**COMMENTS BY WEBBER WENTZEL AS AN INTERESTED PARTY FOLLOWING THE INVITATION TO COMMENT ON THE DRAFT TAXATION LAWS AMENDMENT BILL AND DRAFT TAX ADMINISTRATION LAWS AMENDMENT BILL**

Submission date: 25 August 2017

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1. Introduction

On 19 July 2017 National Treasury and the South African Revenue Service ("**SARS**") published a copy of the draft Taxation Laws Amendment Bill, 2017 ("**the DTLAB**") and draft Tax Administration Laws Amendment Bill ("**the DTALAB**"). The DTLAB and DTALAB introduce draft amendments relating to direct and indirect taxes as well as tax administration.

As one of the leading tax advisory firms in South Africa, Webber Wentzel has a keen interest in legislative reform affecting direct and indirect taxes as well as tax administration. Webber Wentzel would therefore like to thank the Standing Committee on Finance ("**SCOF**") for the invitation to submit written submissions on the draft bills and hereby submits these comments to the SCOF, within the stipulated time period, for its consideration. Webber Wentzel would also welcome the opportunity to appear before the SCOF and make oral submissions.

Webber Wentzel is mindful of the underlying intentions of the draft bills and is supportive of the overarching purpose of the proposed amendments. Indeed, a number of the proposed amendments are seen as positive amendments which should be retained. However, notwithstanding the intentions of the proposed amendments, there are some proposals which require further discussion, assessment and could be seen as problematic. Where such problematic proposed amendments have been identified, we have set these out below and provide possible solutions to the problems identified.

1. Comments on proposed amendments contained in the DTLAB
2. Debt reduction in relation to dormant companies
   1. Proposed amendment to section 19 of the Income Tax Act 58 of 1962 ("ITA")[[1]](#footnote-2)

Currently, paragraph 12A(6)(d) exempts debt from the waiver provisions in paragraph 12A to the extent such debt is reduced, cancelled, waived, forgiven or discharged between South African group companies. There was no equivalent exemption arising from the application of section 19. This has led to numerous difficulties, in particular for cash-strapped companies wishing to wind up their operations, but who cannot afford to trigger and pay cash tax.

The proposed amendment to allow a similar exemption in section 19 is welcomed.

We note, however, the scope of application of the proposed exemption is too limited.

The section 19 group exemption and the current paragraph 12A(6) exemption, which is not currently subject to limitation, only applies to scenarios where the debtor is a dormant group company, where such dormant group company has not traded or received assets or other amounts in the past three years.

Dormant companies being wound up are likely to still receive amounts over years as final receivables are collected from the debtor company's own debtors. The debtor company may sell off written off stock or capital assets and this would constitute trading. Any assets sold would also be assets transferred from the dormant company.

The dormant company would also need to pay or receive refunds from SARS. An amount outstanding may be subject to a dispute. A refund may be subject to an audit. Refunds can only be paid to the debtor company's bank account, which would mean that the waiver of debt can only take place three years after the refund is received from SARS.

A liquidator appointed to wind up a company would claim liquidator fees from the final accounts of the company prepared. The liability for the liquidator's fees would be a liability incurred by the dormant company.

All of the above are common occurrences in companies which are considered dormant or in their last stages of commercial existence. In terms of the proposed amendments, these companies would have to wait for three years after the last payment or transfers are received before the proposed amendment to section 19 could apply. This could result in the waiver of debt in the debtor company taking an extraordinary amount of time, which would be impractical.

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| We propose that the draft amendment allowing for the section 19 exemption to waiver of debt taking place in group of companies be unqualified.  As it is also uncertain what is meant by the exemption not applying in respect of debt incurred, directly or indirectly by that company in respect of any asset disposed of by the debtor company in terms of the corporate rules, we also propose that examples of such debt be recommended for inclusion in the *Explanatory Memorandum.*  Furthermore, we propose the removal of all the above requirements that the dormant company will need to meet and that there only be one requirement that the dormant company will need to meet, i.e. that the dormant company has not carried on a trade for the minimum of one year. This is a requirement which will also align the requirement in section 19 to the existing section 20 on carrying forward the balance of assessed losses. |

* 1. Proposed amendment to paragraph 12A(6)(d) of the Eighth Schedule of the ITA

There is a further amendment to paragraph 12A(6)(d) to align the requirements in this paragraph to the new requirements in section 19. The current group exemption in paragraph 12A(6)(d) will be replaced with a more limited exemption to instances where the debtor is a dormant group company meeting the set of requirements similarly set out in the proposed amendment to section 19.

