THE STANDING COMMITTEE ON FINANCE

TECHNICAL SUBMISSION

From:

EXPATRIATE PETITION GROUP

Submitted by:

TAX CONSULTING SOUTH AFRICA Representative

SUBMISSIONS IN RELATION TO THE 2021 DRAFT TAXATION LAWS AMENDMENT BILL

A. PREAMBLE

1. We wish to convey our appreciation for being afforded the opportunity to make a submission pursuant to the publication of the 2021 Draft Taxation Laws Amendment Bill (Draft TLAB) on 28 July 2021; on a matter which does not only impact so many South Africans abroad, but, much more importantly, will have a significant impact on the future tax base and relationship with South Africans abroad.

2. Our submission is directed at the proposed insertion of section 9HC in the Income Tax Act No. 58 of 1962 ("the Act"), which seeks to apply tax to retirement interests where a taxpayer ceases South African tax residency.

3. We make this submission in the capacity as technical advisor to the Expatriate Petition Group ("EPG"), for whom we have had the privilege of presenting during the introduction of "the expat tax".

4. The courage of the Parliamentary Members of the Portfolio Committee in the 2017

process, as well as the frankness and willingness of National Treasury and SARS officials to engage during the Parliamentary hearings and thereafter, have seen to it that section 10(1)(o)(ii) of the Act was not repealed in its entirety.

5. We pray that this submission should please be considered with equal seriousness, as the taxation of South African expatriate retirement interests will be a harmful enactment; one where, even if additional taxes may be collected, will be no justification for the losses that may be suffered by all South Africans suffered otherwise.

B. THE EXPATRIATE PETITION GROUP

6. The EPG was founded as a Facebook group and which then started an online petition to gather complete facts to be presented before National Treasury and Parliament when the repeal (and eventual limitation) of section 10(1)(o)(ii) of the Act ("foreign employment exemption") was proposed during the 2017 legislative cycle.

7. We were again approached by Barry Pretorius, a founder and who previously led the physical presentation in Parliament, to provide a technical submission to oppose this amendment.

8. The EPG has an active membership of 15,000 South Africans abroad, but more importantly has a global reach of South Africans abroad.

9. We respectfully submit, as fact, that the EPG represents South Africans from diverse ages, ethnicities and backgrounds and does not only represent South African resident taxpayers who are expatriates. The group includes, for example, notable representation of South Africans living in South Africa supported by expatriates working abroad, parents supported by children working abroad, new expatriates considering international work offers, expatriates who have left South Africa many years ago (some 25 years plus) and who still consider themselves empathetic to South Africa.

10. For ease of discussion, we shall throughout this submission refer to these individuals collectively as "expatriates".

C. BACKGROUND

11. It is important to contextualise the proposed amendment from the perspective of expatriates. As noted hereinbefore, National Treasury tabled the amendment to the foreign employment exemption in the 2017 legislative cycle. At that stage, we forewarned National Treasury that the amendment will result in undue hardship for expatriates and will have material negative economic consequences; primarily that expatriates will be forced to make a decision regarding their ties with South Africa and may cease their tax residency as a result. Whilst the full repeal of the exemption was not enacted, there was dire warnings that these types of law changes alienate South Africans abroad, harms the tax base and negatively impacts all South Africans.

12. The South African Reserve Bank ("SARB") and the South African Revenue Service ("SARS") have not been forthcoming with the statistics on the number of South Africans who completed the recognised emigration process through the SARB ("financial emigration"), since the promulgation of the amendment to the foreign employment exemption. As one of the largest service providers on this process in the country (if not the most prominent), we can attest to a surge in financial emigration applications leading up to and after the effective date of 1 March 2020.

