpose of the high-tax exemption is to acknowledge that a taxpayer is unlikely to have had tax avoidance in mind in establishing a CFC in a high-tax jurisdiction, and consequently to turn off the CFC rules if the CFC (applying a notional SA tax calculation as if the CFC was SA tax resident) is, as a result of being located in a high tax jurisdiction, suffering foreign tax at a rate very similar to or even higher than the rate it would suffer if it were a South African tax resident.

The proposed amendment departs from this purpose, in that companies which are legitimately situated in high tax jurisdictions and which factually will be suffering tax at high rates may no longer be able to qualify for the high tax exemption, merely because they utilise the group loss provisions afforded by that particular jurisdiction, or have losses themselves. This would appear to run contrary to a main intention of the CFC rules, and the reason for the high tax exemption, which is to ensure that profits are not shifted offshore to low tax jurisdictions. It also implies that the use of group losses (which may not always be elective in the foreign country) or of a CFC's own brought forward loss represents a form of tax avoidance from a South African CFC perspective.

Denying a CFC the benefit of the high tax exemption simply because it has its own brought forward losses under the tax law in the foreign jurisdiction is particularly draconian. These losses would arguably not be recognised as brought forward under the notional South African tax calculation required by the section because the net income of a CFC is deemed to be nil where the high tax exemption has applied in prior years. Consequently, in a year in which a CFC uses its own foreign brought forward losses to shelter current year income, the notional SA tax calculation will (in terms of this proposed amendment) inevitably result in more SA tax than was suffered in the foreign country because the tax calculated cannot be reduced by the brought forward loss (which would happen in the case of any company that was truly SA tax resident). The playing fields will therefore no longer be level in comparing the two tax regimes and effective double taxation will result, with the CFC's income being taxable not only in its own country at a high rate but potentially also in South Africa under the CFC rules.

To give an example, assume Co A in South Africa holds 100% of the shares in Co B which is located in the USA. Co B is a manufacturing company and is subject to a US federal tax rate of 35%. In 2015, one of Co B's key customers goes insolvent and is unable to pay its debts to Co B. Co B therefore makes a trading loss which is also a loss for tax purposes. The loss is recognised as a deferred tax asset. Co B claims the high tax exemption under the CFC rules, thus giving it a deemed "net income" as defined of nil in 2015.

In 2016, Co B manages to secure a new customer and is profitable. For tax purposes in the US, Co B makes use of its tax loss to shelter some of its 2016 taxable income from cash tax. For accounting and financial statement purposes, Co B still suffers an effective tax rate of 35%. Some of the tax is paid in cash and some is paid by reducing Co B's brought forward tax loss. However, under the CFC rules, if the proposed amendment is enacted, only the cash tax paid by Co B will count as foreign tax paid by Co B for the purposes of the high tax calculation. Any amount which has not suffered cash tax in the US will be fully taxable again in SA under the CFC rules because the brought forward loss will not be taken into account in the notional SA tax calculation. This will increase the effective tax rate on Co B's 2016 taxable income to somewhere between 35% and 63%.

Since the South African tax system does allow companies normally to make use of brought forward losses, there seems to be no policy justification for not allowing this also in the context of the high tax exemption.

Suggested solution / Alternative proposal

It is proposed that this amendment be reconsidered in its entirety as there does not appear to be sound policy reasons for it. Many countries with high rates of tax have provisions allowing for, or even mandating, fiscal unity. Simply because SA has not yet adopted such a system does not seem adequate reason for failing to recognise the use of a group loss as foreign tax paid, albeit not in cash. Fiscal unity simply means that the companies within the group viewed as a whole have all continued to be subject to tax at the high rate but that the portion of the non-cash tax paid is spread over more than one of the companies. Since fiscal unity regimes always require high degrees of common ownership, the other company or companies whose loss is being utilised will almost certainly also be CFCs in relation to the SA taxpayer, causing the use of their loss by another CFC in the group to be no more than a timing difference from a CFC perspective (all that is happening is that the CFC surrendering the loss will not itself be able to benefit from that loss in future years as would normally be the case if group relief did not apply).

As a minimum, if Treasury remains concerned that allowing CFCs to benefit from group loss relief is too generous, since SA does not have a group relief system, then the amendment should be restricted to preventing a CFC from disregarding the use of foreign group losses. The proposed amendment to the current wording of (ii)(bb) of the further proviso to subsection 2A could then be worded as follows:

"(bb) after disregarding any loss in respect of a year other than that foreign tax year [**or from a company other than that controlled foreign company]"** (the words in bold would be deleted**).**

Clause 24: amendment of section 10(1)(gC)

Proposed amendment

An exemption is currently provided for retirement benefits linked to past employment outside South Africa, i.e. with a foreign source, on the basis that the retirement benefits are sourced where the services to which they relate were performed. This exemption is to be amended so that it applies only to South African approved funds.

