The South African Institute of Chartered Accountants

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Dear Sir

CALL FOR COMMENT: THE DRAFT TAXATION LAWS AMENDMENT BILL, 2008, THE DRAFT TAXATION LAWS SECOND AMENDMENT BILL, 2008 AND EXPLANATORY MEMORANDA

We refer to the call for comment on the above-mentioned documents. Set out below please find SAICA's National Tax Committee's submission in this regard.

1. GENERAL

1.1. As with previous submissions, we raise our concerns with the inadequate turnaround time allowed for commenting on the above mentioned Bills.

1.2. This is especially acute in light of the fact that it is unusual for such substantive amendments to be proposed in the Taxation Laws Amendment Act.

1.3. After the 2008 budget speech, there have been a number of documents that have been released by National Treasury. Some of these documents appear to be related, but the relationship is not clear when one reads each document on a stand alone basis.

1.4. We also note that there has been some back-dating of certain proposed amendments. The back-dating of amendments is causing uncertainty in the legislation as taxpayers and tax advisors rely on the legislation without any assumption that changes will be back-dated. Some of the examples are:

- Definition of "distribution" per section 47(1) of the Draft Taxation Laws Amendment Bill, 2008 ("DTLAB 2008") which is deemed to have come into operation on 1 October 2001 and applies to disposals on or after that date; and

- Definition of "refining" per section 53(1) of the DTLAB 2008 which is deemed to have come into operation on 2 November 2006 and applies in respect of a year of assessment ending on or after that date.

1.5. The wording in section 31 needs to be changed to make it clear that between the provisions of section 31(2)(a) and (b) there is an **'and'** i.e. removing any doubt about whether South Africa has local transfer pricing rules.

2. SECTIONS OF THE BILL

2.1 Clause 2 – Proposed amendment to section 1

Contained in the DTLAB 2008, amendments have been proposed in respect of the definition of a "dividend". It is noted that in these proposed changes, the word "capital" has been used. On the other hand, a document titled "Dividends versus Return of Capital" was also released to deal with phase 1 of the two-phased approach for secondary tax reforms. In the "Dividends versus Return of Capital" document, there seems to a proposed detailed definition of "Contributed Tax Capital". It is not clear whether the word "capital" as per the DTLAB 2008 refers to "Contributed Tax Capital" as proposed in the "Dividends versus Return of Capital" document. If the DTLAB 2008 refers to "Contributed Tax Capital" as proposed in the "Dividends versus Return of Capital" document, this definition should be included in DTLAB 2008.

Sub-clause 2(1)(i), the last word on the amendment of paragraph (iiiA) to the definition of a dividend should be 'shareholders' instead of shareholder.

Sub-clause 2(1)(k) of the DTLAB 2008 contains a proposed amendment to paragraph (e) of the definition of "gross income". Previously paragraph (e) provided as follows:

> "any retirement fund lump sum benefit and any other amount determined in accordance with the provisions of the Second Schedule (other than any amount included under paragraph (eA)) in respect of lump sum benefits received by or accrued to a person from or in consequence of his membership or past membership of—
>
> (i) any fund which has in respect of the current or any previous year of assessment been approved by the Commissioner, whether under this Act or any previous Income Tax Act, as a pension fund, provident fund or retirement annuity fund; or
>
> (ii) a fund referred to in paragraph (a) or (b) of the definition of "pension fund",
>
> if such person was a member or past member of such fund during any such year: Provided that the provisions of paragraph (g) of subsection (1) of section nine shall mutatis mutandis apply in the case of any amount determined as aforesaid" (my emphasis).

Based on the current wording of paragraph (e) of the definition of "gross income" read with the provisions in the Second Schedule to the Income Tax Act, No 58 of 1962 ("the Act"), the tax treatment of lump-sum payments from retirement funds are summarised as follows:

- Lump-sum payments from retirement funds are taxable in the hands of the retiring or deceased employee to the extent that the lump-sum payments exceed the tax-free portion of the lump-sum payments. The tax-free portions of the lump-sum payments are determined in terms of the Second Schedule to the Act.

- The current provisions of the Act provide that the taxable portion of any lump-sum payments from retirement funds that relate to services rendered outside South Africa will not be deemed to be from a South African source and will accordingly not be taxable in South Africa. This is due to the fact that paragraph (e) of the definition of "gross income" in section 1 of the Act, which includes the taxable portions of lump-sum payments in gross income, provides that the provisions of section 9(1)(g) shall mutatis mutandis apply in relation to the determination of the taxable portion of lump-sum payments. The extent to which services were rendered by an employee both in and outside South Africa must accordingly be taken into account.