13. While not openly acknowledged by Government, our account seems to be supported by the following statement in the 2020 Budget Review:

> *"Government will increase the cap on the exemption of foreign remuneration earned by South African tax residents to R1.25 million per year from 1 March 2020. <u>Some advisors have recommended emigration, as recognised by the Reserve Bank, as a way to break tax residency. However, this is only one factor considered by SARS. Government wants to encourage all South Africans working abroad to maintain their ties to the country</u>. Consequently, this concept of emigration will be phased out by 1 March 2021. Details appear in Annexure E."* (emphasis added)

14. Government increased the limitation of the foreign employment exemption to R1,25 million and encouraged South Africans to retain their South African ties. As a

consequence of Government's aspirations to keep expatriates in the South African tax net, it was announced that financial emigration will be phased out by 1 March 2021. Annexure E to the 2020 Budget Review supplemented this announcement, which stated that a less restrictive exchange control framework will apply to expatriates and a new emigration process that aligns with this policy change will be implemented.

15. Pursuant to this announcement, in the 2020 Draft TLAB, it was proposed that the definitions of "pension preservation fund", "provident preservation fund" and "retirement annuity fund" under section 1 of the Act be amended to remove reference to the financial emigration process, which allowed for immediate withdrawal of these interests upon emigration. It was replaced with a new test that only allowed a taxpayer to withdraw their retirement interests if they can prove they have been non-resident for tax purposes for a consecutive period of at least three years.

16. The imposition of a three-year lock-up of retirement funds did not accord with the professed policy change of a less restrictive framework. This amendment, too, was widely opposed and we again cautioned National Treasury against enacting a further amendment that would create hardship for expatriates. The amendment was nonetheless promulgated as initially proposed.

17. The sentiment among expatriates was again that National Treasury ignored their plight and pushed through an amendment that will have a direct negative impact on this group of individuals. We can again attest to this based on the rush among our client base to file their financial emigration applications before 1 March 2021.

18. The subjects of the latest proposal to tax retirement interests upon cessation of tax residency is, once again, expatriates. For purposes of this submission, we conducted a survey among the EPG, to determine the impact of this amendment on expatriates. The survey results are that 75.75% have indicated they still have retirement interests in South Africa; whilst 88% of the participants indicated that the amendment would have a negative impact on them personally, of which 64.12% stated that it will materially change their retirement planning.

19. The survey is clear that many South Africans abroad still value the South African

retirement investment offering, but that an unjust tax will cause them to seek greener pastures.

20. Expatriates are again forced to make long-term decisions regarding their residency status. The series of amendments that effectively targets expatriates creates a negative narrative that this group of individuals have to operate within a system where there is no regard for their interests. Moreover, it gives credence to the belief that expatriates are singled out and that there is no certainty on what they may face in years to come.

21. On this basis, we again caution that the proposal to apply an exit tax to retirement interests is counterintuitive to Government's objective to keep the members of this segment of the tax base within the South African tax net.

D. THE AMENDMENT

22. Section 9HC proposes to treat a natural person to have disposed of their interest in a retirement fund on the day before they cease South African tax residency. Section 9HC provides that the value of the interest will be determined on the date of disposal, although the tax will be deferred until the amount is receivable from the fund.

23. The tax will be calculated in terms of the withdrawal tax tables prevailing when the individual receives a payment from the retirement fund. The tax due will be increased by applying interest in terms of section 189 of the Tax Administration Act No. 28 of 2011 ("TAA").

24. The Explanatory Memorandum to the Draft TLAB ("EM") provides the following clarification for the proposed amendment:

> *"**I. Background***
>
> *…*
>
> *When an individual ceases to be a South African tax resident, a member's interests in retirement funds are, due to the provisions of certain treaties, not always subject to tax in terms of the Act. In contrast, for example, when an*

individual ceases to be a South African tax resident, but retains his or her investment in a South African retirement fund, and only withdraws from the retirement fund when he or she dies or retires from employment, section 9(2)(i) of the Act deems such amounts to be from a South African source, thus remaining within the South African tax jurisdiction, despite the individual no longer being a South African tax resident.

