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Dear Ms Langeni and Ms Collins

**COMMENTS ON THE INCOME TAX: FINANCIAL INSTITUTIONS AND PRODUCTS
ITEMS IN THE 2017 DRAFT TAXATION LAWS AMENDMENT BILL**

We would like to thank National Treasury for the opportunity to submit comments in relation to the 2017 Draft Taxation Laws Amendment Bill (the 2017 DTLAB), which was published on 19 July 2017.

This submission contains comments in relation to the **Income Tax: Financial Institutions and Products** items in the 2017 DTLAB only. Please refer to BASA's separate submissions in relation to 1) Income Tax: Individuals, Savings & Employment, 2) Income Tax: Business, 3) Income Tax: International and 4) the Draft Tax Administration Laws Amendment Bill.

For purposes of this document, the Income Tax Act, No. 58 of 1962, as amended, will be referred to as "the ITA" and underlined text indicates proposed new wording while words in bold parenthesis (**[and]**) indicate proposed deleted text. Our submission covers the following topics:

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1. SECTION 24JB – FAIR VALUE TAXATION

1.1 Issue 1

Applicable provisions

Clause 43 of the 2017 DTLAB and the addition of the new subparagraph (9) of section 24JB of the ITA.

Problem statement

Amendments are required to correct the interaction with the other provisions of the ITA where a financial asset that was within the scope of section 24JB now falls outside its scope and *vice versa* as a result of the adoption of IFRS 9 on 1 January 2018. This would be the case where for e.g. loan assets that were previously held at fair value through profit or loss (and therefore in the scope of section 24JB) now fall outside of section 24JB by virtue of being amortised cost accounted.

Proposed solution

By the proposed insertion after section 24JB(9)(b) of -

"...which market value will for the purposes of section 22(3)(a) be deemed to constitute the cost price of such trading stock or the expenditure actually incurred for purposes of paragraph 20(1)(a) of the Eighth Schedule"

1.2 Issue 2

Applicable provisions

Clause 43 of the 2017 DTLAB and the addition of the new subparagraph (2A) of section 24JB of the ITA.

Problem statement

The proposed wording does not address the reversal of any unrealised amount recognised in profit or loss prior to the adoption of IFRS 9 in respect of an instrument issued prior to 1 January 2018, as a consequence of it being held to maturity i.e. unrealised, as a result of fair value changes in own credit risk being recognised through other comprehensive income as opposed to profit or loss.

Proposed solution

By the proposed insertion of an additional section 24JB(2B) of the ITA -

"Where a covered person has, at the end of any year of assessment immediately preceding the year of assessment commencing on or after 1 January 2018, included in or deducted from income any amount attributable to a change in the credit risk of a financial liability issued by that covered person measured at fair value through profit and loss in terms of subsection (2), such covered person must include in or deduct from income any amount in respect of a change in credit risk of that financial liability recognised in other comprehensive income in the years of assessment commencing on or after 1 January 2018."

1.3 Issue 3

Applicable provisions

Clause 43 of the 2017 DTLAB and the addition of the new subparagraph (2A) of section 24JB(2A) of the TLAB 2017.

Problem statement

Technical corrections to the proposed section 24JB(2A) of the ITA and a further correction to clarify that the provision relates to instruments issued after 1 January 2018 only (refer to issue 2).

Proposed solution

(2A) A covered person must include in or deduct from income for a year of assessment ~~[a]ny~~ realised gain or realised loss that is recognised in ~~the~~ statement of other comprehensive income as contemplated in IFRS 9 if that realised gain or realised loss is attributable to a change in the credit risk of the financial liability as contemplated in IFRS 9 and that instrument was issued in any year of assessment commencing on or after 1 January 2018.

2. SECTION 11(jA) - ALLOWANCE FOR IMPAIRMENT LOSSES FOR COVERED PERSONS

2.1 Issue 1

Applicable provisions

Clause 17(1)(a) of the 2017 DTLAB and the new proposed section 11(jA) of the ITA.