The proposed change of the wording of paragraph (e) will have the significant implications for South African resident employees who render services in and outside South Africa – or even mainly outside South Africa as the proposed wording does not refer to the provisions of section 9(1)(g) of the Act nor does any of the other proposed amendments to the Second Schedule to the Act make provision for South African resident employees who render services in and outside South Africa. The implications for the South African resident employee is that where the South African resident employee rendered services in and outside South Africa, the employee will be also be liable for tax on that portion of the lump sum payments received which are attributable to the services rendered outside South Africa. South African expatriate employees who retire will therefore be worse-off under the proposed wording than what the case was previously.

The proposal further goes against the principles applied in other sections of the Act such as those contained in section 10. For example

- Section 10(1)(gC) of the Act makes provision of pensions earned which relate to services rendered outside South African – also by way of reference to section 9(1)(g) of the Act – but it applies only to pensions and not to lump-sum payments.

- Section 10(1)(o) of the Act makes provisions for the exemption of remuneration earned outside South Africa provided certain conditions are met.

Based on the proposed change, a South African resident will therefore always be subject to tax on the full taxable portion of the lump-sums received from retirement funds and, in sharp contrast to the other provisions in the Act, not enjoy a tax exemption in respect of the lump sum attributable to services rendered outside South Africa.

Sub-clause 2(1)(v) the definition of 'provident fund preservation fund', (a)(ii) the wording transferred to this pension preservation fund should be this provident fund preservation fund.

2.2 Clause 8 – Proposed amendment to section 9D(9)(fA)

The amendment to section 9D(9)(fA) of the Income Tax Act, 58 of 1962 as amended ("the Act") is welcomed because it extends the 'passive income' exclusion between controlled foreign companies ("CFCs") to the reduction of debts, which clearly falls within the 'passive income' concept. In addition, it clarifies that the exclusion extends to recoupments, as well as capital gains, whereas currently only a capital gains tax exclusion may apply by virtue of the application of paragraph 12(5) of the Eighth Schedule of the Act.

However, the amendment is effected by substituting new wording for the entire section, which does not contain the proviso which is currently contained in section 9D(9)(fA) of the Act. The proviso reads as follows *"provided that any such amount may, at the election of any resident contemplated in section (2), be so taken into account"*. The result is that the new section 9D(9)(fA) does not allow a resident to elect for the exclusion not to apply. It appears that this is an unintended consequence and we recommend that the proposed wording be amended to include this proviso. More specifically, we request that the current proviso as contained in section 9D(9)(fA) of the Act be retained.

2.3 Clause 9 – Proposed amendment to section 10

Sub-clause 9(c) of the DTLAB 2008 amends section 10(1)(i). According to this amendment, investment income will also be exempt provided it does not exceed R50 000. For the purposes of this amendment, investment income is defined in section 12E of the Act and it includes dividends, royalties, rental, etc. Dividend income is already exempt in terms section 10(1)(k). Therefore, it should be excluded from investment income that triggers tax in terms of this amendment.

The proposed amendment to section 10(1)(k)(ii)(dd) of the Act is welcomed.

2.4 Clause 15 – Proposed amendment to section 20

Sub-clause 15(b), the reference specifically to section 37B(2) is going to cause confusion as section 11(x) already embraces all sections in the Part which ends at S37H. The addition of this reference is superfluous and should be removed.

2.5 Clause 17 – Proposed amendment to section 23A

It has been noted that the effective date of this amendment has not been stated in the proposed amendment, i.e. clause 17(2) reads as follows *"Subsection (1) is deemed to have come into operation and applies in respect of a year of assessment ending on or after that date"*. We assume that this amendment is intended to have come into operation on 1 January 2008. This is obviously an oversight, which was unintended. However, the general date of application for the DTLAB 2008 is 1 January 2009, which will apply unless a date is specified to the contrary.

We request that the date of operation be specifically specified by National Treasury by inserting the words *"on 1 January 2008"* into clause 17(2).

2.6 Clause 19 – Proposed amendment to section 23H

The proposed amendment that the deduction of pre-trade expenditure in terms of section 11A is subject to section 23H implies that pre-trade expenses will be deductible only where the goods or expenses are to be supplied or rendered within 6 months after the end of the year of assessment during which the expenditure was incurred. This time period may not be practical for some pre-trade businesses who may incur pre-trade expenses more than 6 months before trade commences.