Problem identified

Retrospective impact

Binding General Ruling 025 was issued by SARS last year confirming that the current exemption applies to retirement benefits from any fund, whether situated in South African or abroad. Presumably this amendment is in response to that ruling, and is in direct opposition to it.

One of the inherent difficulties when amending legislation that impacts retirement is the necessity of preserving vested rights. No attempt has been made in the proposed amendment to grandfather funds that currently comply with the existing exemption. The amendment will effectively seek to tax accumulated retirement benefits that were previously exempt. The date of receipt of retirement benefit should not impact its exempt status. If the retirement benefits were accumulated as exempt benefits, their status should be preserved as such. It is fundamentally unfair to exempt amounts accruing to retiree who receives a benefit on 28 February 2017, but tax the exact same benefit accruing to a retiree after 1 March 2017.

The amendment will have a significant financial impact on retirees currently drawing an exempt pension, which may be their sole or main source of income. Furthermore, it will unfairly subject to tax annuity payments into the future as compared to retirees who elected to receive an (exempt) taxable lump sum. The imminent change in legislation may even prompt retirees or so-to-retire

members to take a lump sum before 1 March 2017. Tax policy should not impact financial decisions in this way.

The amendment is a change in policy, not a technical correction, and consequently taxpayers have a legitimate expectation that the policy which applied during the course of their working life and retirement contributions should apply when they retire.

Interaction with foreign earnings exemption

Most employees who have contributed to South African funds while working abroad will have either been non-resident at the time (and not taxable on foreign earnings) or will have qualified for the exemption in section 10(1)(o).

Consequently, the vast majority of these taxpayers would not have received a tax deduction for the contributions made, because they would not have had taxable income against which to claim the deduction in the year of assessment where they worked abroad and made the contributions.

Therefore, the concern that there will be a mismatch between tax deductible contributions and exempt benefits is unfounded, it is submitted.

Discouraging local savings

The proposed amendment effectively rewards taxpayers who switch to a foreign fund when they work abroad, and stop contributing to a local fund. The amendment will therefore encourage employees and employers to make contributions to foreign (offshore) retirement funds for outbound expatriate employees, rather than stay in South African funds.

It is difficult to understand why tax policy should encourage foreign savings, and the transfer of funds permanently out of South Africa.

If the exemption remains as it is, the funds will remain in South Africa were they will benefit the South African economy.

Suggested solution

The amendment should not proceed, for the reasons noted above.

If the proposal goes ahead, the amendment should apply only to fund contributions and growth thereon which accumulates in the fund after 1 March 2017. Existing rights should be preserved as exempt benefits.

Clause 24: replacement of section 10(1)(k)(i)(ii) - limitation of dividend exemption in respect of unvested equity instruments

Proposed amendment

Dividends 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" are currently excluded from the income tax exemption, in terms of *proviso* (ii) of section 10(1)(k)(i), unless such dividends are received or accrued in respect of (i) a restricted equity instrument as defined in section 8C or (ii) a share, held by that person.

It is proposed that *proviso* (ii) be amended to exclude only dividends from section 8C equity instruments that have vested in terms of that section, and marketable securities as contemplated in section 8A.

Problems identified

The problems identified above in relation to section 8C(1A) also apply here, particularly in relation to *retroactive effect*.

The provision will apply to amounts received after 1 March 2017, but in respect of REIs acquired before or after that date. The provision therefore seeks to tax amounts received in respect of existing REIs, which were acquired in terms of the current (and historic) rules.

The current version of section 10(1)(k)(i)(ii) specifically permits an employee to receive exempt dividends by virtue of employment in respect of a restricted equity instruments. Share schemes that current exist and pay dividends in compliance with this rule should not now be punished by removing the dividend exemption while the employees still hold such instruments.

Solution

The new version of the proviso should apply only to dividends received in respect of restricted equity instruments acquired after 1 March 2017.

If there are forms of unacceptable avoidance that Treasury wishes to curtail, such as dividends from share buy-backs, then a specific provision dealing with such dividends should be introduced, rather than reversing the current rules for every taxpayer in a restricted equity scheme.

Meaning of "by virtue of employment"

The *proviso* only applies if a dividend is received in respect of services rendered or by virtue of employment. Many taxpayers will argue that a dividend is paid in respect of a share or other instrument and not in respect of services or employment. This argument has considerable merit, supported by case law, and SARS will face a barrage of challenges on this front, it is predicted. After all, how can an amount be received in respect of a restricted equity instrument on the one hand, for the purposes of section 8C(1A), but also be received by virtue of employment, on the other hand, for the purposes of section 10(1)(k)(i)(ii)? This method of dealing with employee-equity derived dividends is not workable in practice.