II. Reasons for change

When an individual ceases to be a South African tax resident before he or she retires and becomes a tax resident of another country, that individual's interest in a retirement fund may be subject to tax in the other country. The application of a tax treaty between South Africa and the new tax resident country may in some instances result in South Africa forfeiting its taxing rights.

Withdrawals from retirement funds by individuals who remain tax resident in South Africa will be taxable when the member either retires, dies or makes a pre-retirement withdrawal. Based on the fact that contributions to retirement fund are deductible when calculating the members annual taxable income, Government wishes to ensure neutrality of tax treatment for all types of withdrawals (irrespective of the individual's tax residency status at withdrawal).

In instances where South African tax residency is ceased, Government further wishes to ensure that there is a mechanism in place that ensures that tax is calculated on the correct value as there will be a lag between the time when tax residency is ceased and withdrawals from the retirement fund are possible and tax is due (this in light of the 2020 amendments to the definitions of "pension preservation fund", "provident preservation fund" and "retirement annuity fund")."

25. The proposed amendment is set to take effect from 1 March 2022.

E. TREATY OVERRIDE

26. A treaty override is described by the Organisation for Economic Co-operation and

Development ("OECD")[1] as *"the enactment of legislation which is intended to nullify unilaterally the application of international treaty obligations".*

27. In other words, a treaty override is where a contracting state enacts domestic legislation that will contravene the provisions of a double tax agreement ("DTA") concluded with another country.

28. We accept that the Article that deals with pensions and similar amounts is not uniform across South Africa's treaty network. For purposes of illustration, we shall inform this discussion with reference to Article 18 of the OECD Model Tax Convention ("MTC"), the wording of which aligns with several of our DTAs, including. Australia, New Zealand, People's Republic of China, Hong Kong SAR, Denmark, Germany, Italy, Portugal, Spain and the United Kingdom.

29. Article 18 of the MTC provides as follows:

> *"Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State."*

30. Patently, Article 18 assigns the sole taxing right of these amounts to the country of residence. As pointed out by the EM, where an amount contemplated under Article 18 accrues from a South African retirement fund to a taxpayer who is no longer resident, that amount may not be taxed in South Africa. The taxpayer's new country of residence will have the sole taxing right, irrespective if the amount is deemed to be from a South African source.

31. Section 9HC proposes to tax the taxpayer's retirement interest specifically to get around Article 18, because if it is taxed when the amount accrues or is actually received, SARS will have no right to tax this amount. Section 9HC is specifically configured to circumvent the DTA and this much is acknowledged in the EM:

[1] The Recommendation concerning Tax Treaty Override, adopted by the OECD Council on 2 October 1989.

"When an individual ceases to be a South African tax resident before he or she retires and becomes a tax resident of another country, that individual's interest in a retirement fund may be subject to tax in the other country. <u>The application of a tax treaty between South Africa and the new tax resident country may in some instances result in South Africa forfeiting its taxing rights</u>." (emphasis added)

32. The fiction created under section 9HC constitutes a Double Tax Treaty override, confirmed as such by the wording of the EM. It has always been sacrosanct for a proud National Treasury and SARS, that we adhere to our treaties and do not create treaty overrides. This directly adversely impacts South Africa's international tax treaty partners and / or will create a double tax for our expatriates.

33. We plead with the Parliamentary Portfolio Committee to demand response hereon and which has not been shared in the EM, for example –

33.1. Are expatriates targeted by National Treasury, given that the only South African treaty override ever considered is aimed at this group only?

33.2. What is the actual loss to the fiscus (the quantified amount) which underpins the mischief this seeks to address that warrants such an extraordinary break from a proud and important principle?

33.3. What guarantees or safeguards are provided against double taxation or the other breaches which necessarily occurs when our fiscal framework sails into the unchartered waters of breaking our double tax treaties?

