Kindly note that references to sections, parts and schedules in our comments below relate to the Income Tax Act No. 58 of 1962 and schedules thereto, unless stated otherwise.

1. RATES AND THRESHOLDS

In paragraph 5 of Appendix 1 – "Rates of Normal Tax and Rebates", reference is made to the definition of an "employment company" in section 12E. The definition of an "employment company" in section 12E was deleted in the Revenue Laws Amendment Act 2008 with effect from 1 March 2009. Presumably the reference should now be to a "personal service provider" as defined in the Fourth Schedule to the Income Tax Act.

2. INDIVIDUALS AND EMPLOYMENT

2.1. Travel (car) allowances: repeal of deemed kilometre method

No comment at this stage.

2.2. Unification of employment-related medical scheme contributions

No comment at this stage.

2.3. Retirement of lump sum benefit calculations

We submit that the wording in Appendix 1, paragraph 10(b)(ii), creates an unfair tax burden on a retirement fund lump sum benefit where there has been a previous retirement fund lump sum withdrawal benefit. The wording in the paragraph will have the effect that the benefit of the R300 000 tax free amount (other than the R22 500 available on withdrawal) for retirement fund lump sum benefits will be lost where there has been a prior retirement fund lump sum withdrawal benefit. This contention is discussed below.

In applying the proposed tables in the Draft Taxation Laws Amendment Bill to retirement fund lump sum benefits and retirement fund lump sum withdrawal benefits it is necessary to aggregate current and prior year lump sum benefits. A credit is then granted for tax on lump sums in the prior year. However, the credit is not granted for tax actually paid but a hypothetical amount of tax on those lump sums that would have been paid by applying the table.

For example, paragraph 10(b)(ii) of the Draft Rates of Normal Tax and Rebates in Appendix 1 to the Draft legislation provides the following credit:

"The amount of tax levied in terms of item (i) must be reduced by an amount equal to the tax that would be leviable on the person in terms of ***that*** *item in respect of taxable income comprising the aggregate of –*

(aa) retirement fund lump sum withdrawal benefits; and

(bb) retirement fund lump sum benefits,

received by or accrued to that person prior to the accrual of the retirement fund lump sum benefit contemplated in item (i)(aa)."

The wording therefore requires the reduction in tax payable as calculated on the aggregate of all lump sum benefits to be reduced by a hypothetical amount calculated using the retirement fund lump sum benefit table. If the taxpayer had not benefited from the R300 000 exemption upon retirement previously by using a notional calculation, the benefit of this deduction is lost.

This can be illustrated in the following examples:

	Example 1	**Example 2**	**Example 3**	**Example 4**
Withdrawal benefit received in prior years	0	100 000	200 000	300 000
Tax payable in terms of 10(a)(i)	0	13 950	31 950	49 950
Lump sum on retirement	400 000	300 000	200 000	100 000
Cumulative lump sums	400 000	400 000	400 000	400 000
Tax per Table 10(b)(i)	18 000	18 000	18 000	18 000
Reduction in Table 10(b)(ii)	0	0	0	0
Net tax payable	18 000	18 000	18 000	18 000
Total tax actually paid	18 000	31 950	49 950	67 950
Difference		13 950	31 950	49 950

While a person retiring and receiving a lump sum of R400 000 on retirement will be subject to tax of R18 000, where that person has received a withdrawal benefit previously the benefit of the R300 000 exemption will be lost to the extent of the previous withdrawal benefit. The "difference" row in the above table indicates the effect of the way the reduction is applied.

While it is accepted that the different tax tables provide an incentive for taxpayers not to withdraw benefits but to retain the funds within a retirement funding vehicle, we submit that the present method of calculating the tax payable unnecessarily prejudices persons who have, prior to retirement, received a withdrawal benefit.

<u>Request</u>

We request that the Table be amended to allow a reduction of the taxes actually paid in terms of item 10(1)(a)(i) and 10(1)(b)(i) against the tax calculated on the aggregate

amounts of lump sum benefits using the table in item 10(1)(b)(i), limited to the amount of tax payable. In this way the taxpayer would retain the benefit of an amount of R300 000 tax free on lump sums from retirement.

If this was implemented, the tax payable in the examples above would be as follows:

	Example 1	**Example 2**	**Example 3**	**Example 4**
Withdrawal benefit received in prior years	0	100 000	200 000	300 000
Tax payable in terms of 10(a)(i)	0	13 950	31 950	49 950
Lump sum on retirement	400 000	300 000	200 000	100 000
Cumulative lump sums	400 000	400 000	400 000	400 000
Tax per Table 10(b)(i)	18 000	18 000	18 000	18 000
Reduction in Table 10(b)(ii)	0	13 950	18 000	18 000
Net tax payable	18 000	4 050	0	0
Total tax actually paid	18 000	18 000	31 950	49 950
Difference		0	13 950	31 950

While there is additional tax payable in respect of withdrawals, the lump sum on retirement is not further taxed and the taxpayer benefits from the tax free sum on retirement.

Note the reduction in item 10(1)(a)(ii) should not be adjusted in the same manner as the present reduction of a notional amount of tax will preserve the tax free amount, whereas an adjustment to actual tax paid will mean that the benefit of the R300 000 exemption will be lost.

2.4. Minor beneficiary funds

No comment at this stage.

2.5. Remedial recognition of pre-1998 benefits for public servants

No comment at this stage.

2.6. Treatment of unrealized gains on death

No comment at this stage.

2.7. Learnership allowance simplification

No comment at this stage.

