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Mr B Viljoen
Committee Secretary: Portfolio Committee on Finance
3rd Floor 90 Plein Street
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Parliament of RSA
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**Per e-mail: bviljoen@parliament.gov.za**

Dear Sir

**2008 Draft Revenue Laws Amendment Bill and draft Revenue Laws Second Amendment Bill**

Please find attached the comments by Deloitte on the 2008 draft Revenue Laws Amendment Bill and draft Revenue Laws Second Amendment Bill.

Please note that these comments are an initial version of our comments, which address chiefly the issues of policy contained in the draft Bills. A more comprehensive version of our comments, incorporating also issues of drafting and other technical matters, will be submitted to Treasury in due course, but by 29 August 2008.

We thank you for your consideration of these comments.

Yours faithfully

**Le Roux Roelofse**
**Director: Tax Services**
**Deloitte & Touche**
**Practitioner Registration No.: C4F4542**

cc: Mr G Smith - Treasury: **Per e-mail: greg.smith@treasury.gov.za**

**DRAFT REVENUE LAWS AMENDMENT BILL AND REVENUE LAWS SECOND AMENDMENT BILL**
**COMMENTS BY DELOITTE & TOUCHE**

As per your requirements as set out in the Media Statement on the Revenue Laws Amendment Bills, 2008, our comments are provided in the order listed as per the Annexure to that Media Statement (set out below for your convenience).

Where no specific page reference is provided below in relation to an issue, this indicates that we have not commented on such issue at this stage, but may well still do so in our more comprehensive comments to be provided to National Treasury by 29 August 2008.

## DELOITTE COMMENTS

### A. Retirement Issues

1. Taxation of withdrawals from retirement funds

The need for the change is described as being two fold. Firstly, the tax-free amount is very low and has not been adjusted for a number of years. Secondly, the averaging formula is complex and is dependent upon information which the retirement fund or retirement fund member cannot easily access or determine.

The Explanatory Memorandum refers to the tax payable on withdrawals from retirement funds as being the application of the personal income tax tables applied separately to the benefit. This amendment does not appear to be included in the draft Revenue Laws Amendment Bill. The tax-free amount will be the taxable income equivalent of 50% of the primary rebate i.e. presently R23 000.

The proposed change will be significantly prejudicial to lower and middle income taxpayers who withdraw from retirement funds after having been members for some years. Examples of the potential effect are given below. These examples illustrate that the proposed tax regime will increase the tax payable on withdrawals significantly and the lump sums will be taxed at a rate which is significantly above the rate of tax at which the taxpayer concerned would have enjoyed deductions. The examples illustrate an increase in the tax payable in excess of 60%.

It is submitted that this change is inequitable for taxpayers who withdraw benefits from retirement funds. The previous system had the logic of deducting tax at the average rate, which was more likely to give a result which approximated the benefit enjoyed by the taxpayer while contributing to the fund. The proposed change will tax lump sums at rates which are significantly in excess of the benefit received by the taxpayer while contributing.

While the ideal of having a more simplified system is supported, this should not be at the expense of equity. While there should be disincentives for withdrawing funds from retirement funds, it is submitted that the Income Tax Act is not the appropriate means to achieve this aim, as it could be significantly prejudicial to the taxpayers concerned. For example a retrenched employee may use the funds to set him- or herself up in a business.

The increase in the tax free amount is to be welcomed, however, due to the size of lump sums payable on withdrawal the amount is still insignificant.

***Example 1***

| | |
|---|---|
| Employee presently earning per annum | R180 000 |
| Period of employment | 20 years |
| Employee contribution to retirement fund | 7.5% |
| Employer contribution to retirement fund | 7.5% |
| Annual increase in earnings | 10% |
| Annual increase in value of retirement fund | 15% |
| Taxpayer’s current marginal rate of tax | 25% |
| Taxpayer’s current average rate of tax | 20% |
| Value of retirement fund on withdrawal | R917 000 |
| Current tax payable on withdrawal | R181 967 |
| Tax payable under proposed rules | R304 610 |
| Increased tax payable | 66% |
| Average rate of tax payable under proposed rules | 34% |