The limitation of the group exemption to paragraph 12(A)(6)(d) will detract rather than assist with the waiver of debt where there is a group company which is distressed. We had discussed the difficulties of meeting these requirements in 4.1 and these reasons apply equally here.

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| We propose that paragraph 12(A)(6)(d) be retained in its existing form. |

1. Proposed new sections 19A and 19B on converting debt to equity
   1. Problems arising from new section 19A

We submit that the recoupment of interest previously claimed as deduction for financially distressed companies in these new sections is highly problematic.

Firstly, interest deductibility for the debtor company would have been subject to the limitation rules in section 23M, which would apply in most circumstances. A debtor company could have paid interest but not have been able to claim the full amount as a deduction. This would have resulted in a negative cash flow effect.

Secondly, large amounts of capitalized interest which are due but not payable to a non-resident lender would on conversion of such capitalized interest to equity become due and payable and trigger interest withholding tax. The already financially distressed company has to fund the payment of potentially large amounts of interest withholding tax to SARS, resulting in a significant negative cash flow impact.

Thirdly, depending on the amount of assessed losses in the debtor company, the new sections may result in normal tax payable through the recoupment, resulting in further significant negative cash flow for the debtor company.

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| We propose that there be included an additional paragraph (c) in the definition of "recoupable interest" to read as follows:  "*(c) was not subject to tax in the hands of the person to which the interest accrues*".  This proposal will align section 19A with section 23M. The amounts of capitalized interest which are converted to debt and which trigger interest withholding tax must be taken into account to prevent double taxation on the same economic value of such interest.  Furthermore, we propose that the definition of "recoupable interest" specifically exclude interest which has been paid and which was not part of the capitalized amounts which are converted to equity. |

* 1. Problems arising from section 19B

The difference between the face value of the debt and the market value of the issued shares at date of de-grouping can be a recoupment.

Should the value of the shares after conversion decrease, this will result in a potential recoupment for the debtor / issuer company if the debtor / issuer company de-groups within five years of the date of conversion of debt to equity.

The requirement on the debtor / issuer company and the creditor company to remain in the same group of companies for five years is overly restrictive and prevents the group from restructuring to improve cash flows within the group.

The recoupment value to be determined should be the higher of market value of the shares issued on the date of conversion and date of de-grouping.

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| We propose that section 19B not apply where the de-grouping occurs as a result of the termination of the legal existence of the issuer company from winding-up or deregistration.  In addition to the above, we propose that the requirement to remain in the same group of companies for five years be replaced with a requirement for the creditor company to retain, together with any connected person, a controlling interest in the issuer company.  Finally, we propose that the five year period be limited to one year after the date of conversion. |

1. Proposed amendments to section 22B/paragraph 43A: subscription/buyback and dividend stripping
   1. Problems arising from proposed amendments

The proposed amendments are currently very widely drafted and would appear to unintentionally deem a number of ordinary course transactions to be income or proceeds in the hands of the recipients.

For example, the redemption of preference shares held by large shareholders which usually occur on a set redemption date and tranche would have the redemption value included as income or proceeds for capital gains tax ("**CGT**") purposes of the recipient.

There is no distinction between cash distributions and distributions *in specie.* An *in specie* distribution would have already been subject to CGT in the hands of the company making the distribution. The full value of the distribution *in specie* would again be included as income or subject to CGT in the hands of the recipient shareholder, resulting in double taxation of the same economic gain.

A company may distribute its cash or similar asset/s to its parent company in anticipation of liquidation or deregistration and arguably section 47 of the ITA cannot apply. If this distributing company is liquidated or deregistered within 18 months, the parent company will be subject to CGT on the value of the dividend.

The deeming provisions also currently apply to shares in general and not only to equity shares, as would be anticipated, which stretches its application far beyond the mischief which the proposed amendments intend to address.

There is also no consideration to the application of the corporate rules. For example, A holds all the shares in B and C. The group undertakes a restructure after which A holds B, and B holds C. If C has paid a dividend to A within 18 months of A disposing of its shares in C to B (either via section 42 or section 45), a CGT liability will probably arise in the hands of A.

There is no link between the receipt of the dividend and the disposal by the shareholder company of its shares in the company distributing the dividend and the following issues could, *inter alia*, arise:

in a listed company context where a listed company pays an annual dividend, two cycles of dividends may be inadvertently caught in these rules in relation to an investor who may hold its shares on a passive basis in the company which pays the dividends;

BEE shareholders often gear the acquisition of their investment in a company and rely on dividends to pay down debt - any CGT liability is likely to impair an ability to acquire an interest on this basis;

often in order to depress the equity value of a company and thereby ensure that a BEE party may acquire an unencumbered equity ownership of the profits of the company going forward, it is necessary to declare a dividend to a parent before the parent sells down, say, 25.1% of the equity to BEE parties. A potential CGT liability will limit the option for the parent company to sell its shares to the BEE party/ies within 18 months of the distribution.