2.8. Employer-provided post-retirement medical aid

No comment

2.9. Deductibility of employer contributions to retirement annuity funds

No comment at this stage.

2.10. Payouts of employer pension surpluses

No comment at this stage.

3. BUSINESS

3.1. Certified emission reductions – tradable carbon emissions reduction credits

Introduction to comments on environmental incentives (relates to headings 3.1 and 3.2)

We believe that providing taxpayers with an incentive to invest in projects that result in carbon reductions or the reduction of energy use is the correct approach to address climate change mitigation in South Africa.

The new feed-in-tariffs set by NERSA for renewable power generation combined with the tax incentives proposed as sections 12K and 12L will allow more projects to be viable in South Africa and as a consequence reduce South Africa's carbon emissions.

The exemption of income received from carbon credits in the proposed 12K will be an added incentive to invest in Clean Development Mechanism ("CDM") projects in South Africa. The incentive to improve energy efficiency in the proposed section 12L would encourage a reduction in energy usage in South Africa.

Comments on the proposed Section 12K

Exemption

The proposed section 12K(2) allows income received from the disposal of a certified emission reduction ("carbon credits") derived from a CDM project to be exempt from tax. It is proposed that the exemption is only applicable if the disposal occurs before

31 December 2012, the expiry date of the first commitment period of the Kyoto Protocol. However, carbon credits are earned over a 10 year period or a seven year period with the option to renew the crediting period. If the option to renew is taken up the carbon credits will be earned and transacted over a 21 year period. Therefore the issuing of new carbon credits are not restricted to the expiry of the first commitment period of the Kyoto Protocol in 2012 but new projects cannot be registered after that unless a new commitment period is established. Consequently, as the legislation is drafted currently, only one year's carbon credits can be disposed of tax free by the originator, where in actual fact a revenue stream of 10 years or seven years with the option to renew is available to a taxpayer.

We suggest that section 12L(2) state that any income received from the disposal of a carbon credit derived from a CDM project registered before 31 December 2012 should be exempt. The above should also allow income received from Clean Development Mechanism projects registered previously - before the introduction of section 12K - to be exempt in years going forward.

3.2. Energy efficiency

<u>Comments on the Proposed Section 12L</u>

Energy or Electricity Incentive

It is unclear from the wording of the proposed section 12L whether this is an incentive to use less energy or less electricity. Although the two are related, the emphasis could change the interpretation of section 12L. For instance, if it is intended to be an electricity usage reduction incentive, a taxpayer could switch to another energy feedstock such as diesel or gas. The use of electricity will decrease and the taxpayer would be able to claim an allowance on the reduced use of electricity. However, the same amount of energy would be used and from an environmental perspective switching fuels stocks may not result in reduced emissions.

When focussing on energy usage, what would constitute a saving? Will a process that is made more efficient by using a waste product such as steam to generate more energy, which reduces electricity usage, qualify for the allowance as overall the same amount of energy is used? In this instance less electricity would be used and possibly less carbon emissions due to the efficiencies.

We suggest that the wording of section 12L be changed to make it clear what the incentive is for.

Effective Date

Per section 118 of the draft Taxation Laws Amendment Bill, the section 12L amendment to the Income Tax Act will come into operation as from the commencement of year~~s~~ of assessment ending on or after 1 January 2010. Consequently, a taxpayer with a February 2010 year end would be entitled to the proposed section 12L allowance in that year. However, in terms of the proposed section12L, a baseline must be determined in accordance with the Regulations. Consequently, a taxpayer wanting to qualify for the allowance will not be able to do until such time as the Regulations to provide for the one year lead time to develop the required baseline have been issued.

We suggest that the regulations be issued as soon as possible. Alternatively, the allowance should come into operation for years of assessment commencing on or after 1 January 2010, once the regulations have been issued.

3.3. Pre-sale dividends/dividends stripping

The proposed paragraph 43A(2)(c) of the Eighth Schedule to the Income Tax Act refers to debt incurred by the resident company "*or any company that is a connected person in relation to the resident company*". Since the mischief being targeted by the new paragraph 43A is the dilution in value of the resident company for capital gains tax (CGT) purposes as a result of a debt funded distribution, we do not understand the relevance of any debt that might be incurred by any other company that happens to be a connected person in relation to the resident company. Debt incurred not by the company itself, but by connected parties will have no impact on the value for CGT purposes of the company being sold. The same comment also applies to the proposed section 22B(2)(c).

3.4. Dividends tax: specialised regulated intermediaries

No comment at this stage.

3.5. Dividends tax: withholding refinements

<u>Clause 8 amends section 1 of the Income Tax Act</u>

Paragraph (g) of clause 8 amends the definition of "contributed tax capital" to read *"... and has by the date of the transfer determined in writing to be an amount transferred, which written determination must be communicated, in writing, to those shareholders"*.

Communicating the transfer to shareholders in writing could be very onerous. The legislation should clarify of the forms of communicating "in writing" that will be acceptable. For instance, would a SENS announcement be sufficient, or does each shareholder need to be communicated with directly?

Clause 60 amends section 64K of the Income Tax Act

Section 64K reads *"....the person must submit to the Commissioner any declaration submitted to the person by a beneficial owner and relied upon by the person..."*

The need to submit all declarations to the Commissioner is onerous and is not in line with current move to self assessment. Rather than submitting all declarations, a question should be included in the IT14 requiring confirmation from the company that all declarations have been received and will be retained for a specified period.