***Example 2***

| | |
|---|---|
| Employee presently earning per annum | R120 000 |
| Period of employment | 20 years |
| Employee contribution to retirement fund | 7.5% |
| Employer contribution to retirement fund | 7.5% |
| Annual increase in earnings | 10% |
| Annual increase in value of retirement fund | 15% |
| Taxpayer's current marginal rate of tax | 18% |
| Taxpayer's current average rate of tax | 18% |
| Value of retirement fund on withdrawal | R611 000 |
| Current tax payable on withdrawal | R109 656 |
| Tax payable under proposed rules | R182 210 |
| Increased tax payable | 66% |
| Average rate of tax payable under proposed rules | 31% |

**C. Individuals**

2. Broad-based employee share schemes

Section 8B of the Income Tax Act ("the Act") regulates the taxation of amounts derived from a broad-based employee share plan. These schemes have not been widely used since their introduction, in part because it has a low tax-free ceiling per employee of R9 000 over a period of three years.

Clause 10(d) amends the definition of "qualifying equity share" contained in section 8B(3) of the Act, by raising the tax-free ceiling from R9 000 over a period of three years, to R50 000 over a period of five years. While this is a significant increase, we doubt whether it would be meaningful enough to lead to a much greater take-up of the broad-based employee share plan. To achieve that, we would recommend that the tax-free ceiling per employee be raised to R100 000 over a period of five years.

## D. Corporate and commercial

### 1. STC Reforms

### a. Conversion from STC to dividends tax

1.1. Definition of "contributed tax capital" ("CTC")

*1.1.1 Foreign investors*

This definition is unfair to foreign investors which contribute to South African companies, in exchange for shares, assets that have never previously been within the scope of South African tax. The shares issued in exchange for these assets should give rise to CTC equal to the market value of the assets contributed. SARS accepts this principle elsewhere in the Act e.g. the change to paragraph 12(4) of the Eighth Schedule is designed to allow controlled foreign companies ("CFCs") that are becoming South African tax resident, to bring assets previously not within the South African tax net into that net at current market value. Similarly any company becoming a CFC brings its assets into the South African tax net at market value. This principle is fair and in line with international norms. It will discourage foreign investment if the value of assets contributed to South African companies by persons outside the South African tax net is deemed to be lower than their real value for the purposes of the CTC definition.

*1.1.2 Contributed tax capital at start of period*

Given Treasury's views that any system that relies on a historical tracking of transactions should be eliminated from the tax system, perhaps it should be legislated that on the effective date, "pure" share capital and share premium as it is classified for tax purposes (NB: this classification may of course differ from what is shown in the books) at the end of the taxpayer's last financial year-end, should equal CTC, and the proposed rules should only apply to transactions concluded after that year-end. "Tainted" share capital derived e.g. from capitalising reserves would not be CTC.

1.2. New dividends tax

*1.2.1 Meaning of "paid"*

It is important to clarify what Treasury will accept as 'paid'. For example, if a dividend is credited to a loan account by the paying company, would Treasury accept that it is 'paid' as contemplated and therefore a trigger for the payment of the

dividend withholding tax? In addition, unclaimed dividends are very common: if these dividends are held in an account pending the payment thereof (for example, when the recipient is traced), presumably this would not be considered as payment.

*1.2.2 Refund period*

Where a person who is exempt from the dividend withholding tax (or required to pay at a reduced rate) only provides the declaration required in order to claim exemption after the dividend has been paid, it is proposed that that person may recover the withholding tax from the company paying the dividend upon payment of any subsequent dividend. If the withholding tax is not recovered within one year of the payment of the dividend the person that received the dividend may recover the amount from SARS. If no claim is lodged within three years of the dividend being paid the refund due would be forfeited. In our view, there is no reason why the recipient should not be able to present the declaration (with supporting documents) immediately to SARS (directly as opposed to through the paying company) for a refund of taxes paid. It is not acceptable that there be a waiting period involved.

*1.2.3 Deemed dividends*

It is interesting to note that the dividend withholding tax regime does not cater for 'deemed dividends' that were brought into the STC net by way of section 64C. For example, it is not clear what transitional measures would apply in circumstances where a loan to a shareholder that was deemed to be a dividend and subject to STC, is repaid post the effective date for the introduction of the dividend withholding tax. Would the shareholder be entitled to a credit for dividend withholding tax purposes?