Problem statement

The new proposed section 11(jA) of the ITA allows –

“an allowance equal to 25% of the loss allowance relating to impairment, as contemplated in IFRS 9” and provides that –

“the allowance must be increased to 85 per cent of so much of that loss allowance relating to impairment as is equal to the amount that is in default, as determined by applying the criteria in paragraphs (aa)(ii) to (vi) and (b) of the definition of ‘default’ as defined in Regulation 67...” .

Therefore, it would appear that covered persons are obliged to utilise the impairment numbers as stated in their annual financial statements, which are calculated in accordance with IFRS 9, since the section stipulates *“the loss allowance relating to impairment, as contemplated in IFRS 9”* (underlining indicates own emphasis) as the starting point to determine the ambit of the loss allowance of 25%.

Thereafter, covered persons are then referred to an external reference, not found in IFRS 9, to determine the extent of those impairment numbers which are eligible for an increased allowance of 85%.

BASA has been in discussion with National Treasury and SARS regarding the manner in which BASA’s members will be taxed going forward in relation to impairments once IFRS 9 is implemented. As a point of departure, it was accepted that the tax treatment should be determined with reference solely to the accounting treatment, so that no adjustments are required for tax purposes to the audited impairment numbers for accounting purposes. This would result in banks not being required to run two sets of models.

However, the reference to Regulation 67, as opposed to IFRS 9, does not align with the 'only one model' principle.

We understand what National Treasury is attempting to achieve by referencing Regulation 67 and in our opinion is equally achievable by simply referring to "credit-impaired financial asset", as defined in IFRS 9, which is outlined in Appendix A of IFRS 9 as follows –

"A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

- (a) Significant financial difficulty of the issuer or the borrower;*
- (b) A breach of contract, such as a default or past due event;*
- (c) The lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;*
- (d) It is becoming probably that the borrower will enter bankruptcy or other financial reorganisation;*
- (e) The disappearance of an active market for that financial asset because of financial difficulties; or*
- (f) The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.*

It may not be possible to identify a single discrete event – instead, the combined effect of several events may have caused financial assets to become credit-impaired"

When the above objective evidence determines that the financial asset is a "credit-impaired financial asset", the impact in the accounting impairment model is that the financial asset will be moved from what is commonly referred to as stage 2 for IFRS 9, i.e. "2 – significant increase in credit risk", to stage 3, i.e. "3 – credit impaired".

Given that the Explanatory Memorandum refers to stage 3 (on page 41) as "Stage 3: includes financial assets that have objective evidence of impairment at the reporting date (SI)" and then explains (on page 42) that "it is proposed that the following allowance to be allowed in determining the taxable income of a covered person as defined in section 24JB of the Act: ... 85 percent of SI provision...", it would appear it is National Treasury's intention for the increased allowance to reference the IFRS 9 stage 3 accounting number.

Therefore, it would make more sense if section 11(jA) of the ITA simply referred to the IFRS 9 definition of "credit impaired financial asset" only, which equates to the stage 3 impairments for IFRS 9 purposes, rather than referencing Regulation 67.

In addition, if section 11(jA) of the ITA no longer refers to Regulation 67 to determine what is eligible for the increased allowance, it will be very clear that the tax treatment would be determined with reference solely to the accounting treatment and that the stage 3 impairment number for accounting purposes is the number against which the allowance of 85% may be claimed.

Proposed solution

Accordingly, we propose that section 11(jA) of the ITA be amended as follows –

“Provided that the allowance must be increased to 85 per cent of so much of that loss allowance that relates to a credit impaired financial asset as defined in Appendix A to IFRS 9 [relating to impairment as is equal to the amount that is in default, as determined by applying the criteria in paragraphs (aa)(ii) to (vi) and (b) of the definition of ‘default’ as defined in Regulation 67...]