Clause 62 inserts section 64M into the Income Tax Act

Section 64M(2) states that any amount that is refundable must be paid to that person as part of any subsequent dividend. What happens if there are no further dividends declared? Will the person never receive a refund?

The legislation relating to the requirement for a company to pay a refundable amount to a person from whom it was incorrectly withheld is unclear. Should the refundable amount be effectively claimed back from SARS by the company by deducting it from the company's next payment of Dividends Tax to SARS? The wording of the draft Bill should be reconsidered to clarify these practical issues.

Section 64M(3) states that no amount will be refunded after 3 years of the amount being withheld. What happens if there is no dividend declared and paid within 3 years? Does the individual lose the refund? That does not appear equitable.

These comments are also applicable to section 64L dealing with the refund of tax in respect of certificated shares.

3.6. Dividends tax: distributions of shares and share rights

The proposed definition of "dividend" in section 1 of the Income Tax Act is couched in extremely wide terms and is sure to give rise to interpretational difficulties and complexities. Whilst the need is understood for a definition that is comprehensive in scope and application, this should not give the legislature licence to enact a provision that has virtually unbridled reach and goes well beyond the established meaning of a "dividend".

A dividend in essence represents a distribution of profits by a company to its shareholders whereby the company is impoverished. The profits can be realised or unrealised profits. However, a dividend as commonly understood does not include the return of original share capital or share premium to shareholders, as is recognised by SARS, and also does not include any action, whether on the part of the company or of its shareholders, which does not diminish the patrimony of the company. This latter aspect, however, is not recognised by the proposed amendment and will result in major complexities and ambiguities.

We see no justification for the proposed definition. Firstly, the definition will be at variance with section 90 of the Companies Act, in that it recognises that a dividend could be paid for tax purposes which would not constitute an allowable payment to shareholders for corporate law purposes. As a matter of policy, that is highly unsatisfactory. Secondly, we currently have a dividend definition in our Income Tax Act which is working well and is well understood. Thirdly, inasmuch as there may be abuse under the existing law, that could be targeted either through deeming certain actions to be a deemed dividend, as is proposed, or through triggering a taxable event at shareholder level.

We also have a number of difficulties with the application of the proposed definition. For instance, included in the proposed definition of "dividend" is *"... (d) by way of enhancement of the preferences, rights or other terms relating to that share; or (e) by way of any other means..."*. How would you calculate "an enhancement"? When does this occur? What is envisaged in "by way of any other means"?

In addition, the Explanatory Memorandum refers to capitalisation shares and value shifting arrangements, but the section does not read like that. Section 64R(1)(a) reads *"a transfer of shares by that company; or"*. Shouldn't it read *"a transfer or issue of shares of that company"*?

We therefore strongly submit that the revised dividend definition not be enacted as proposed and would be happy to engage with National Treasury to explore wording for a suitable alternative.

Finally, we note that it would appear as if the redemption of shares in a foreign mutual fund (open-ended investment company) will be treated as a taxable foreign dividend. We doubt whether this is intended, as the dividend definition was quite recently amended to ensure that such redemption proceeds are not treated as dividends. We recommend that the exemption from dividend treatment be maintained in any new dividend definition.

3.7. Dividends tax: deemed dividends

The proposed section 64P(c) of the Income Tax Act exempts the provision of financial assistance from being a dividend if:

- it bears interest at a rate that is not lower than the "prescribed rate" as defined in section 1, paragraph (b); and
- the rate is not lower than would be charged to a member of the general public, not being an employee or shareholder, in similar circumstances.

We submit, firstly, that the financial assistance should not be a dividend if it bears interest at a rate not lower than a market-related rate. Financial assistance provided on arm's length terms should not be treated as a dividend. It is conceivable that in a given instance a market-related rate might be less than the prescribed rate. In such instance, it would run counter to the whole thrust of the anti-avoidance legislation to target tax driven transactions by deeming the financial assistance to be a dividend. We submit, secondly, that the second requirement imposed by section 64P(c) be scrapped. If a loan is provided on arm's length terms, it would per definition be commercial. There is therefore no need to introduce yet a further hurdle to be crossed in order to deem the financial assistance not to be a dividend.

In relation to the situation where a company ceases to be tax resident, we note that the formula used to calculate the deemed dividend does not exclude the contributed tax capital from the value of the deemed dividend. We see no justification for the Dividends Tax to be imposed on contributed tax capital and request that the formula be changed accordingly.

In addition, we note that in terms of the current STC legislation, if a loan is deemed to be a dividend and STC is payable thereon, when the loan is repaid a STC credit arises. Why is there no similar provision in the new Dividends Tax provisions?

3.8. Collective investment schemes in securities: conduit principles in respect of ordinary distributions

The proposed change to the taxation of CIS represents a fundamental departure from the existing taxation regime and more time is needed to consider its full impact. In the interim, we wish to note the following:

- Paragraph 61 of the Eighth Schedule should be amended to delete the reference to company;

- By treating the CIS as a trust, it will be deemed to have a 28/29 February tax year-end. An amendment is needed to permit the CIS to have a year-end that coincides with its financial year-end.

3.9. Telecommunications license conversion

No comments at this stage.

3.10. International submarine telecommunications cables

Problem statement 1

The amendment to section 12D of the Income Tax Act is deemed to have come into operation on 1 January 2009 and applies in respect of assets acquired on or after that date. The current implementation date for the amendment to section 12D will mean that assets acquired prior to 1 January 2009 will not qualify for the allowance.

However, section 12D was originally inserted by section 23(1) of Act No. 30 of 2000 and was deemed to come into operation on 23 February 2000 and is applicable in respect of any pipeline, transmission line or cable or railway line contracted for and construction, installation or erection of which commenced on or after that date.