2.7 Clause 20 – Proposed insertion of section 23K

Clause 20 of the DTLAB 2008 inserts section 23K into the Act. In terms of this section there is a limitation of cost by the acquiring taxpayer, if the taxpayer acquired equity shares from a connected person and such connected person in turn had acquired the equity shares within two years from the date of disposal to the taxpayer. In terms of this limitation, the cost of such equity shares to the taxpayer is equal to cost to the connected person less **deductions allowed to that connected person** plus paragraph (n) gross income plus the capital gain at the respective inclusion rate.

It is not clear whether the deductions allowed to a connected person include a deduction of the base cost resulting from the disposal by such connected person to the acquiring taxpayer. If this deduction includes the base cost, then the acquiring taxpayer is in a worse tax position. As the cost of acquisition is likely to be closer to nil if the base cost of the acquired asset is high.

It is not clear why this section does not cover the deemed proceeds in the hands of the connected person to 'mirror' the base cost of the acquiring taxpayer. The principles applied to paragraph 38 of the Eighth Schedule to the Act should equally apply by ensuring that the proceeds of the connected person are taken over as the base cost of the acquiring taxpayer.

The Explanatory Memorandum refers to Media Statement on Taxation Laws Amendment Bills, 2008: Company Restructuring Measures dated 21 February 2008 for an explanation in respect of this proposed new section. However, the Media Statement in question does not contain any explanation in this regard. We respectfully request the immediate issue of a Media Statement providing the requisite explanation, which was clearly omitted from the Media Statement on Taxation Laws Amendment Bills, 2008: Company Restructuring Measures dated 21 February 2008, as this section warrants an explanation.

Section 23K(2). This section seems to be unduly harsh because of the second reference to 'at any time'. This means that even a person no longer connected during that 2 year period is brought into the section. Is this the intention?

2.8 Clause 23 – Proposed amendment to section 41 definition of "group of companies"

<u>We would like to take the opportunity to thank National Treasury for re-looking at the de-grouping provisions</u>

<u>Preamble to the issue</u>

The amendment to the "group of companies" definition in section 41, contained in Revenue Laws Amendment Act 35 of 2007 had the effect of excluding all foreign companies (as defined in paragraph (b) of the definition of a "company" in section 1 of the Act) from this definition. However, the change is only effective from 1 January 2009. The commentary in the Explanatory Memorandum to the 2007 Bill was that "*fully or partially exempt companies will now fall outside intra-group relief (including foreign companies falling wholly or partially outside the South African tax net and enforcement)…"*

Objections were raised, via the Banking Association of South Africa ("BASA"), to the exclusion of foreign companies from this definition. In response thereto, the Portfolio Committee on Finance did not accept comments as to the discriminatory nature of the exclusion of non-residents, commenting that *"Only companies fully within the tax net (from a substantive and administrative viewpoint) can be members of a group. Hence, the exclusion applies equally to foreign and domestic parties outside the net"*.

<u>The current issue</u>

It is disappointing to note that the explanation in the Media Statement on Taxation Laws Amendment Bills, 2008: Company Restructuring Measures dated 21 February 2008 re-iterates National Treasury's desire to exclude foreign companies from group relief. In particular, CFCs are subject to tax in South Africa, as though they were South African tax resident in terms of the provisions of section 9D of the Act, however they are excluded from the group relief provisions since they are foreign companies. However, the Explanatory Memorandum provides a detailed explanation of how foreign companies effectively managed within South Africa should enjoy group relief, as long as these companies have registered as external companies under the Companies Act of 1973.

The exclusion of CFCs and the inclusion of foreign companies, which are effectively managed in South Africa, from the group relief provisions are discriminatory against the South African resident parent of a CFC. In the majority of the examples provided in Media Statement on Taxation Laws Amendment Bills, 2008: Company Restructuring Measures dated 21 February 2008, the structures are aimed at foreign companies investing in South Africa. However, National Treasury seems to have lost sight of South African companies investing abroad. These groups are forced to navigate complicated CFC legislation and will now be excluded from South African tax relief if they restructure their foreign group. This is compounded by National Treasury's statement in the Media Statement on Taxation Laws Amendment Bills, 2008: Company Restructuring Measures dated 21 February 2008 that they are contemplating repealing paragraph 64B of the Eighth Schedule of the Act.