2.2 Issue 2

Applicable provisions

Clause 17(1)(a) of the 2017 DTLAB and the new proposed section 11(jA) of the ITA.

Problem statement

We suggest not to use an external reference in section 11(jA) of the ITA, as detailed in section 2.1. of this submission above.

In addition, the external reference used in section 11(jA) of the ITA to Regulation 67 of the Banks Act, may in any event create *unintended consequences* when covered persons are determining the extent of the IFRS 9 impairments which are eligible for the higher allowance (of 85%).

In particular, only certain subparagraphs of the definition of ‘default’ are referred to, i.e. “...as is equal to the amount that is in default, as determined by applying the criteria in paragraphs (a)(iii) to (vi) and (b) of the definition of ‘default’ as defined in Regulation 67...”.

The exact subparagraphs referred to in Regulation 67 are as follows –

- a) Exposures other than retail exposures, be deemed to have occurred when the bank is of the opinion that the obligor is unlikely to pay his/her/its credit obligations in full without any recourse by the said bank to actions such as the realisation of security, which opinion of the bank, as a minimum, shall be based on the matters specified below.
 - (i) **The bank is about to sell the credit obligation at a material credit-related economic loss;**
 - (ii) **The bank has consented to a distressed restructuring of the credit obligation, which restructuring is likely to result in a reduced financial obligation caused by, for example, the postponement of principal, interest or fees;**
 - (iii) **The bank has applied for the obligor’s bankruptcy or a similar order in respect of the obligor’s credit obligation;**
 - (iv) **The obligor has applied for or has been placed in bankruptcy or similar protection and the said event is likely to avoid or delay repayment of the credit obligation to the banking group.**
- (a) Exposures other than retail exposures be deemed to have occurred when a **material obligation of an obligor is overdue for more than 90 days**; (underlining and bold text indicates own emphasis).

As is noted from the extract above, there is a preamble to both subparagraphs (a) and (b), which refers to “exposures other than retail exposures”. Given that covered persons have exposures to retail and other clients, and the retail exposures are rather substantial, even 100% in the case of certain covered persons, it would appear that one

needs to be very careful in how Regulation 67 is interpreted, i.e. whether to exclude retail exposures or not.

We submit that given that the wording in section 11(jA) of the ITA refers to “so much of that loss allowances relating to impairment as is equal to the amount that is in default, as determined by applying the criteria in paragraphs (a)(iii) to (vi) and (b) of the definition of ‘default’ as defined in Regulation 67...” one should only need to refer to the *default criteria* in the definition of ‘default’, and disregard the preamble sections (which would exclude the majority of a covered person’s book if retail exposures are to be disregarded). The default criteria, which have been copied from Regulation 67 above, are in italics and in bold.

Furthermore, we submit that if regard is had to the Explanatory Memorandum, then the reference to “exposures other than retail” should be disregarded, as the Explanatory Memorandum refers (on page 42) to “85 per cent of SI provision that is equal to the amount in default as determined by applying the criteria in paragraphs (a)(iii) to (iv) and (b) of the definition of default as defined in Regulation 67 of SARB contained in Government Gazette No. 35950 of 12 December 2012” (underlining indicates own emphasis). By referring to the “SI provision”, which was specifically referred to in BASA’s 2012 SARS ruling, it would appear that National Treasury has confirmed that all impairment provisions are in scope, since the SI provision under IAS 39 included all impairment provisions, including retail. We also note that the Explanatory Memorandum does not refer to paragraphs (a)(v) and (a)(vi) of Regulation 67 while the proposed section 11(jA) does refer to these paragraphs.

In any event, we are only pointing out these issues for completeness (since the current version of section 11(jA) of the ITA references Regulation 67) whereas we do not agree with such reference to an external source outside of IFRS 9 (as detailed in section 2.1. of this submission above).