Request 1

The amendment to section 12D is made to broaden the application of the existing section to include joint ownership interests in submarine cables. We request that this amendment be made effective in accordance with the original date on which the section was deemed to come into operation, being 23 February 2000, and with application to any joint ownership interest acquired on or after that date.

Problem statement 2

The amendment to section 11(f) includes the substitution of paragraph (dd) of the proviso, with a new paragraph (dd). This amendment allows the deduction of a premium paid for the indefeasible right of use (IRU) of access to the international submarine communications cables. However, this deduction will only be allowed if the IRU has a legal term of at least 20 years. We understand that the industry norm for these types of IRU arrangements is for contracts to be entered into for 15 years.

Request 2

We request that an adjustment be made to the proposed legislation to amend the term required from 20 years to 15 years.

Problem statement 3

Paragraph (dd) of the proviso in section 11(f) provides for an exception where three requirements are met, the second of which reads *".... (B) substantially the whole of which is located outside the territorial waters of the Republic"*.

Request 3

The legislation should be clear in what is meant by *"substantially the whole..."*.

3.11. Improvements on leased government land

Leases with government, provincial administrations and municipalities typically have a duration of 10 years with a renewal option. It is therefore requested that the proposed 20 years be reduced to 10 years to enable the provision to be more widely applied.

In its current form the proposed amendment will not apply to improvements effected on after 1 January 2009 in respect of leases entered into before 1 January 2009. In comparison thereto improvements effected on or after 1 January 2009 in respect of leases entered into on after 1 January 2009 will qualify for tax relief. This situation will be unfair. It is therefore submitted that the proposed amendment should apply to all improvements effected on or after 1 January 2009, regardless of when the lease was entered into.

3.12. Depreciation on improvements

Problem statement in relation to 37B

Section 37B was introduced in the Revenue Laws Amendment Act, 2007 and was deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2008.

The language used in Section 37B as it currently reads creates certain of the inconsistencies referred to in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2008. The Explanatory Memorandum makes it clear that the amendments to Section 37B will be made with the intention of removing these

inconsistencies. However, for the period from 1 January 2008 to 1 January 2010 (the date the amendment to section 37B becomes effective), it is not clear how the language used in Section 37B should be interpreted.

Request in relation to section 37B

To eliminate any uncertainty in relation to the interpretation of the language used in section 37B for the period 1 January 2008 to 1 January 2010, we request that that the amendment to this section be made effective with retrospective effect to the date on which the section was initially deemed to have come into operation, being 1 January 2008.

Other anomalies in applicable sections referred to in paragraph 3.12 of the draft Explanatory Memorandum

In section 12F, the previous definition of airport asset which includes "aircraft hanger," now reads "aircraft, hanger," which creates a totally different outcome. This error has then rolled through to the proposed amendment to the definition. The term appears twice in the definition.

The 'Applicable sections' referred to in paragraph 3.12 suggests an amendment to section 24G (toll road operators) which would seem appropriate in the context. However no amendment appears in either the first or second draft Amendment Bills.

3.13. Adjusting ring-fencing of losses for financial leasing

Inclusion of section 8(4) recoupments in definition of 'rental income' in determining limitation of available asset allowance

Taxable capital gains (and as such taxable income) attributable to the disposal of lessor affected assets still fall outside the 'ring-fence' of rental income and will be taxed where asset allowances are deferred. As they are an integral part of the lessor's business this would appear anomalous.

We would recommend that the legislation be amended to include in the definition of rental income the capital gain (or perhaps only taxable capital gains) attributable to the disposal of that affected asset.

3.14. Cross-issue avoidance – remedying unintended anomaly

Section 24B (2) of the Income Tax Act is a hugely problematic section. The section is worded very broadly and as a result, catches within its scope a range of commercial

transactions which should never have been targeted as they represent no threat to the South African tax base.

The proposed amendments are the most recent in a series that have been introduced over the last few years aimed at curing specific problems caused by subsection 24B(2) as these become known to Treasury. Unfortunately, many more problems exist than can be cured by *ad hoc* "patches" to the section and each time an amendment has been made to try and narrow the ambit of the section, the wording of the amendment itself seems to bring further problems with it. In our opinion, it is time for a fundamental re-consideration of the purpose of subsection 24B(2), the mischief SARS is concerned about (which is not clear to us) and whether a much more narrowly drafted provision is not the answer in order to eliminate this perceived mischief without causing the huge problems for non-abusive transactions that taxpayers are currently battling with.

We set out below three examples illustrating where section 24B (2) has caused practical problems in our client base in the last six months alone. We have no doubt that other practitioners are experiencing similar difficulties.

<u>Example A</u>

A group headquartered in South Africa (SA) acquired assets and shares from an unrelated company in the European Union (EU). Some of the assets (immovable property and manufacturing plants) were sold directly by the third party seller to a foreign subsidiary of the SA listed company located in the same country as the seller.

However, since in the current economic environment it was not possible to raise funding for the entire transaction, it was agreed that a portion of the purchase price would be settled by the SA listed company issuing shares to the seller. This issue of shares by the SA parent company was done in part payment of the purchase price owed to the seller by the SA company's foreign subsidiary, thereby creating a debt owed by the subsidiary to the SA parent.