However, what is more concerning is the manner in which the amendments to the definition of "group of companies" have been drafted. Clause 23(1)(b) of the TLAB deletes the reference to a company contemplated in paragraph (b) of the definition of "company" (which refers to foreign companies). Thereafter, the reference to a company contemplated in paragraph (b) of the definition of "company" is reintroduced by clause 23(1)(d) of the TLAB, which inserts a new category of assets to be excluded from proviso (i) to the "group of companies" definition, but it is limited to foreign companies which are effectively managed in South Africa and registered in terms of the Companies

Act of 1973. The manner in which this amendment has been drafted has the opposite effect to what the Explanatory Memorandum stipulates. The definition of group of companies excludes companies listed in proviso (i), and foreign companies have been removed from this list. Thereafter, foreign companies effectively managed in South Africa have been added as a new category of companies to be included in proviso (i), i.e. they are excluded from the definition and prohibited from claiming group relief.

Therefore, we should be delighted with the manner in which the definition of "group of companies" has been drafted because it allows foreign companies to claim group relief, except for those which are effectively managed in South Africa. However, according to the Explanatory Memorandum, this is clearly not the intention of National Treasury.

In addition, with the proposed change to the South African Exchange Control regime, which will result in Banks being granted additional prudential limits within which to hold foreign assets, there may be a significant transfer of foreign assets currently held by foreign group companies to South African banks, which will require reliance on group relief. Since the effective date for the amendment to the definition of "group of companies" is 1 January 2009, there is a small window of time within which the South African Banking Industry has to restructure their affairs. However, there is no indication as to the length of time it will take for the amendments to these prudential limits to take effect. There is a risk that the transfer of foreign assets in line with the changes to Exchange Control will have a punitive tax effect for the Banking Industry, if such transfers take place after 1 January 2009. The proposed solution below will eliminate this risk.

<u>Proposed solution</u>

Once National Treasury recognises the error that has been made, they will no doubt amend the legislation to once again exclude foreign companies from the "group of companies" definition. In doing so, it is proposed that they exclude CFCs from the proviso relating to foreign companies, since they are within the South African tax net and their South African parent companies should be allowed the same group relief in relation to their foreign owned subsidiaries as they receive for locally owned subsidiaries. This will be achieved by amending proviso (i) by adding the following underlined provision, as follows: *"(aa) that company is a company contemplated in paragraph (b), <u>excluding CFCs</u>, (c), (d) or (e) of the definition "company".*

2.9 The "group of companies" definition

There was an amendment to the definition of "group of companies" in 2007, by virtue of which proviso (i) was expanded to include companies if *"(i) … (cc) any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10 were it to be received by or to accrue to that company"*. The Explanatory Memorandum to the 2007 Bill stated that *"The intention is not to exclude companies from a group merely as a result of that company receiving a particular type of income that is exempt. The intention is to exclude companies if all or every receipt and accrual of that company is exempt. For example, a company will not be excluded from a group merely as a result of the receipt or accrual of an exempt dividend, unless all other receipts and accruals of the company would also exempt." [sic]*

However, based on the wording of paragraph (i)(cc) quoted above, the stated intention was not attained. In terms of the amendment, which was promulgated in terms of Revenue Laws Amendment Act 35 of 2007, not only a company receiving any form of exempt income would be excluded from utilising group relief provisions, but even companies not receiving exempt income but in whose hands income would be exempt if received, would be excluded. As local dividends would be exempt if received by any company, it follows that **all companies** will be caught in the ambit of the exclusion contained in paragraph (i)(cc) and **thus no company will qualify** to utilise the group relief provisions or the STC exemption in terms of section 64B(5)(f) of the Act.

We understand that, in response to submissions made in relation to this provision by a number of parties that this would adversely affect holding companies that only received dividend income, SARS/National Treasury in their response to the Parliamentary Committee on Finance (see Comment #3 on page p9 of the Portfolio Committee on Finance Revenue laws Amendment Bills & Securities Transfer Tax Bills Response Document dated 9 November 2007) stated that they accepted this comment and that *"the draft legislation admittedly contains a technical problem that creates this undesirable result for holding companies. The proposed legislation will accordingly be modified to remedy this concern"*. Clearly the wording, which appears in Revenue Laws Amendment Act 41 of 2007, does not attain this.

<u>Proposed solution</u>

This requires the immediate attention of National Treasury, as it is conceivable that if this provision remains in its current form, no taxpayer will be entitled to group relief after 1 January 2009 nor has been entitled to STSC relief in terms of a section 64B(5)(f) election since 1 October 2007. It appears that National Treasury were seeking to exclude only 'non-tax paying companies', however this is not achieved by the current wording of paragraph (cc) of proviso (i).