F. DOUBLE TAXATION

34. The EM does not address that section 9HC may result in double taxation of retirement interests.

35. From a treaty perspective, we shall again refer to the MTC, as the credit provisions under DTAs are not uniform either. Article 23B of the MTC determines that the country of residence must give a credit in respect of *"income…which may be taxed in the other Contracting State in accordance with the provisions of this Convention…"*

36. In other words, the country of residence is obliged to provide a credit in terms of the treaty insofar as the income in question was taxed in accordance with the provisions of the DTA. On the basis that section 9HC overrides the DTA, the future country of residence would not be required to give a credit for taxes paid in South Africa.

37. This position aligns with our domestic credit mechanism under section 6*quat* of the Act, which does not afford a tax credit where the tax imposed by another country is illegitimate.

38. The alternative would be for the country of residence to give a credit in terms of its domestic legislation. It is not clear if National Treasury has done the groundwork to establish if the countries that will enjoy a sole taxing right will in fact give a credit on this basis.

39. A supposition that our treaty partners will, or should, give a credit in these cases can best be described as ironic in light of Government's decision to repeal section 6*quin* of the Act.

40. Section 6*quin* provided for a foreign tax credit that applied to foreign withholding taxes imposed in respect of service fees from a South African source. The credit provided relief where treaty partners imposed withholding taxes on services in contravention of the DTA.

41. The Davis Tax Committee's Interim Report on Action 6: "Preventing Treaty Abuse" noted that Section 6*quin* resulted in a situation where *"South Africa effectively eroded its own tax base as it was obliged to give credit for taxes levied in the paying country."*

42. Section 6*quin* was repealed in the Taxation Laws Amendment Act No. 25 of 2015. The EM explained the reason for this change as follows:

> *"The special tax credit regime is a departure from international tax rules and tax treaty principles in that it indirectly subsidies countries that do not comply with the tax treaties. <u>South Africa is the only country in the world that provides for this kind</u>*

of tax concession. Effectively, it encourages treaty partners not to abide by the terms of the tax treaty in respect of the taxation of fees and thus give them taxing rights over income that is not sourced in those countries. Consequently, it defeats the whole purpose of the tax treaty." (emphasis added)

43. In the context of this passage quoted from the EM, the notion that any country would, or should, give a credit where a tax is imposed in contravention of the treaty is non-sensical. To use National Treasury's own words, there is no other country *"that provides for this kind of tax concession."*

44. It is extraordinary, though, that National Treasury would seek to introduce a provision that stands in direct contrast with its strong views on the departure from international tax rules and treaty principles. The gravity of this policy decision is addressed in the submissions that follow.

45. For purposes of this discussion point, we note that section 9HC will, undoubtedly, result in the double taxation of retirement interests where the DTA gives the sole taxing right to the country of residence. As the proposed tax will be illegitimate in the context of the DTA, there will be no relief for the taxpayer in these cases.

46. We wish to respectfully remind the Portfolio Committee of the section 6*quin* debate where the consequences of the removal of this section were so eloquently explained by the now late Carel Gericke, one of our brightest tax minds of recent times and who sadly passed earlier this year. There was no-one in attendance who did not appreciate his explanation why the removal of the clause does not support investment in South Africa and for those with interest in the historical records, his example of an international call center is a good study for any student of international tax. The section was nevertheless repealed due to sound policy considerations. We humbly submit that if the exact same policy considerations are applied by the Committee, this proposed enactment cannot be supported.

G. CONTRAVENTION OF SECTION 108 OF THE ACT

47. The conclusion and status of international treaties is catered for in terms of section 231 of the Constitution. Section 231(4) of the Constitution determines that *"[a]ny*

international agreement becomes law in the Republic when it is enacted into law by national legislation…"

48. Section 108(1) of the Act is the enabling legislation that makes provision for the enactment of international agreements, specifically concluded for the purpose of preventing double taxation i.e., a DTA. Section 108(2) then states that as soon as a DTA is published in the Government *Gazette*, its provisions shall have the effect as if enacted in the Act. In other words, once promulgated, a DTA forms part of our domestic law; it is subsumed under the Act.