As a result of the application of section 24B (2), this debt had no base cost, meaning that as and when this loan is repaid, CGT will be payable in SA on the entire amount! Section 24B (3) is too narrowly worded to provide any relief in these particular circumstances. However the circumstances in question are by no means unusual. In the context of a listed group, it is always shares in the listed parent rather than in any of that company's subsidiaries that would be issued where shares are to form part of the consideration for assets acquired by the group.

Example B

A South African company wished to introduce a BEE partner. Since the BEE company did not have cash, in order to facilitate the transaction it was agreed between the parties that in a first step, the BEE company would acquire an asset (a manufacturing plant) which the SA company wanted, from a third party in exchange for an issue of shares. Immediately afterwards, the BEE company contributed the asset acquired to the SA company in exchange for an issue of shares in the SA company. After this transaction, the BEE company held 16% of the shares in the SA company.

As a result of the application of section 24B(2), the BEE company arguably is at risk of having no base cost in its shares in the SA company since SARS could argue that the SA company would not have issued shares to the BEE company had the BEE company not issued its own shares to the seller of the asset immediately beforehand. The words "by reason of or in consequence of" in section 24B(2) are very broad in their scope. Should 24B(2) apply, the result will be completely illogical. If the BEE company had simply taken step 1, it would have had a base cost in the asset acquired. There is no reason why the taking of step 2 should then result in the BEE company forfeiting any base cost in the asset ultimately acquired by it i.e. the SA company's shares.

Example C

A listed South African company is considering a transaction in terms of which a foreign listed company will issue shares in itself to the SA company and in return the SA listed company will issue shares in itself to the foreign company. This is a classic "cross issue" of shares situation. However it is not abusive, and there seems to us no reason why the SA listed company should not get a base cost in the new shares issued to it. If a South African company issues shares in return for any other type of asset acquired, it is readily accepted that the SA acquirer would get a base cost equal to the lower of the value of the shares issued or the asset acquired. Why should this principle change simply because the assets being acquired happen to be new shares which have an easily calculated market value, in a well established foreign listed group?

Proposed change to section 24B

With regard to the amendments proposed to section 24B in the form of the new 24B(2C), these unfortunately seem to us to do very little to address the kind of fundamental problems outlined above, and do not even completely address the specific problem being targeted.

Currently, a problem will arise if a South African company (Company A) acquires an asset e.g. land, in exchange for an issue of shares and then contributes the land to any other company (company B) for shares or debt within an 18 month period. Company A will then have no base cost in the shares or debt issued to it by Company B and Company B may have no base cost in the asset acquired. Treasury is seeking to fix this problem, but only to the extent that the asset is transferred within the 18 month period to a controlled group company. We do not understand the reasoning behind this limitation. If an asset of value is acquired by Company A in exchange for shares (a step which would normally give Company A a base cost in that asset) and Co A then decides for good commercial reasons to dispose of the asset or a portion of it within 18 months to any other entity (whether a controlled group company or not) in exchange for shares or debt, why should Company A effectively lose its base cost and why should the ultimate purchaser of the asset, which is paying an arm's length price for it, be prejudiced by being denied a base cost in the asset for CGT purposes?

3.15. Liquidating, winding up or deregistration of exclusive residence companies

(These comments refer to the draft Explanatory Memorandum, Part VII of the Income Tax Act, paragraph 51A of the Eighth Schedule and the Transfer Duty Act)

<u>Qualifying companies</u>

The introduction of a concession period to extricate private domestic residences from corporate holding entities and transfer them into the name of the effective 'owner/ resident' free of taxation is to be welcomed. These holding structures were typically set up in a different era and often to avoid certain discriminatory legislative constraints such as the Group Areas Act. The opportunity to transfer the property out of the holding entity made available at the time of introducing CGT was not available to all entities due to certain restrictions imposed in the enabling legislation.

Many people who wanted to take advantage of the opportunity could not do so and continue to bear the ongoing costs of having their personal residence in a separate legal entity. Such costs include preparation of financial statements, tax compliance costs, restrictions on raising personal finance, and the inherent CGT and STC liability when the property is eventually sold. The desire to transfer homes out of these entities has existed for a number of years and the Companies Act annual fee is yet another cost of such holding.

In this regard, inter-vivos trusts were also commonly used as an holding entity for domestic residences. In addition, domestic resident holding companies were

themselves often held by an inter-vivos trust. The exclusion of these holding structures from the proposed relief would appear to run counter to the objective of providing natural persons with the opportunity to register their domestic residences in their own name without triggering an onerous tax burden in getting to that position.

Submission on qualifying companies

Given the background, it is submitted that the concession currently proposed ought to be extended to all domestic residence holding entities, including inter-vivos trusts and domestic residence holding companies held by inter-vivos trusts, to enable all such domestic residences to be transferred to the natural person who effectively owns them.

Alternatively, given that domestic residence holding entities are often jointly owned by family members, the provisions should be expanded to include situations where the shareholders are connected persons (natural or otherwise) in relation to the taxpayer.

In addition, the definition of "domestic residence company" in the draft legislation should be amended to make it clear that close corporations are included in the ambit of "company", by changing the reference to "shares" to include a member's interest.

This will also enable an increased number of non commercial inactive / dormant entities to be terminated and removed from the CIPRO, SARS and title deed registers.

Domestic residence held as sole asset

Certain of these companies may have held other personal assets – sometimes linked to the domestic residence. By restricting the concession to companies holding a domestic residence as the sole asset, people are denied the opportunity to remedy their situation regarding their domestic residence.

It is submitted that companies holding domestic residences be entitled to dispose of any other non-residence assets prior to taking advantage of the concession and paying such taxes (CGT and STC) as are attributable to those assets.