Furthermore, the section is deemed to have come into operation on 19 July 2017, and applies in respect of any disposal on or after that date. This is problematic for many transactions that are being implemented. Many transactions involving the sale of shares in a company have been entered into and currently await fulfilment of suspensive conditions (for example, Competition Commission and SARB approval). The sellers of the shares in these circumstances would not have "priced" into their transactions the effective retrospective nature of the proposed amendments by including in income or proceeds of the seller, all dividends received in the 18 month period preceding disposal of shares on or after 19 July 2017.

Many companies may have distributed ordinary course dividends within 18 months prior to a disposal which is envisaged to occur after 19 July 2017, and may now be required to delay these transactions to ensure that these dividends are not retrospectively recharacterised as capital proceeds.

In many instances, material equity shareholders in a company may choose to fund (or in fact may already have) the company (along with other funders) in the form of preference shares. Very often, arrear dividends may be settled at the same time that the preference shares are redeemed. In terms of the current proposals, the redemption of preference shares in these circumstances will trigger a CGT liability in the hands of the material equity shareholder. In terms of pre-existing arrangements, preference shareholders would not have concluded the terms of their preference share investment with reference to a potential CGT liability.

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| We propose the following amendments to section 22B and paragraph 43A:   * include a "carve-out" in relation to a disposal of shares arising from the liquidation or deregistration of the company effecting the distribution and a disposal of shares by way of an application of the corporate rules; * exclude *in specie* distributions from the ambit of these rules; * create a link between the dividend and an action by another party in acquiring ownership of the shares in the company effecting the distribution; * only include dividends or proceeds received or accrued on or after 19 July 2017 within the ambit of these rules; and * exclude funding instruments such as preference shares from the ambit of these rules. |

1. Proposed insertion of section 8G: contributed tax capital ("CTC") and its application in respect of non-resident shareholders
   1. Submission

Currently, CTC could arguably be distributed to a non-resident shareholder in due course free of dividends tax. It is useful to note that the Explanatory Memorandum states that the second structure envisages SA HoldCo applying the proceeds of the subscription made by a non-resident to repurchase shares in SA HoldCo. The wording in the proposed section does not seem to support this conclusion.

The reason for the proposed introduction of section 8G is to disallow the creation of CTC at the level of a South African tax resident company ("**NewCo**") where NewCo is interposed between a foreign tax resident company ("**ForeignCo**") and another South African tax resident company ("**TargetCo**"). Instead, the CTC of NewCo will be deemed to be the CTC of TargetCo apportioned according to the percentage interest that NewCo holds in the shares of TargetCo and the rules apply where a "group of companies" as defined in section 1 of the ITA exists between the ForeignCo, NewCo and TargetCo save for the percentage being 50% as opposed to 70%.

It is probably understandable that where NewCo is interposed between ForeignCo and TargetCo and where a shareholding relationship between ForeignCo and TargetCo already exists, that a potential loss to the *fiscus* arises. However, in the context of a new acquisition, a foreign purchaser ("**ForeignCo**") should not be subject to any form of discrimination should the ForeignCo choose to effect a local acquisition via a local entity (NewCo) which it capitalises with equity (as opposed to, say, a shareholder loan).

We submit that on a policy basis, a foreign acquirer should be entitled to choose to invest cash in subscribing for new shares in a South African entity (NewCo) and should be entitled to extract as a return of capital and free of a dividends tax liability, the amount which it contributes as capital into South Africa. Given South Africa's desire to attract foreign investment, it does not seem prudent to potentially impose dividends tax (of what could be a rate of 20% if no tax treaty applies) on almost the full value of the amount which a foreign acquirer invests into South Africa, as such an outcome could clearly result in the return on an investment in South Africa being considered to be unattractive when compared to alternative opportunities in other jurisdictions.

In addition, it is not clear which companies are being referred to in section 8G(3)(b) with regards to a "group of companies".

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| We propose that the wording of section 8G be reconsidered and, in particular, harmonised with the explanation given in the Explanatory Memorandum. In addition to this, we propose that the wording of section 8G(3)(b) be revised to specify which companies are being referred to when reference is made to "group of companies" therein.  Furthermore, we propose that a foreign acquirer be entitled to choose to invest cash in subscribing for new shares in a South African entity and to extract as a return of capital and free of dividends tax liability the amount which it contributes as capital in South Africa. |

1. Submission on amendments to section 9D and the new section 25BC

The changes proposed are extremely broad in scope and, if implemented, will have the effect of putting South African tax residents with indirect interests in foreign companies, which are held through trust structures, in a worse position than they would have been in had they simply held the foreign shares directly.