49. Accordingly, as section 9HC would override some of the DTAs in our treaty network, it contravenes the provisions of the DTA itself. By extension it flouts the provisions of section 108 of the Act.

50. How this conflict will be resolved from an interpretive perspective is a further question that needs addressing. In this regard, the Supreme Court of Appeal in *Commissioner for the South African Revenue Service v Tradehold Ltd [2012] JOL 28890 (SCA)* held that where there is a conflict between a DTA and the Act, the DTA modifies our domestic law to the extent that it enjoys preference:

> *"Once brought into operation a double tax agreement has the effect of law. Double tax agreements effectively allocate taxing rights between the contracting states where broadly similar taxes are involved in both countries, <u>and modify the domestic law and will apply in preference to the domestic law to the extent that there is any conflict</u>."* (emphasis added)

51. In other words, where a conflict arises, the DTA occupies a higher status than the applicable provision in the Act. Beyond the fact that section 9HC will contravene the Act itself, it is not clear if National Treasury deliberated over how the conflicting provisions ought to be reconciled.

H. CONTRAVENTION OF THE VIENNA CONVENTION

52. South Africa is not a party to the Vienna Convention on the Law of Treaties ("VCLT") but its main provisions, which constitute customary international law, are binding on

South Africa. This position has been confirmed by the Constitutional Court in *Law Society of South Africa and Others v President of the Republic of South Africa and Others [2018] ZACC 51*:

> *"Although South Africa is not party to the Vienna Convention, it is bound by some of its major provisions like articles 18 and 26."* (emphasis added)

53. Article 26 of the VCLT holds as follows:

> *"Every treaty in force is binding upon the parties to it and must be performed by them in good faith."*

54. Patently, where South Africa enacts a domestic provision that circumvents a DTA, it violates its good faith obligation under Article 26 of the VCLT.

55. In turn, Article 18 of the VCLT holds as follows:

> *"A State is obliged to refrain from acts which would defeat the object and purpose of a treaty when:*
>
> *(a) it has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not to become a party to the treaty; or*
>
> *(b) it has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed."*

56. According to Article 18 of the VCLT, South Africa must refrain from acts that would defeat the object and purpose of a treaty, at least until such a time as it has made its intention clear not the be a party to the treaty. While Article 18 is directed at obligations before a treaty is enacted, we submit that where South Africa enacts a provision that leads to double taxation, which it will, it defeats the object and purpose of the DTA, thereby contravening Article 18 of the VCLT as well.

57. It is not clear from the EM if National Treasury considered South Africa's obligations

under international law in making this proposal, but the decision to enact section 9HC signals a deviation from a longstanding policy to respect these obligations.

58. Throughout our history, South Africa has refrained from violating its treaty obligations, even in the face of aspects that pose real harm to the fiscus, such as practices under controlled foreign companies, transfer pricing and other tax evasion schemes.

59. We plead that, in the context of expatriates, an exception cannot be made. This unprecedented policy decision adds to the narrative of marginalisation of the expatriate population, but perhaps more importantly is against the principles and spirit of law, which many have fought to uphold.

I. DISTORTIVE EFFECTS OF SECTION 9HC

60. The operation of section 9HC is such that the "amount" for purposes of the tax is determined on the day before the taxpayer ceases residency. The tax, however, only becomes payable when the amount is receivable from the retirement fund, which will be levied in terms of future tax tables.

61. In other words, it is entirely possible that the tax will be paid years or even decades after the taxpayer ceases residency.

62. The reality is that the value of retirement interests is determined by the underlying investments, such as equities. It is entirely possible, especially in the current fiscal climate, that the value of these investments may decline after the tax was triggered.

63. On account of Regulation 28 made under the Pension Funds Act No. 24 of 1956 ("PFA"), taxpayers do not have freedom to structure their investment in a way that will normally hedge against such adverse fluctuations.