We assume Treasury will also be introducing provisions that govern deemed dividends under the new dividends tax regime, akin to the current section 64C.

*1.2.4 Liability for tax*

The proposed section 64K(7) provides that every shareholder and director that controls or is regularly involved in the management of the overall affairs of an unlisted company as defined in section 41 or an unregulated intermediary that is liable to withhold tax is personally liable for the dividends tax and any related penalty and/or interest. We believe this provision goes too far. It leaves the door open for debates around who is, or is not, “regularly involved” in the management of the company’s affairs on a *de facto* basis. In most cases, shareholders will not have any control over matters such as the withholding of dividend tax. Section 64K(3) already gives SARS the ability to look to the paying company for any tax due but not paid.

Possibly provision should be made in the legislation that the paying company would be absolved from any penalties or interest on the underpayment of the dividend withholding tax where the company has obtained the declaration and the recipient failed to inform the company of a change in circumstances.

*1.2.5 Textual changes required*

In subsection 64G(4)(a) the word "undertaking" should be replaced with the word "notification" in order make sense of the provision (otherwise the beneficial owner will be deemed to cease being the beneficial owner merely because he gives an undertaking to the company to notify them as and when he ceases to be the beneficial owner). The same applies in section 64H(4)(a).

## 2. Passive holding companies

We question seriously whether these provisions are necessary. In practice, we do not come across situations in which individuals choose to hold financial instruments in companies rather than holding them directly, to benefit from an income tax rate arbitrage. It should be noted that on disposal of the financial instruments, companies pay capital gains tax at a higher rate on any gains made than individuals do. Once the new dividends tax is in force, the individual shareholder of the company will suffer a 10% withholding tax on the remittance of dividends out of the company. In addition, companies entail administrative costs. Hence the position in tax terms for an individual, in considering whether to hold a financial instrument directly or house it in a company, is not as straightforward as a simple comparison between the individual and corporate rates of income tax.

The provisions are complex, and will be difficult to administer for both taxpayers and SARS. If, as the Explanatory Memorandum states, the provisions will be applied subjectively, we think they will very rarely be applied in practice and the benefit to the *fiscus* is likely to be negligible, at the expense of additional administration. Although we have not researched this in depth, at this stage we are not aware of any countries other than the US that have provisions dealing specifically with passive holding companies. In the US, the PFIC provisions are very different from what is being proposed here.

If anything, we urge Treasury consider a widening of the scope of the unbundling provisions to allow individuals to simplify their investment structures or vehicles without incurring capital gains tax, stamp duty and transfer duty. It should also be considered to allow investors enough time to use these provisions for them to benefit from the exemption from STC on the distribution of pre-1 October 2001 capital profits.

The Explanatory Memorandum states that SARS will rely on subjective considerations to determine whether or not a company qualifies as a passive holding company and even spells out what those considerations are. However, nowhere in the actual legislation is reference made to these subjective tests.

If Treasury believes it essential to introduce these measures, which we question, then the following in our opinion should also qualify as "excluded companies":

- A CFC owned by a listed group (why should only South African subsidiaries of a listed parent qualify?)
- A foreign collective investment scheme (why should local collective investment schemes qualify but foreign collective investment schemes –which will almost certainly derive more than 50% of their income from financial instruments –not qualify as excluded companies?)
- A company that is less than 50% owned by individuals (directly or indirectly). If the company is not owned by individuals, the possibility of tax arbitrage (which we understand to be the mischief which the new section 9E is seeking to address) simply does not exist, because the company and its shareholders would be subject to exactly the same rate of tax on passive income.