Proposed solution

If the reference to Regulation 67 were to remain in section 11(jA) of the ITA, then the Explanatory Memorandum would need to be expanded to state that *only the default criteria* in the specific subparagraphs of Regulation 67 *are relevant* in determining which impairment provisions are eligible for the increased allowance of 85%, and that *the preamble sections to the subparagraphs in Regulation 67*, which state “exposures other than retail”, *should be disregarded*.

However, given that we have proposed that this reference to Regulation 67 be removed from section 11(jA) of the ITA, as indicated in section 2.1. of this submission above, all references to Regulation 67 would need to be removed from the Explanatory Memorandum entirely.

2.3 Issue 3

Applicable provisions

Clause 17(1)(a) of the 2017 DTLAB and the new proposed section 11(jA) of the ITA.

Problem statement

The new section 11(jA) of the ITA will replace the BASA 2012 ruling relating to the claiming of allowances by covered persons.

In due course, once IFRS 9 has been in effect for some time, little regard will be to the way in which allowances were calculated under IAS 39. However, the Explanatory

Memorandum refers in detail to the manner in which a covered person's allowances were calculated in terms of IAS 39, including references to the IBNR, PSI and SI provisions, and even refers to such provisions (on page 42) when explaining how allowances under section 11(jA) should be calculated.

Proposed solution

It is recommended that the Explanatory Memorandum should only retain such references to IBNR, PSI and SI in relation to the IAS 39 treatment of allowances. Thereafter, the Explanatory Memorandum should rather reference the IFRS 9 terminology when explaining how the allowances, which are eligible for an 85% allowance under IFRS 9, are to be determined, i.e. stages 1 to 3.

2.4 Issue 4

Applicable provisions

Clause 17(1)(a) of the 2017 DTLAB and the new proposed section 11(jA) of the ITA.

Problem statement

In order to ensure that section 11(jA) of the ITA applies to all impairment provisions in relation to assets generated by a covered person, it is imperative that the definition of a "covered person", for the purpose of section 11(jA) only, includes securitisation vehicles where the financial assets of the vehicle were originated by a bank.

In addition, "covered person", for the purpose of section 11(jA) only, needs to include all other money-lending operations in a banking group, such as credit card issuing companies, since these entities are consolidated into a banking group and subject to that banking group's capital requirements.

Proposed solution

The ambit of a "covered person" as defined in section 24JB of the ITA needs to be updated for the purposes of section 11(jA) of the ITA to include securitisation vehicles holding assets originated by a bank and other money-lending operations in a banking group, in section 11(jA) of the ITA, as follows –

"if the person is a covered person as determined by applying the criteria in paragraphs (c)(i) to (iii) and (d) of the definition of covered person in section 24JB(1) and including securitisation vehicles, where the financial assets of the vehicle were originated by a covered person as included in the ambit of this section".

2.5 Issue 5

Applicable provisions

Clause 17(1)(a) of the 2017 DTLAB and the new proposed section 11(jA) of the ITA.

Problem statement

BASA is appreciative of the uplift in the impairment allowance in section 11(jA) of the ITA to 85% for stage 3 IFRS impairments (which is what the reference to Regulation 67 appears to confirm, as discussed above). However, as discussed previously with National Treasury, BASA remains of the view that an uplift to 85% of stage 3 of the IFSR 9 impairments as an allowance in section 11(jA) of the ITA is not an accurate reflection of the actual credit loss profile of its members. It is the experience of BASA

members that, by the time a debt reaches stage 3, it is generally bad and the loss will be suffered.

Given that stage 3 credit impairments under IFRS 9 will likely remain largely on the same current levels as the specific impairments (SI) in terms of IAS 39, **which already take recoveries into account, BASA believes that an uplift in the impairment allowance in section 11(jA) of the ITA to 100% for stage 3 IFRS impairments is warranted. This would eliminate the double counting of anticipated recoveries.**

Proposed solution

We accordingly request that “[85] per cent” is replaced with “100 per cent” in section 11(jA) of the ITA.