3.16. Shelf company start ups and small business relief

No comment at this stage.

3.17. Oil and gas incentives and ancillary trades

No comment at this stage.

3.18. Venture capital company refinements

No comment at this stage.

4. INTERNATIONAL

4.1. Conversion of the controlled foreign company (CFC) ruling exemptions

We thank Treasury for converting the exemptions currently available by way of a rulings process to exemptions provided for in the law. We think this is a positive development and one in the interests of both taxpayers and SARS.

<u>Foreign Business Establishment</u>

With regard to the proposed definition of "foreign business establishment" (FBE) we have the following comments:

- We are not sure why paragraphs (b) to (e) of the existing definition (relating to e.g. mining operations, construction sites, agricultural land used for farming and certain vessels, rolling stock and aircraft) appear to have been deleted and wonder if this occurred in error. Very good reasons existed for having these paragraphs included and inequitable tax treatment will result if these elements of the definition of FBE are removed.

- The current definition of FBE refers to an office etc which "*is used or will continue to be used*" by the taxpayer for a period of not less than one year. The proposed definition refers only to "*the continuous carrying on of the business…for a period of not less than one year"* and to business being conducted through offices etc *"for at least one year"*. We recommend the existing wording be retained as it makes it clear in the case of start up businesses that a one year period does not already have to have expired before the FBE exemption can be claimed.

- Subparagraph (e) of the proposed FBE definition states that the fixed place of business must be located in the foreign country solely or mainly for a purpose other than the postponement or reduction of any South African tax or "*any tax imposed by any sphere of government…in any other country*". We believe it to be entirely inappropriate for South Africa to appoint itself as the world's custodian

of tax revenues, particularly because to do so actually works against the interests of the South African economy and could work against the interests of our neighbouring countries. We are not aware of any other country anywhere that would penalise its own taxpayers if they entered into a structure which reduced foreign taxes, thereby increasing the amount of profit flowing back to the home country! (Even in countries such as the US which has highly developed tax avoidance provisions, the reduction of foreign taxes is accepted by the IRS as a legitimate business purpose).

For example, assume a South African company sets up an operating company in India. Since an Indian company held directly by a SA parent company will be subject to Indian capital gains tax as and when the shares are sold, the group's existing Mauritian intermediary company is interposed in order to avoid potential Indian tax on any future sale. After some years the Indian Co is sold to a non resident of SA at a profit. Had the SA parent held the Indian Co directly, no SA tax would have resulted due to the participation exemption. The same exemption applies to the Mauritian intermediary under the CFC rules. However, if the SA parent had held the Indian Co directly, Indian tax would have been payable on the transaction, whereas under the India/Mauritius treaty, provided the Mauritian company meets certain criteria, India is not able to tax the Mauritian company on the gain. Consequently, by using the Mauritian intermediary, the SA parent benefits by retaining indirectly the full value of the proceeds, undiluted by foreign tax obligations. It is hardly in SA's interests to disincentivise taxpayers from using intermediary holding company structures of this kind by potentially denying them FBE status.

It is surely hypocritical for SA to hold itself out to potential foreign investors into Africa as a gateway for their investment, and to allude in doing so to our beneficial network of African tax treaties, while at the same time penalising SA taxpayers that choose to use intermediary holding companies outside SA to make investments because these are located in favourable treaty jurisdictions!

In practice, we think it will be very difficult if not impossible for SARS to determine whether or not a CFC has been established with the sole or main purpose of reducing or postponing foreign tax and believe there is significant risk of SARS defaulting to a practice that automatically denies FBE status to a CFC if it does result in an effective reduction of any form of foreign tax whether or not this was its sole or main purpose, and whether or not the foreign country itself would regard the situation as abusive. Many countries deliberately offer reduced rates or other tax incentives to attract foreign investment (e.g. Botswana's IFSC regime). Would a Botswana IFSC company automatically be denied FBE status because it pays less tax than other Botswana companies? How would SARS view a situation where a DTA network has legitimately been used to reduce foreign

withholding taxes, and the countries where the taxes have been reduced are quite happy with the situation and do not regard it as tax avoidance?

We therefore recommend that the reference to postponement or reduction of foreign taxes be deleted.

Proviso to the definition of FBE

The proviso to the definition of FBE reads *"....of any other company - (i) incorporated in the country in which the fixed place of business of the controlled foreign company is located; (ii) if that other company forms part of the same group of companies as the controlled foreign company; and (iii) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company …"*

In respect of (i) which contemplates the situation of two companies sharing facilities – the draft legislation states that both companies need to be incorporated in the same country. This is too narrow. We suggest that it would be sufficient if both companies are incorporated or tax resident in the same country.

4.2. Foreign portfolio dividends

No comment at this stage.

4.3. Repeal of foreign loop exemption

We object to the repeal of section 64B(3A)(d). STC is not a tax at shareholder level but a corporate tax charge. There is no justification for imposing tax on a company's income at 28% and STC on profit distributions at 10%, if it is a South African tax resident, or at 33%, if it is a non-resident, and then again imposing STC on that income if received by a SA tax resident company as a foreign dividend, when it is on-distributed as a dividend to shareholders. This really amounts to double taxation and contradicts the policy rationale underlying the STC tax regime, i.e. that STC should only be imposed once on the distribution of profits by a SA tax resident, and that accordingly an STC credit should be granted in respect of dividends received by an SA resident company in respect of profits that have borne SA tax at the normal corporate rate.