It is suggested that paragraph (cc) of proviso (i) of the "group of companies" definition should be deleted pending National Treasury drafting a provision which captures the essence of the exemption that they are aiming to achieve.

2.10 Clause 26 – Proposed amendment to section 45

There are two broad areas of proposed changes to section 45 of the Act, namely (a) that transfers settled by cash are to be excluded from the intra-group relief, and (b) that transfers funded by way of internal loan notes will potentially give rise to double tax (on disposal of the assets, as well as on repayment of the loan).

We believe that these changes have the potential to negatively impact a wide range of legitimate intra-group transactions.

The limitation of roll-over relief up to market value limits many commercial funding transactions that rely on these provisions to facilitate growth of smaller and medium sized enterprises. In addition, this proposed amendment may negatively impact numerous "BEE" deals, which rely on the application of cash funded transactions which rely on group relief.

Sub-clause 26(1) of the DTLAB 2008 amends section 45, by introducing subsection 3A. This amendment requires that the transferor company is deemed to have acquired the debt instrument is exchange for asset disposed of for an amount equal to the lesser of market value or base cost as per paragraph 20 of the Eighth Schedule to the Act in the case of a capital asset or the amount deducted in terms of section 11(a) in the case of stock.

As result of this change, there could be differences between the face value of the debt reflected in the annual financial statements of the transferor and the amount recognised as a base cost for tax purposes. Does this mean that when the loan is settled the transferor should liable for capital gain on the difference between amount paid by the transferee and this deemed base cost?

We are of the view that this amendment is likely to affect normal transactions that are effected in terms of section 45. As indicated in the Media Release, the transactions which are similar to the example provided in the Media Release should be dealt with under General Anti Avoidance Rules rather than amending section 45.

Sub-clause 26(2), proposes the new subsection 45(4A) to come into effect on 1 January 2009, while (4A) states that subsection (4) (being the section that specifically allows the consecutive transfer of assets in a group in terms of section 45,) will not apply in respect of a company that ceases to from part of a group due to the change in the 'group' definition, unless the company so ceases after 20 February 2008 due to another reason. Not only is this stated quite confusingly, should the effective date now not also be moved to the date of the media statement, being 21 February 2008.

Summary of negative financial impact of proposed changes on classes of legitimate business transactions

- The proposed redefining in section 45(1) as to what constitutes an intra-group transaction for purposes of the roll-over relief precludes transactions whereby the purchase price is settled in cash. In effect the roll-over relief is denied, thus accelerating a tax cost and negating a relief explicitly provided for in the legislation, by reference to a wholly normal transaction which is not used to avoid tax.

- The proposed section 45(3A) in turn effectively turns a roll-over relief section into a taxing section. Instead of roll-over relief applying a taxpayer is in effect hit with a double tax charge (with no means of avoiding the cascading effect by means of a dividend) in respect of a single economic benefit.

- Both of the above negative aspects of the proposed changes in legitimate business transactions are we submit wholly unacceptable. It is worth noting that the proposed changes in effect render the purported relief in section 45 meaningless – it is no longer a section which provides relief.

Classes of legitimate business transactions prejudiced by proposed changes

In respect of the above, and in the limited time available since publication of the Media Statement and Bill, we have identified below a number of classes of business transaction

which do not involve a cashing out but which would be severely impacted (negatively) by the proposed changes, including;

- BEE transactions (internally funded);
- BEE transactions (externally funded);
- Securitisations;
- Other transactions (preclusion of cash transactions);
- Other transactions (use of debt instruments); and
- Leveraged transactions

Proposed solution

The proposed amendment to section 45 should be deleted, as it is our view that the tax avoidance issues that were cited to support this tax amendment should be more adequately addressed by simple de-grouping provisions, or even general anti-avoidance provisions based on business rationale.

2.11 Clause 29 – Proposed amendment to section 64B

Sub-clause 29(1) of the draft Taxation Laws Amendment Bill, 2008 amends section 64B(5)(f) by limiting the intra-group relief within the group of companies. It is not clear in the Explanatory Memorandum as to why this proposed change was made. We are of the view that it is unfair for dividend declared with the group of companies to be subject to STC while such dividend is still within the group of companies as defined. This appears to defeat the purpose section 64B(5)(f).

We are not sure of the purpose of the proviso "Provided further that the provisions of this paragraph do not apply in respect of a dividend declared by a controlling group company to a controlled group company".