2.6 Issue 6

Applicable provisions

Clause 17(1)(a) of the 2017 DTLAB and the new proposed section 11(jA) of the ITA.

Problem statement

Given that the proposed reduction in the PSI (stage 2) and SI (stage 3) impairment allowances, as envisaged in the current draft of section 11(jA) of the ITA, will be effective for years of assessment commencing on or after 1 January 2018, this means that these reductions will negatively impact BASA’s members in a single year.

Given the negative impact of IFRS 9 on a bank’s balance sheet in 2018, i.e. retained earnings and the opening balance impairment provisions, the incurral of additional cash tax during the same period will be onerous on the banks.

Proposed solution

We respectfully request that National Treasury consider allowing a phase-in period of at least three years, in the same manner as was allowed when section 24JB of the ITA became effective, since the transition to IFRS 9 is an accounting requirement, over which the members of BASA have no control.

2.7 Issue 7

Applicable provisions

Clause 17(1)(a) of the 2017 DTLAB and the new proposed section 11(jA) of the ITA.

Problem statement

The new proposed section 11(jA) of the ITA allows:

“an allowance equal to 25% of the loss allowance relating to impairment, as contemplated in IFRS 9”.

The impairment provisions in paragraph 5.5.1 of IFRS 9 provide as follows:

“An entity shall recognise a loss allowance for expected credit losses on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a contract asset or a loan commitment and a financial guarantee contract to which the

Impairment requirements apply in accordance with paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d)." (Underlining indicates own emphasis).

As "a lease receivable" is included in the above definition, section 11(jA) grants an allowance in respect of the impairment of leases. However, leases are also fixed assets for lessors and wear & tear allowances are claimed by the lessor in terms of the ITA. Accordingly, two different tax allowances would be allowed for leases in terms of the ITA if "lease receivables" are included in the scope of section 11(jA) of the ITA.

Proposed solution

The wording in section 11(jA) of the ITA should be updated as follows:

"an allowance equal to 25% of the loss allowance relating to impairment, as contemplated in IFRS 9, except for lease receivables".

3. SECTION 24J – REMOVAL OF THE 'ALTERNATIVE METHOD'

Applicable provisions

Clause 42 of the 2017 DTLAB and section 24J of the ITA.

Problem statement

Section 24J of the ITA made provision for the application of an "alternative method" as opposed to the "yield-to-maturity method". The "alternative method" is defined as –

"... a method of calculating interest in relation to any class of instruments which—

- a) conforms with generally accepted accounting practice;
- b) is consistently applied in respect of all such instruments ... for all financial reporting purposes; and
- c) method achieves a result in so far as the timing of the accrual and incurral of Interest is concerned which does not differ significantly from the result achieved by the application of the provisions of subsections (2)(a) and (3)(a);"

The Explanatory Memorandum explains the reason for the change as being "... *that generally accepted accounting practice or GAAP is no longer applicable.*"

Whilst it is true that generally accepted accounting practice and GAAP are no longer applicable, they haven't been deleted, but merely replaced by IFRS. The removal of the "alternative method" will have a significant impact on BASA's members, due to the fact that they have to a large extent relied on this method to avoid minor discrepancies between the tax treatment and accounting treatment of many assets. To the extent that the "alternative method" can no longer be applied, it will create further divergence between the tax treatment and accounting treatment and will require significant system alterations.

Proposed solution

We propose that the "alternative method" be retained, but aligned to the use of "IFRS" instead of "generally accepted accounting practice", in the same manner as clause 32(a) of the 2017 DTLAB has proposed to update section 22 of the ITA, as follows –

"...as in accordance with [***generally accepted accounting practice***] IFRS..."

Yours faithfully



Leon Coetzee

Chairman: The Banking Association of South Africa, Direct Tax Committee



Cas Coovadia

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