We note the comments in the Draft Explanatory Memorandum regarding loop structures and the DAT mechanism. However, where a so-called loop was legitimately sanctioned by the SARB, its mere (legal) existence should not be a reason to deny the SA recipient of the dividends an STC credit.

4.4. Deferral of deductions relating to offshore short-term insurance reserves

It is proposed that the calculation of the net income of CFCs conducting short term insurance business be done in future without allowing for deductions of certain estimated liabilities provided for in terms of section 28(2)(cA) of the Act.

We believe that this provision loses sight of the policy underlying CFC legislation, which ought to be (and is globally) to collect the same amount of tax on the CFC's income (assuming it does not qualify for exemption) as would have been collected had the CFC's operations actually been conducted by a taxpayer in the country where the CFC rules are being applied. The purpose of CFC legislation should not be to collect tax on revenue that would never have been taxable in SA in the first place had the business concerned been conducted by a local taxpayer.

The justification given for this proposed harsh measure is that CFCs conducting short term insurance business which derive income that is not exempt "are likely to be suspect from a tax compliance point of view". This is a sweeping generalisation and generalisations should not serve as a foundation for tax legislation.

While the use of captive insurance companies is an area where tax abuse occurs, it is out of touch with economic reality to suggest that all captive insurance companies are set up for the purpose of engaging in tax avoidance. Particularly since 9/11, it has become increasingly essential for multinational groups to self insure a portion of their group risk as the cost of laying this off externally is prohibitive (assuming external cover can even be found). As the Explanatory Memorandum acknowledges, there are good non tax related reasons for doing this through a non SA subsidiary.

If a foreign captive is not carrying on genuine insurance business, then its income should already be imputed to South Africa without the benefit of any section 28(2)(cA) deductions as section 28 only applies to genuine insurers which are accepting true risk. In addition, it is unlikely that such a company would have a foreign business establishment. If the foreign captive is carrying on genuine insurance business, but is located in a low tax jurisdiction, SA will already be collecting tax on its income on the same basis as would occur had the CFC been incorporated in SA, i.e. including section 28(2)(CA) deductions, which we submit is the appropriate policy approach.

Consequently, the companies that will be most adversely affected by this proposed change will be genuine insurance companies located in relatively high tax jurisdictions – hardly the companies likely to be guilty of tax avoidance! They will be adversely affected because their home country will allow them deductions for

certain estimated liabilities while SA going forward will not. Hence they are unlikely to qualify for the new section 9D exemption based on paying foreign tax equal to at least 75% of the SA tax notionally applicable, and the foreign tax credits available to the SA parent for offset against the SA tax due are likely to be lower in future than the SA tax payable. We therefore see the proposed change as a classic example of penalising the "good guys" across the board simply because this approach is easier than taking steps to identify and target the real culprits through the tax audit process.

5. SPECIALISED ENTITIES AND CIRCUMSTANCES

5.1. Agricultural trusts

No comment at this stage.

5.2. FSB consumer education foundation

No comment at this stage.

5.3. Tax relief for public benefit organisations and recreational clubs – retrospective approval

No comment at this stage.

5.4. Transitional period for revised taxation of clubs

No comment at this stage.

5.5. Repeal of provisional tax status of Public Benefit Organisations, recreational clubs and home associations

No comment at this stage.

5.6. *De minimis* thresholds: for bodies corporate, share block companies and home owners associations

No comment at this stage.

5.7. Converted section 21 companies

No comment at this stage.

5.8. Film cash subsidies converted

We welcome this amendment.

5.9. Film allowance — refinement of anti-avoidance rules

Although we support the amendments to section 24F in general we would like to raise the following concerns.

Definition of "film owner"

The SA film industry battles to obtain funding, and this is probably the largest problem facing the local industry. Globally banks, and specifically special film funds operated by banks, are major funders of film projects. The limitations placed on the definition of "film owner" will deprive the local industry from a source of funding and will, in all likelihood result in the industry growing more slowly than might otherwise be the case.

At risk rule

We welcome the extension of the "at risk" rule from 10 years to 15 years.

6. ESTATE DUTY

6.1. Portable spousal deduction

Section 5 of the draft Taxation Laws Amendment Bill proposes a change to section 4A of the Estate Duty Act. The terms of the proposed change are broadly to the effect that if a spouse dies leaving his/her entire estate to his/her surviving spouse, then the surviving spouse will be entitled to an additional abatement of R 3.5 million on his/her death. This additional abatement, when added to the surviving spouse's own abatement, would mean a total abatement of R7 million would be available to the survivor.

The proposal is an attempt by the legislator to simplify matters and obviate the need to do complex estate planning in order to ensure that "use" is made of both spouses' abatements.

In its current form the proposal will not achieve its intended objectives as it is too restrictive in requiring that the first dying spouse must leave his/her entire net estate to the second dying. We say this because, in practice, almost no one leaves their entire estate to their surviving spouse. Bequests are almost always left to third parties.

For example, bequests are left to relatives (such as grandchildren), former employees, and friends. In addition, specific items of jewellery or furniture (which may constitute family heirlooms) are often left to persons other than the surviving spouse. Testators often also wish to leave their estates to their children subject to the surviving spouse having a usufruct over the estate. In all these circumstances the proposed amendment would exclude the surviving spouse from being entitled to an enhanced abatement.

In our view, the amendment should allow the surviving spouse to use the balance of the abatement that his/her predeceased spouse did not utilise. Thus, if the first dying spouse only, for example, used R1 million of his/her abatement, the survivor should be able to use the remaining balance of R 2,5 million as an additional abatement in his/her estate.