2.12 Clause 30 – Proposed amendment to section 64C

Clarity still needs to be obtained as to where an asset is transferred at below market value. Is it required physically for the transferor to reduce its profits (physical debit the income statement) and for the shareholder to physically credit its' income statement. The intention of "taken into account" must be clarified.

Sub-clause 30(1) of the DTLAB 2008 amends section 64C(4)(k) of the Act with effect from 1 October 2007. It is understand that the object of this section is to avoid the erosion of the STC base through inter-company loans. However, it appears that the section has resulted in unintended consequences.

For example in a vertical holding there should be deemed dividend when a loan is provided by a shareholder to its subsidiary. However, where one of these companies is a not part of Group of Companies (i.e. less than 70% held) as defined in section 1 of the Act, it appears that a downward loan could result in a deemed dividend. In this

situation A holds say 55% in B who holds 80% in D. If B provides a loan to D, there is a deemed dividend in the hands of B and this is not exempt in terms of section 64C(4)(k). There is deemed dividend even though B and D are a Group of Companies because A is not part of the Group of Companies. In this case D (as a subsidiary of A and B) is a connected person to (or in relation to) A (who is a shareholder to B).

Another example is where a loan is provided by a subsidiary to its sister subsidiary in a horizontal structure. These loans should not be viewed as intended to erode the tax base. For example if A holds 65% in B and 65% in C, a loan made by one subsidiary to another subsidiary is likely to trigger a deemed dividend even though there was no tax benefit to A (who is a shareholder).

The loans referred to in the above examples could be written off is the borrower does not funds to settle the outstanding amount. The provisions of section 64C(4)(k) do ensure that there is no double deemed dividend resulting from the release or relief from the obligation.

2.13 Clause 33 – Proposed amendment to paragraph 2B of the Second Schedule

The reference to the Divorce Act does not specify divorces before the changes to the Act.

2.14 Clause 37 – Proposed amendment to paragraph 6 of the Second Schedule

Sub-clause 37(a), Second Schedule, Paragraph 6(a)(iv), why is a transfer from a provident preservation not permitted as a deduction if transferred to a Retirement Annuity Fund. This would be a transfer to a more restrictive fund. Suggestion is to add "The transfer to a Retirement Annuity Fund".

Sub-clause 37(b), Second Schedule, Paragraph 6(b), the limit imposed here of R1800 has not been amended. This limit should line up with the permissible lump sum withdrawals of R50 000 or at least the tax threshold.

2.15 Clause 38 – Proposed amendment to paragraph 11B of the Fourth Schedule

The explanatory memorandum proposes that the annualising of salary be not effected in certain circumstances. This is not what the new section 11B of the Fourth schedule does. The new 11B is exactly as it was previously. The paragraph needs revision.

2.16 Clause 42 – Proposed amendment to paragraph 12 of the Eight Schedule

Clause 42(a) refers to 'subject to paragraph 24'. Clause 42(c) deletes subparagraph 4 of the paragraph. Paragraph 24 still refers to subparagraph 4 and has not been amended?

2.17 Clause 46 – Proposed amendment to paragraph 67A of the Eight Schedule

The word property has been removed and replaced with securities. The section still refers to part 5 of the Collective Investment Schemes Act which is about property. This should be changed to Part 4 unless the CIS Act has been changed.

2.18 Clause 47 – Proposed amendment to paragraph 74 of the Eighth Schedule

The paragraph has an incorrect spelling of dividend.

2.19 Clause 45 – Proposed amendment to paragraph 64B of the Eighth Schedule

The proposed amendments to subparagraph (2) of paragraph 64B of the Eighth Schedule to the Act are problematic in two instances.

Firstly, the wording of the proposed subparagraph (2)(b)(ii) which reads as follows *"in the circumstances contemplated in paragraph 12(2)(a) as a result of a disposal to a person contemplated in sub item (i)"* effectively restricts CFCs, which become South African residents when they become effectively managed in South Africa, from claiming a capital gains tax exemption in terms of paragraph 64B on the deemed capital gains event which occurs in terms of paragraph 12(2)(a). This is unduly punitive towards CFCs.

Secondly, the wording of the proposed subparagraph (2)(b)(i) which reads as follows *"to a person that is not a resident nor a controlled foreign company"* effectively prohibits a capital gains tax exemption in terms of paragraph 64B in respect of the restructure of a CFC to another CFC. The Media Statement on Taxation Laws Amendment Bills, 2008: Company Restructuring Measures dated 21 February 2008 specifically states that *"Paragraph 64B has twin aims…paragraph 64B eases the restructuring of foreign subsidiaries remaining under South African control"*. This amendment clearly contradicts the purpose of paragraph 64B by denying a capital gains tax exemption in the event of a restructure of a CFC to another CFC.