The legislation states when the first part of the new section 9E comes into force but is silent as to when subsection 9E(2) comes into force –this is presumably a typing error as both 9E(1)( and (2) should come into force at the same time

**5. Intellectual property arbitrage**

5.1 <u>Proviso to subsection 9D(10)(a)(iii)</u>

The new proviso to section 9D(10)(a)(iii) seems overbroad. Given the introduction of section 23I in January 2009, is this proviso really necessary? If the IP in question was never owned or developed in South Africa but happens to be licensed *inter alia* to South African residents that have an interest in the IP owning company, why should this be considered abusive as long as the CFC owning the IP has appropriate business substance and has itself developed the IP without South African involvement? It is possible and (we have seen this in practice in client situations) that a foreign company owning IP licensed to both South African and non South African residents, is then bought by one of those South African residents in the IP industry and becomes a CFC. Why should the CFC not be eligible for a ruling under section 9D(10)(a)(iii) where the royalty arrangements precede the acquisition of the CFC's shares and hence could not possibly have been entered into with any form of South African tax avoidance in mind?

5.2 Section 23I

The proposed changes to the original wording of the new section 23 I are to be welcomed. However, there are still instances where this section is overbroad. For example, we are seeing many examples of individuals who own IP emigrating to other countries. On ceasing to be South African resident, those individuals are taxed on the market value of the IP owned by them. When they arrive in their new country, they start to do business there by licensing out the IP that was previously within the South African tax net. Businesses that previously used the IP in South Africa wish to continue to do so. It seems very harsh that these local users will be denied a deduction simply because within the preceding two years the IP was the property of a South African tax resident (especially as that resident will have paid CGT in respect of that IP on emigration).

Similarly there is no justification for penalising innovative South African residents who develop IP and then sell it on arm's length terms to unconnected non-residents. Again the South African resident will pay tax on any gain on sale. Why should South African users of the IP thereafter be denied a deduction for their royalties simply because the IP has within the preceding two years been the property of a resident?

Our recommendation to cure the problems discussed above is that 23I(2)(b)(ii)(bb) be deleted from the section.

**K. Other**

**Draft Revenue Laws Second Amendment Bill -- 2008**

*Abolition of basic amount – Clause 13, amending paragraph 20 of the Fourth Schedule to the Act*

Under the current provisional tax system, taxpayers are allowed to base their first and second provisional tax payments on their basic amount without the risk of incurring any penalties and interest. The basic amount is the taxpayer's taxable income as per the last year assessed.

The proposed amendment removes the safety net of the "basic amount" for purposes of penalties in relation to the underpayment of the second provisional tax payment, thereby upsetting a very simple way of calculating and paying provisional tax.

We strongly believe that the removal of the safety net of the basic amount for purposes of penalties for underpayments of provisional tax will result in undue hardship for many taxpayers.

Many taxpayers cannot estimate their taxable income with any certainty at year-end and are often dependent upon external factors that have a significant effect on their taxable income. Such factors include:

- The effect of exchange rates on the results
- Timing differences that can only be calculated after year-end
- Details of interest and capital gains from fund administrators
- Reliance on third party accountants to produce financial statements reflecting financial results for the year
- Reliance on the issuance of IRP5 certificates to individuals that are only issued after year-end.

It is submitted that the proposals will lead to a much greater degree of complexity for taxpayers. It could, and will, also give rise to highly inequitable results where a taxpayer underestimates his taxable income by more than 10%, as the taxpayer would be exposed to a penalty of 20% of the tax underpaid (i.e. the difference between the tax as estimated and the tax that would have been payable on his 90% of his estimated taxable income), and interest.

**L. Clause-by-clause technical comments**

*Paragraph 64B of Eighth Schedule*

The criteria for exemption from capital gains tax on a capital distribution from a foreign company (treated as a deemed disposal) are being aligned with the criteria for exemption under the participation exemption in the context of a real disposal of foreign shares. This change is a logical one.

However, it is not reasonable to introduce the change in years of assessment ending on or after 1 January 2009 i.e. retrospectively for some taxpayers. It is very possible that large distributions have been made by foreign companies to companies that are already into their 2009 tax year (e.g. companies with March or June year-ends) and which were entitled to assume at the date of distribution that any deemed capital gain triggered would be tax-exempt.

The change should rather be prospective to distributions made, e.g. on or after 1 January 2009. It should not be made effective earlier because certain foreign countries have legal formalities which take several months to complete in the context of a capital distribution i.e. the first steps may have been taken before the change to the law was announced, but the actual distribution will only be final in e.g. 2 to 3 months time.