The draft Explanatory Memorandum gives two reasons for the proposed amendment being so restrictive. The first reason given is that only the will is kept as a permanent record and that, in the absence of details of the amount of the abatement granted to the first dying, the second dying could benefit unjustifiably because of the lack of evidence. This explanation does not, with respect, make sense. Firstly, the onus to prove the unutilised abatement in the predeceased spouse's estate would be on the executor of the second dying's estate. Secondly, the Master of the High Court retains detailed records of estate documents and accounts submitted to it, going back for many years. Consequently, proof of the abatement which has been utilised in the first dying's estate should be readily available.

The second reason given by the Explanatory Memorandum for requiring the entire estate of the first dying to be left to the second dying relates to the fact that the enhanced abatement should only apply in cases where, in effect, a professional has not drafted the will. This reason in our view ignores the fact that in most cases where the first dying dies intestate, with an estate of any significance, the second dying will be precluded from benefiting from the enhanced abatement because, in terms of the rules of intestate succession, the surviving spouse is unlikely to be the sole heir.

Finally, we submit that the new dispensation should apply to the estates of second dying spouses, who die after the effective date, irrespective of when their predeceased spouses died. To require the first dying spouse to die after the effective date would unfairly prejudice those individuals who had not used the services of professional estate planners in the past.

6.2. Usufructuary estate planning scheme

Section 6 of the draft Bill proposes a change to the method of valuation of a usufruct passing to an heir on the death of a deceased. The proposed section would value the

usufruct over the life expectancy of the recipient rather than the actual term of the usufruct where this is shorter than the life expectancy. The proposed change is in order to counter perceived avoidance. This avoidance occurs where a spouse leaves a usufruct to his/her surviving spouse on his or her death and consequently claims a deduction in terms of section 4(q) of the Estate Duty Act of the value of the usufruct. The avoidance arises on the death of the second dying where the usufruct does not cease immediately but continues for a limited period of time after the second dying's death.

The proposal deals effectively with the perceived avoidance but we are concerned that that it is going to also affect the valuation of arrangements that have no estate duty avoidance motive or effect.

Proposal

We propose that the valuation basis for a usufruct passing on the death of a deceased remain unchanged with the proviso that, where a deduction has been claimed in respect of that usufruct in terms of section 4(q) of the Estate Duty Act in the estate of the first dying, the new valuation basis proposed in the draft Bill should apply.

This proposal would effectively deal with the proposed avoidance without unfairly impacting other legitimate arrangements which have nothing to do with avoidance.

7. INDIRECT TAX

7.1. Indirect tax treatment of share block companies

No comment at this stage.

7.2. Impact of value-added tax on re-organisations

No comment at this stage.

8. SPECIAL MEASURES RELATING TO THE SHARING OF GENERAL FUEL LEVY REVENUE

No comment at this stage.

9. OTHER TEXTUAL CHANGES IN THE DRAFT TAXATION LAWS AMENDMENT BILL NOT DEALT WITH IN THE "EXPLANATION OF MAIN AMENDMENTS"

9.1. Clause 13 of the draft Taxation Laws Amendment Bill – amendment to section 9(1)(g) of the Income Tax Act

We note that section 9(1)(g) has been amended to include lump sums. In our view section 10(1)(gC) should be similarly amended to provide for an exemption for such lump sums.

9.2. Clause 16(1)(h) of the draft Taxation Laws Amendment Bill – amendment to section 11(n) of the Income Tax Act

Treasury should consider increasing the amounts of R1 750 and R3 500 as these have been fixed for a long period of time.

9.3. Clause 26 of the draft Taxation Laws Amendment Bill – amendment to section 12I of the Income Tax Act

To be consistent with the other amendments, we recommend that the definition of Greenfield project also exclude the terms "new & unused".

9.4. Clause 89 of the draft Taxation Laws Amendment Bill – amendment to paragraph 45 of the Eighth Schedule

Paragraph 45 is amended by the insertion of subsection (4). Effectively this makes qualifying for the primary residence exemption more difficult. We do not believe that this section introduces a fair taxation principle. If these circumstances are present some form of apportionment is more appropriate.

10. DRAFT TAXATION LAWS SECOND AMENDMENT BILL

10.1. Section 88A - Settlement of Disputes

This section provides that the Part IIIA dispute settlement processes are only available after the issue of an assessment.

Some matters which may be the subject of a dispute, whether of law or fact, are often addressed without the issue of an assessment, especially where there is a 'self-assessment' process in place. These include employees' tax issues, donations tax,

STC and other taxes such as VAT (via section 32(2)). Payment or settlement is often made via an 'adjusted' return.

Submission

Consideration should be given to making Part IIIA available in circumstances where a formal assessment is not issued as a matter of course.

10.2. Section 89quin – Compounding of interest

The amendment proposes that interest payable under the Act be compounded daily. While commercial practice is that interest is calculated on a daily basis, it is compounded (added to the capital) over a longer recognised period – usually monthly (NACM), sometimes quarterly, half-yearly or even annually. To compound interest daily would lead to a non-commercial outcome, be administratively cumbersome and give rise to a disproportionately high effective interest rate.

Submission

We recommend that SARS specify a compounding period in line with commercial practice for the calculation of interest.

10.3. Amendment to paragraph 20 of the Fourth Schedule to the Income Tax Act

In our view the amendments made to this provision and the explanation in the draft Explanatory Memorandum regarding unsophisticated taxpayers show that National Treasury is out of touch with commercial reality. We request that this provision be reconsidered in light of the numerous submissions already made in respect hereof.