<u>Proposed solution</u>

Clause 45(1) should be amended as follows –

- The reference to a *"controlled foreign company"* in subparagraph (i) should be deleted; and
- The following wording should be deleted from subparagraph (i): *"as a result of a disposal to a person contemplated in sub-item (i)"*.

3. MONETRY LIMITS

3.1 Section 10(1)(x) propose that the R30 000 exemption be increased to at least R50 000.

3.2 Paragraph 11(4)(a) Seventh Schedule. Propose that the R3000 loan to an employee which is exempt be increased to R9000. This will also line up with section 8B(3).

4. DRAFT TAXATION LAWS SECOND AMENDMENT BILL, 2008

4.1 Clause 16 – Proposed amendment to paragraph 2 of the Fourth Schedule

Sub-clause 16 (1) – this amendment proposes to remove the words "at the option of the employer". This creates an administration nightmare if the employer does not deduct the

medical aid from the employee's salary on a monthly basis and pay it over to the medical aid.

4.2 Clause 18 and 20 – Proposed amendment to paragraph 18 and paragraph 20 of the Fourth Schedule (Sub-clauses 18(b) and 20(1))

Failure to lodge the duly completed annual return will in future result in the imposition of an automatic penalty of 10% of the total employees tax deducted or withheld during the past year. The amount of this penalty can be enormous and, in our opinion, is out of all proportion to the "offence". The penalty can be remitted by the Commissioner only if he is satisfied that the circumstances warrant it.

A further and even more draconian provision is proposed.

Until the abovementioned annual return is lodged with SARS (usually electronically) **and** it is found to be acceptable to SARS, the employees will get no credit for PAYE actually deducted from their remuneration and paid over to SARS on their behalf.

The Commissioner, if "circumstances warrant" can allow the tax paid to be credited against the tax liability of the employee. It is amazing that the proposal is to penalise employees for the failure of their employers unless they can convince SARS to be lenient.

It is rather shocking to see that SARS intends to punish innocent employees for the wrong-doings of their employers! Punishing innocent bystanders goes against the grain of any fair and civil society and I am appalled by the proposal. It also goes against the spirit of our constitution in terms of which the citizens of the country is guaranteed fair and equitable treatment!

4.3 Proposed VAT amendments – Third party bank accounts

We refer to the proposed amendment in respect of which the proviso to section 44(3)(d) may be deleted. We wish to bring to the attention of National Treasury and the South African Revenue Service ("SARS") the various administrative problems this deletion may cause for non-resident and local VAT vendors.

Non-resident VAT vendors

Many foreign entities which are based off-shore and which are not incorporated in South Africa as a company or a subsidiary of a company are conducting an "enterprise" as defined in section 1 of the VAT Act and therefore have a liability to register for VAT purposes.

Section 23(2) of the Value-Added Tax Act, no 89 of 1991 ("the VAT Act") states that:

"Every person who, in terms of subsection (1) of section 50A, becomes liable to be registered shall not later than 21 days after becoming so liable apply to the Commissioner for registration in such application form as the Commissioner may direct and provide the Commissioner with such further particulars and any documentation as the Commissioner may require in such application form for the purpose of registering that person: Provided that where-

(i) …

(ii) *Such person is* *not a resident of the Republic*, *such person shall be deemed not to have applied for registration until he has –*

(aa) *appointed a representative vendor as contemplated in section 48(1) in the Republic and furnished the Commissioner with the particulars of such representative vendor;*

(bb) *opened a banking account with any bank, mutual bank or other similar institution for the purposes of his enterprise carried on in the Republic and furnished the Commissioner with the particulars of such banking account."* (see our underlining)

The VAT Act requires that a foreign entity provides the Commissioner for Inland Revenue ("CIR") with the details of its appointed representative vendor and bank account. Many foreign entities have an operation in South Africa which is merely an activity that qualifies as an enterprise for VAT purposes. Such operations sometimes do not have any employees in South Africa which means that the foreign VAT vendors need to find a South African resident willing to act as representative vendor and also need to open a bank account.

The requirements of the Financial Intelligence Centre Act ("FICA") are very strict regarding the opening of bank accounts and it is generally difficult to meet this requirement as the foreign vendors usually do not have any employees in South Africa with the seniority to attend to this matter.

