

## **Standing Committee on Finance: Report-Back Hearings**

**(25 August 2009)**

### **Taxation Laws Amendments Bills, 2009**

#### **Final Response Document**

## **1. BACKGROUND**

### **1.1 Process**

The Taxation Laws Amendment Bills, 2009 contain all the annual tax proposals as announced in the 2009 Budget Review. National Treasury and SARS conducted the initial briefing before the Standing Committee on Finance on 11 June 2009. Public responses before the Committee were conducted on 24 June 2009.

### **1.2 Public comments**

Website release of the Taxation Laws Amendment Bills occurred on 1 June 2009. Public written responses were due as of 26 June 2009. Approximately 50 organisations provided comment of over 600 pages (Annexure). A National Treasury/SARS workshop was also held with taxpayers and tax practitioners to further clarify the issues. This all-day engagement occurred on 30 June 2009. Separate meetings to discuss specialised issues were also held. The official report back to the Standing Committee on Finance was held on 5 August 2009.

## **2. POLICY ISSUES AND RESPONSES**

Provided below are the responses to the policy issues raised by the comments. Comments that fall wholly outside the scope of the Bill have been disregarded.

### **2.1 INCOME TAX: RATES AND THRESHOLDS**

#### **2.1.1 RATES TABLE**

*Comment (Appendix 1 Paragraph 5):* In 2008, the employment company and employment trust anti-avoidance regimes were merged into the newly created personal service provider regime. Therefore, the reference to the employment company regime should be completely removed from Schedule 1 and replaced by reference to "personal service provider."

*Response:* Comment misplaced. The references to the previous regime are needed as a result of overlapping years of assessment. The old definitions must therefore remain in place for one more year (and then the paragraph will no longer be required). For instance, if a company was subject to the employment company anti-avoidance regime and has a

year of assessment ending on 30 June, the employment company anti-avoidance regime applies to that company until 30 June 2009.

### **2.1.2 CAPITAL GAINS TAX PRIMARY RESIDENCE EXCLUSION**

*Comment (Clause 89; Paragraph 45(2) of the 8<sup>th</sup> Schedule):* Under current law, the sale of a primary residence is eligible for the R1.5 million capital gain exclusion. The proposed amendment also allows the exclusion of homes disposed of for no greater than R2 million. However, the exclusion for disposals up to R2 million does not cover persons who have not ordinarily resided in that residence for the requisite two year period or who have used their residence for partial trade purposes. The R2 million should accordingly be extended (and pro rated) when these circumstances apply.

*Response:* Not accepted. The rule was only intended for a limited range of simplified circumstances where the R2 million rule could further ease administration and compliance. Once the circumstances become more complicated for other reasons, the need for the R2 million simplifying rule is no longer relevant.

*Comment (Clause 89; Paragraph 45(1) of the 8<sup>th</sup> Schedule):* Clarification is required as to whether the primary residence exclusion is applicable to disposals which result in proceeds exceeding R2 million. In other words, if the primary residence is disposed of for more than R2 million, the pre-existing exclusion of R1.5 million of gain no longer appears to apply.

*Response:* Comment misplaced. The R1.5 million gain/loss rule always applies. The R2 million gross rule is a safe harbour for smaller homes. This issue will be addressed in the explanatory memorandum for added clarity.

## **2.2 INCOME TAX: INDIVIDUALS AND EMPLOYMENT**

### **2.2.1. CLAIMS OF BUSINESS TRAVEL AGAINST VEHICLE ALLOWANCES: REPEAL OF THE DEEMED KILOMETRE METHOD**

*Comment (Clause 12(1)(a); Section 8(1)):* The complete removal of the deemed kilometer method in respect of the travel (car) allowance as of 1 March 2010 is too radical given this method's widespread usage. The deemed kilometre method should instead be phased out over time.

*Response:* Not accepted. The phase-out already began several years ago. Previous amendments progressively decreased the deemed business kilometres. The proposed amendment effectively completes the progressive phase-out.

*Comment (Clause 75(b); Paragraph 1 of the 4<sup>th</sup> Schedule):* Under current law, 60 per cent of a travel (car) allowance is subject to pay-as-you-earn withholding with the business travel deductible upon assessment. This 60 per cent rule applies to all aspects of the travel (car) allowance – i.e. for both the deemed kilometre method and the actual kilometre method. Now that only the actual

kilometre method remains, no reason exists to increase the 60 per cent threshold for pay-as-you earn to 80 per cent.