It has also been suggested that a dividend can only be received "in respect of employment" if it is paid on a special class of shares held only by employees, or as a corporate distribution triggered by some kind of employee performance target being met. If this is the intention of the legislation, then it needs to be made far more explicit than at present.

Solution

It should be accepted that dividends are never received in respect of employment, and that the basis of the *proviso* is unsupported by the common law. The attempt to tax dividends as remuneration should be discontinued. The employee will pay income tax on the equity awarded, in terms of section 8C, and any dividends received will be dividends in the ordinary course. If there are specific areas of abuse, such as share buy-backs, these should be targeted with specific provisions.

Clauses 5(1)(d) and 33: "Clarifying the tax treatment of government grants

The 2016 DTLAB aims to clarify the tax treatment of government grants by proposing certain amendments to section 1 and section 12P of the Income Tax Act (see sections 5(1)(d) and 33 of the DTLAB).

The proposed amendments follow upon the deletion of section 10(1)(zI) by the 2015 TLA Act. That same TLA Act then inserted the text of section 10(1)(zI) into the new section 12P(2A). Both of the said changes took effect on 1 January 2016, and apply in respect of government grants received or expenditure incurred on or after that date.

In spite of the 2015 amendments above, section 12NA(3) of the Income Tax Act still reads as follows (our emphasis):

*"Where any amount as contemplated in section **(10)(1)(zI)** is received by or accrues to a person from the government of the Republic…"*

We accordingly submit that the reference to section "10(1)(zI)" in section 12NA(3) above must be deleted, and replaced by a reference to section *"**12P(2A)**"*.

Clause 52: Amendment of section 41, read with section 24I(10A) of the Income Tax Act

Proposed amendment

Clarifying the non-application of the re-organisation rules to deferred exchange gains: it is proposed to exclude debts that are subject to section 24I(10A) from being transferable in terms of the corporate rules.

Objection / Problem identified

The volatility of the Rand against major currencies is well known. The effect is that an unrealised foreign exchange gain can quickly reverse and become a foreign exchange loss and vice versa.

In the explanatory memorandum it is stated that foreign exchange differences should be treated in the same manner as interest. However, the two are not comparable. Exchange differences are dependent on currency movements (which are volatile and can move both ways) whilst interest is accounted for on a yield-to-maturity basis (which always moves in one direction, i.e. it is either interest income or an expense).

As such, no valid reason has been provided why a section 24I(10A) instrument should be treated differently from any other section 24I instrument.

The purpose of the corporate rules is to allow a transferee to "step into the shoes" of a transferor in respect of the tax attributes of assets (e.g. tax cost, allowances, inherent profits or losses in trading stock, inherent capital gains or losses in capital assets, etc.) and the proposed amendment is contrary to this purpose.

If the proposed amendment has been triggered by tax avoidance, then we would suggested a more targeted approach to deal with the issue, such as an amendment to section 103 of the Income Tax Act to prevent trafficking in unrealised foreign exchange losses.

A further issue that is of significant concern is that the proposed amendment only deals with one element of a foreign currency denominated loan receivable, namely the foreign exchange differences. With respect to foreign currency denominated loans receivable, there is a second

element that must be dealt with, namely capital gains, and the proposed amendment does not deal with that at all.

The interaction between section section 24I (foreign exchange differences) and section 25D (capital gains) is very well illustrated in examples 1 and 2 on page 664 of the SARS Comprehensive Guide to CGT. This relates to section 19.7 of the Guide. From the example, it may be noted that when a debt owed to a person in a foreign currency is realised, then the realisation has both section 24I and capital gains tax consequences.

The concern with the current amendment is that it will trigger a realisation under section 24I when a debt instrument is transferred but it will not also trigger a realisation for capital gains tax purposes. The result will be that the transferee will acquire the transferor's historical base cost in the asset because the relevant corporate rule will apply to capital gains tax consequences. However, the section 24I history will not be transferred as a result of the application of the proposed amendment. This will lead to a mismatch and potential double taxation. Should the proposed amendment be proceeded with, then it is suggested that the aforementioned issue be resolved by providing that the section 24I(10A) instrument will be treated as being realised on transfer both with respect to section 24I foreign exchange differences as well as with respect to capital gains tax (and not only with respect to section 24I, which is currently the position).

Suggested solution / Alternative proposal

For the reasons set out above, we disagree with the exclusion of the section 24I(10A) instruments from being transferable in terms of the corporate rules and suggest that, if there is mischief which has triggered this amendment, that the mischief concerned be addressed through a more targeted approach.

However, should the proposed amendment be proceeded with, then the interaction between section 24I and capital gains tax must be properly addressed. In order to do this it is suggested that the law should provide that the section 24I(10A) instrument will be treated as being realised on transfer both with respect to section 24I and capital gains tax (and not only with respect to section 24I, which is currently the position).