The process of opening a non-resident business bank account is an onerous task. We list some of the requirements obtained from the four major banks of South Africa:

- Bank report from the foreign bank;
- Company resolution to open the account;
- Utility bill to prove the VAT branch's residential address;
- Certified copies of passports of all members who have signing powers on the account and a letter to state why a South African identity document is not available;
- Income tax number, or letters confirming why there is no income tax registration number;
- Certificate of Incorporation and Memorandum and Articles.

From the above it is clear that the opening of a non-resident business bank account for an entity that does not have any real presence in SA, is almost impossible which is quite often the case. This is because the banks require proof of a residential address of the VAT branch. This is almost impossible to provide as the foreign entities are mostly only "virtual branches" for VAT purposes. Furthermore, it would be very time consuming since frequently the Memo and Articles are not English and needs to be translated.

Currently, the representative vendor's bank account is being used and the foreign entity signs the VAT119(i) which indemnifies SARS where any refunds are paid into a third party bank account. In most cases, this is only done to meet the requirement of section 23(2)(ii)(bb) of the VAT Act.

We were also advised that banks are generally reluctant to open business bank accounts which will not be operational. Opening a bank account involves much work and costs to the bank. Where the account is going to be, for practical reasons, dormant it is not financially viable to open such accounts.

It is clear from the above discussions with the banks that the opening of a bank account purely to satisfy the requirements of the VAT Act is very difficult.

The proposed amendment to delete the proviso to section 44(3)(d) will have the effect that foreign entities which need to register VAT branches will not be able to use their representative's bank account as SARS will not be able to pay refunds into a third party bank account. This will place a huge burden on the foreign entity to open a bank account which will most probably be dormant as the bulk of the payments to SARS and customers and customers to the off shore entity will be effected from the main entity offshore via electronic funds transfer. The only purpose of the bank account will be for refunds.

Suggestions:

In summary we propose two possible alternatives:

1. That the VAT119(i) may still be used in circumstances where the VAT branch does not have any employees or fixed place of business in South Africa and a representative vendor is appointed.

2. As an alternative, we suggest that the requirement to have a bank account in South Africa be deleted. This means that section 23(2)(ii)(bb) should be deleted from the VAT Act, and foreign VAT branches are allowed to use their offshore bank accounts. In this instance, SARS will transfer any refunds to the off shore bank account of the VAT branch registered in South Africa for VAT purposes.

Group companies

In some cases group companies which are registered at the Registrars' office maintain only one bank account for the group. This is to be more cost effective and to maintain control of the cash flow. This means that the subsidiaries and branches of the main entity do not have their own bank accounts and all VAT liabilities are paid from the one bank account and all refunds are paid into the same bank account.

If the proviso to section 44(3)(d) is deleted all subsidiaries and/or branches of the company may have to open bank accounts which will be costly and the control of the cash flow will be lost.

Although section 23(2)(ii) only requires non-residents to open a bank account, section 23(2)(i) states the following:

"where a person who applies for registration under this subsection has not provided all particulars and documentation as required by the Commissioner, that person shall be deemed not to have applied for registration until he has provided such particulars and documentation to the Commissioner;"

It is a requirement of the VAT101 and 102 registration forms to provide the Commissioner with the details of the entity registering for VAT purposes including details of a bank account.

In many cases, the VAT119(i) is being used to assist the applicant with this process.

Reason for the amendment

It is not clear what the purpose for the proposed amendment is.

Suggestions:

- That the VAT119(i) may still be used in circumstances where the Head Office is a registered company in South Africa and does have different branches and/or subsidiaries.

Request

The explanatory memorandum on the proposed bill has not given any reasons for the amendment. Only once these reasons are known to us will be in a position to address SARS' concerns in order to find a mutual solution.

4.4 Proposed VAT amendments – Increase in registration threshold

Clause 21 of the Bill propose that the implementation date for the increase in the compulsory registration threshold should be 1 March 2008 (not 1 July 2008 as currently stated) to avoid uncertainty / unnecessary registration in the period until 1 July 2008.

5. INTEREST

Per the Explanatory memorandum the change to section 89quat is to allow SARS to charge interest on underpayment of tax from the effective date, and also to grant interest on overpayments of tax.

However, the proposed amendments do not deal with 89quat(4), which also need to be amended to bring it in line with section 89quat(2), to allow taxpayers to qualify for interest on overpayment.

Please do not hesitate to contact me should you require further information.

Yours faithfully

M Hassan CA(SA)
PROJECT DIRECTOR: TAX
The South African Institute of Chartered Accountants