Imputation to South African tax resident beneficiaries (other than companies) of foreign trusts or foundations is intended to be achieved by National Treasury by way of the introduction of a new section 25BC and not by expanding section 9D.

Section 25BC provides that where any resident (other than a company) is a beneficiary of a non-resident trust or a foreign foundation and that trust or foundation holds a participation right as defined in section 9D(1) in a foreign company, and that foreign company would have constituted a CFC had that trust or foundation been a resident, any amount received by or accrued or in favour of that person during any year of assessment from that trust or foundation by reason of that person being a beneficiary of that trust or foundation, must be included in the income of that person.

The use of the words "any amount" in section 25BC seems punitive as this *prima facie* suggests that all amounts vested in a resident beneficiary of a qualifying trust/foundation, whether or not derived from the applicable underlying foreign company, will be taxable as income in that beneficiary's hands.

It appears that the amounts which will be imputed to the South African resident beneficiary would not be calculated with reference to section 9D, and accordingly none of the section 9D exemptions (such as the foreign business establishment, high-tax jurisdiction, or intra-CFC exemptions), would be available to the South African resident beneficiary.

The words "any amount" in section 25BC also suggest that no matter how proportionately small any distribution to the South African tax resident beneficiary may be, relative to distributions to other beneficiaries, and despite that fact that the South African resident beneficiary may have no control of any kind over the foreign company, the South African resident beneficiary will be disadvantaged under the CFC rules. The breadth of the proposed provision means that it is likely to catch many structures which are in no way abusive or tax driven.

The reference to "any amount" also suggests that section 25BC will override section 25B(2A) which currently applies to exempt foreign dividend income in the hands of South African resident beneficiaries of an offshore trust if such dividend income is capitalised in the trust and only vested in the beneficiaries in a subsequent year of assessment.

It is not ideal to refer to an accounting standard when determining whether the net income of a foreign company is to be attributed to the resident shareholder.

It is also uncertain how this will be practically calculated as once IFRS 10 consolidates the financial results of the foreign income, this is done in the financial statements of the holding company as a an aggregate amount, with the removal of the minority interest as a line item.

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| We propose that paragraph (b)(i) in the proposed definition of "controlled foreign company" and section 25BC be deleted in the DTLAB.  The OECD/G20 Base Erosion and Profit Shifting Project Action 3: 2015 Final Report ("**Action 3 Report**") in paragraph 26 on page 21 makes a passing reference to trusts as follows:  "*26. Although CFC rules would appear based only to apply to corporate entities, many countries include trusts, partnerships and PEs in limited circumstances to ensure that companies in the parent jurisdiction cannot circumvent CFC rules just by changing the legal form of their subsidiaries*." (Our emphasis.)  The reference to the use of trusts is also only in limited circumstances. Further, paragraph 26 is not a specific recommendation in the report, more of an observation. We propose that more research into comparable jurisprudence be done to ensure that should the CFC definition include trusts, the scope of such definition be limited to ensure that South African resident beneficiaries party to tax structures which are neither abusive nor tax driven are not disadvantaged under the CFC rules. These South African resident beneficiaries should not be in a worse position than if they had held the foreign shares directly.  Further, offshore trusts or foundations that have South African charities and public benefit organisations ("**PBOs**") as beneficiaries and which own more than a 50% share in foreign companies would also be caught in the proposed section 25BC. Any philanthropic distributions by these trusts or foundations to the individual recipients of the South African charities and PBOs would be subject to South African income tax. This is surely not the intention of the proposed amendments.  In addition to the above, we propose that the term "interest" in a foreign foundation or non-resident trust and as well as the term "foundation" be clarified.  Furthermore, we propose that an alternative reference tool, other than an accounting standard, be used when determining whether the net income of a foreign company is to be attributed to a resident shareholder.  Paragraph 35 and 36 of the Action 3 Report further describes different types of control, and the control exercised by IFRS 10 (page 25 of report) is but one example of such control. There are practical issues on how the parent entity should include the consolidated interest into the parent entity's income. |

1. Conclusion

We trust that the SCOF will accept these comments in the spirit of engagement and constructive development of the law in the best interests of all people living, working and doing business in South Africa. We are grateful for the opportunity to provide these comments to the SCOF and look forward to engaging with the SCOF on other proposed amendments in the future.

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1. Unless indicated to the contrary, references in this submission to "section" are references to sections already contained in, or which are proposed to be contained in, the ITA. [↑](#footnote-ref-2)