Submissions on the proposed amendment to section 11(j) of the Income Tax Act No. 58 of 1962

1. Background

1.1. In accordance with an accrual system of taxation in South Africa, a taxpayer is required to pay tax to the *fiscus* on accrued income. However it may be that the actual receipt of such income may be doubtful. In an accrual system, relief should accordingly be given to a taxpayer to avoid the prejudice arising from a tax liability in respect of a (potentially) bad debt.

1.2. Inherently, such doubtful debt relief involves making a prediction about whether a debt will become irrecoverable.

1.3. The recently inserted section 11(jA) of the Income Tax Act provides codified doubtful debt relief to a certain group of "covered" taxpayers.

1.4. Section 11(jA) relief does not extend to a substantial group of taxpayers (including a broad range of very large credit providers). This excluded group has many of the same features as the covered group, which:

1.4.1. have highly sophisticated technology which enables them to predict their bad and doubtful debts with a high level of accuracy, i.e. similar to any "covered person"; and

1.4.2. will have to comply with the same accounting standard as a "covered person", i.e. IFRS9.

Thus these taxpayers currently obtain doubtful debt allowances by engaging with the Commissioner on a discretionary basis. We refer to them as "IFRS9 Taxpayers"

1.5. Section 11(jA) and the proposed amendments to section 11(j) make reference to taxpayers having to comply with IFRS9, of which the following has been said:

> *"International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board (IASB).*
>
> *Having an international standard is especially important for large companies that have subsidiaries in different countries. Adopting a single set of world-wide standards will simplify accounting procedures by allowing a company to use one reporting language throughout. A single standard will also provide investors and auditors with a cohesive view of finances.*

High-quality financial information is the lifeblood of capital markets

Accounting standards are a set of principles companies follow when they prepare and publish their financial statements, providing a standardised way of describing the company's financial performance. Publicly accountable companies (those listed on public stock exchanges) and financial institutions are legally required to publish their financial reports in accordance with agreed accounting standards.

(*https://www.ifrs.org/about-us/who-we-are/)*

The World Bank has been a long-term supporter of work to develop a single set of high-quality global accounting standards."

(*http://www.worldbank.org/en/news/press-release/2017/05/15/ifrs-foundation-and-world-bank-deepen-cooperation-to-support-developing-economies-in-their-use-of-reporting-standards)*

1.6. In terms of the current discretionary dispensation of section 11(j), which extends to all taxpayers other than the "covered persons", the Commissioner may take cognisance of their high levels of predictive accuracy and accordingly grant the appropriate levels of doubtful debt protection. This will no longer appear possible in terms of the proposed "one size fits all" changes to section 11(j) for persons who are not "covered persons". This is discussed further below. The following table illustrates the current and proposed treatment of the doubtful debts provisions under IFRS9 for the two different categories of taxpayer.

PROPOSED SECTION 11(J) ALLOWANCE COMPARED TO EXISTING SECTION 11(jA) ALLOWANCE FOR "COVERED PERSONS"

IFRS 9 Category		**Section 11(jA) allowance (refer note 1)**	**Proposed section 11(j) allowance (refer note 2)**
Stage 1	Performing accounts which have not deteriorated since origination.	25%	25%
	Provide for 12 months expected losses.		
Stage 2	Accounts where there has been a significant deterioration in credit risk.	40%	25%
	Lifetime credit losses have to be provided for.		
Stage 3	Accounts where there has been a default event.	85%	25%

Note 1: Although section 11(jA) is closely aligned to IFRS 9, there are minor differences, none of which significantly alters the inferences that can be drawn from this table.

Note 2: It is assumed that the intent is to extend the 25% allowance to all three stages although the wording in the Draft Bill is not entirely clear.

2. Comments on proposed amendment to section 11(j)

2.1. We have been advised by taxpayers who have made some calculations of the impact of the proposed changes that they are materially onerous. In simple terms they will be required to pay substantial additional amounts of tax on amounts that they will not collect. This gives rise to a permanent and material funding cost, which, we submit, is unjustified.

2.2. It is currently proposed that the IFRS9 Taxpayers be given a 25% codified allowance irrespective of their individual circumstances, and that the discretion available to the Commissioner in the current section 11(j) will be deleted entirely. We submit that there is a fundamental conceptual problem with the "one-size-fits-all" approach:

2.2.1. Firstly, the proposed amendments do not distinguish between taxpayers with different circumstances such as their business model, or the accuracy of their doubtful debt provisioning ; and

2.2.2. The proposed amendments do not take cognisance of the particular "buckets" of debt / stages of delinquency of debt (as IFRS9 does) and which many of the taxpayers' systems do in fact identify, with great accuracy.

2.2.3. It is submitted that the greater the accuracy of the prediction that the debtor will default, the greater the allowance ought to be, as there is no justification for requiring the taxpayer to pay any amount of tax on an amount which is highly unlikely to be recovered. The same percentage allowance therefore cannot be applied across all levels or stage of delinquency. Section 11(jA) correctly, we submit, recognises this.

2.2.4. The proposed 25% allowance implies that taxpayers who report under IFRS9 to their shareholders are inaccurate 75% of the time, whereas anecdotally we have been informed by many of them that their provisioning is generally 90-95% accurate in predicting future debtor behaviour. This is information which listed companies prepare in line with a single set of world-wide standards, used to report to their shareholders and stake holders. It is inconceivable that the implied probability of inaccuracy (75%) can be a constant regardless of having observed more loss events in later stage delinquency.

2.3. Arguably, many IFRS9 Taxpayers apply the same single standard and the same amount of rigour in quantifying and classifying their debtors as do those who fall under section 11(jA) and, with respect, there seems no logical reason for the difference in treatment.

2.4. Currently, the section 11(j) discretion would allow SARS in appropriate cases to apply similar principles to those contained in section 11(jA) to a broader set of taxpayers, on a case by case basis. The proposed removal of the discretion makes this impossible.

2.5. Moreover, the removal of the discretion closes the door to one important method of resolving categorisation disputes about which debts are “bad” and which are “doubtful”, and will result in increased litigation between SARS and taxpayers.

3. Proposed solutions / way forward

3.1. One solution would be to expand the ambit of section 11(jA) to cover taxpayers who, just like “covered persons”, have the systems to divide delinquent debtors into the relevant delinquency buckets (discussed above) and are required to report in terms of IFRS9. It could be achieved by an amendment to the definition of “covered person”.

3.2. Alternatively, the IFRS9 Taxpayers require a model which approximates the methodology of section 11(jA) with whatever appropriate modifications are required. We understand that many taxpayers are willing and able to workshop this with National Treasury if the opportunity were to be extended.

3.3. We strongly submit that the current discretionary regime should be retained until an appropriate legislative regime has been workshopped and considered fully by all affected parties. It is acknowledged that there is a desire to move to a self-assessment system, which makes discretionary provisions problematic. It might be that a hybrid approach could be considered, whereby a codified percentage allowance is the default method, but provision is made for SARS to grant a ruling to depart therefrom, in order to achieve a fair and reasonable result.