64. The upshot is the taxpayer may end up paying tax on a higher amount than what they actually receive, not to mention the fact that interest will be levied in respect of the inflated tax, at potentially higher tax rates. In these cases, the tax may be exceedingly punitive.

65. We accept that the converse may also apply, where the value of the retirement interest increases considerably after cessation of residency. But in this case, it appears the additional growth will nonetheless be taxed and there will be no loss for the fiscus, although the operation of the proposed section is not clear on this eventuality.

66. The imposition of interest is in itself a vexing prospect. The lock-in rule, together with the application of section 9HC, will in most cases result in at least a three-year delay between cessation of residency and the payment of the related tax (when the retirement interest may be withdrawn). This discrepancy, which was self-created by Government, will force taxpayers to incur interest on an unquantifiable amount, further eroding their retirement benefit. It is a concept that is, with respect, inane.

67. As a whole, the configuration of section 9HC is at cross-purposes with the fundamental principles that underlie our tax system. It is only logical that tax should be imposed on an amount that can be quantified; with this we mean the amount to which the taxpayer will become unconditionally entitled, at which point in time the same amount may be liquidated to discharge the concomitant tax obligations. These are trite principles distilled through decades of jurisprudence.

68. Inherently, section 9HC creates a massive distortion; tax is triggered on a fictitious amount, which will be levied with exacted interest, based on unknown tax rates. This we submit is attributable to the fact that section 9HC is contrived. It defies all the principles of a “good” tax.

69. Ultimately, section 9HC serves an additional disincentive to keep retirement interests in South Africa, or to use retirement funds at all as saving mechanism.

J. ANCILLARY SUBMISSIONS

70. We wish to briefly note certain ancillary items that appear to have been disregarded in the formulation of the proposed section –

70.1. The imposition of interest, as contained in the proposed section, is

incongruent with the applicable provisions of the TAA. Section 187 of the TAA imposes interest in respect of a "tax debt", which is defined in section 169(1) as *"[a]n amount of tax due or payable in terms of a tax Act".* Section 9HC states that the tax on the retirement interest is not "due and payable" until the amount is receivable. It follows that the deferred tax would not constitute a "tax debt" and will not be subject to interest in terms of Chapter 12 of the TAA.

70.2. In a similar vein, the definition of "retirement fund lump sum withdrawal benefit" does not cater for a deemed disposal of retirement interests. The provisions of the Second Schedule, as they currently read, would not allow for the value of the retirement interest to be treated as an amount contemplated in paragraph 2(1)(b)(ii) of the Second Schedule to the Act, as is proposed.

70.3. The PFA and retirement fund rules do not make provision for an exit from the fund upon ceasing residency. Section 9HC effectively overrides the PFA and the rules of retirement funds, which means that these would have to be amended to accommodate the proposal.

K. CONCLUSION

71. As a general point, the proposed insertion of section 9HC is the latest in a series of legislative amendments that antagonises the expatriate population. It forces these individuals to take stock of their position and we anticipate that it will result in more of these taxpayers permanently cutting their ties with South Africa.

72. Based on the EM, it appears that National Treasury is alive to the fact that the proposal constitutes a treaty override. In any event, for the avoidance of doubt, we record that the enactment of section 9HC will constitute South Africa's first treaty override.

73. Flowing from this conclusion, there will be instances where section 9HC will result in double taxation of retirement interests, in which case taxpayers will not be afforded any relief.

74. Due to the status of the DTA in our law, the enactment of section 9HC will contravene the Act, as well as South Africa's obligations under the VCLT. This decision signals a deviation from longstanding policies, which appear to be justified by the fact that the proposal is directed at a targeted group of taxpayers.

75. The operation of section 9HC will have immensely distortive results, where the accrued retirement interest will be detached from the imposed tax liability.

76. The proposal as contained in the Draft TLAB does not account for the cascade of other provisions in the Act, other pieces of legislation and retirement fund rules that will have to be amended to make the provision remotely operational.

We herewith further request to make submissions at the public hearings on Tuesday 31 August 2021.

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