*Response:* Not accepted. Of concern is the fact that taxpayer claims of costs relating to actual business travel will often be less than the costs based on the deemed business travel. This shortfall will result in those taxpayers having to pay tax on assessment - amounts that taxpayers may not have on hand. In any event, taxpayers travelling long distances on business will continue to be able to get the benefit of costs of business travel against their vehicle allowances by requesting a SARS directive.

## **2.2.2 RETIREMENT LUMP SUMS**

*Comment (Appendix I - Paragraph 10):* When a member of a retirement savings fund withdraws a lump sum from that fund before retirement, this withdrawal works against the R300 000 retirement exemption pursuant to the accumulation principle. While this rule is designed to discourage pre-retirement withdrawals, this rule is unfair when members make a withdrawal to cover shortfalls during periods of unemployment.

*Response:* Partially accepted. The proposed amendment will be revised so that if retirement savings withdrawals are due to a job loss event (i.e. retrenchments) the amounts withdrawn will be taxed by applying the retirement tax table. In these circumstances, a member will benefit from the R300 000 exemption. However, accumulation will remain (e.g. once the R300 000 exemption is used for the pre-retirement "job loss" withdrawal, the R300 000 exemption cannot be used again).

On a collateral note, another provision that has come under scrutiny during these difficult economic times is section 10(1)(x), which allows a R30 000 exemption when an employer pays amounts on termination of service to employees. Criticisms have been raised that this R30 000 amount has not been increased for many years. Given the above concession, consideration will be given to removing section 10(1)(x) in future. In terms of this proposal, payments currently qualifying under section 10(1)(x) would effectively form part of the R300 000 amount. This proposal would provide significant tax relief before retirement. It should be noted that any exemption used before retirement for this purpose would again be lost upon retirement due to the accumulation principle.

*Comment (Appendix 1 - Paragraph 10):* Under old law, the member spouse was subject to tax if retirement funds were split upon divorce with this tax falling upon the member when the other spouse withdrew the funds. Under current law, the clean-break principle properly taxes the withdrawing spouse, not the member. However, a small category of divorces remain subject to the old law with the added burden of applying the accumulation principle against the member spouse when the other spouse withdraws funds. This kind of post-1 March 2009 withdrawal accumulation stemming from pre-13 September 2007 divorce orders should be removed so that the member spouse is not unfairly penalised.

*Response: Accepted.* Lump sums will no longer be includible in respect of post-1 March 2009 withdrawals associated with pre-13 September 2007 divorce orders. This non-inclusion will apply for both the member and the spouse so the accumulation principle will no longer be relevant. This change will simplify compliance and enforcement without any meaningful cost to the fiscus given the small amounts involved.

### **2.2.3 MINOR BENEFICIARY FUNDS**

*Comment: (Clause 71(1)(c); Paragraph 3 of the 2<sup>nd</sup> Schedule):* Under current law, if a member of a retirement savings fund dies, payment from that fund to a beneficiary fund is exempt. Once the amounts are within the ambit of the beneficiary fund, growth within that fund is exempt and the payout to the beneficiary is taxable. While we understand the benefits of shifting the point of taxation from beneficiary payouts to taxation on death, this shift creates transitional problems, especially because the proposal dates back to 1 March 2009. A number of retirement savings funds have already made transfers to beneficiary funds on the assumption that these transfers were exempt. These retirement savings funds will now be liable for tax even though they released the payouts to the beneficiary funds.

*Response: Accepted.* The backdating of the amendment so that tax applies to death benefits paid by retirement funds to a minor beneficiary fund will be limited. This backdating will apply only to the extent funds have not already been transferred to minor beneficiary funds. Taxation of death benefits paid to a beneficiary fund will not be subject to the proposal (i.e. will not be taxed) if the transfer occurred between 1 March 2009 and 5 August 2009. Note that these funds will still be exempt when paid out by the beneficiary fund to the beneficiary (so as to maintain simplified administration for the beneficiary fund).

### **2.2.4 POST-RETIREMENT MEDICAL AID**

*Comment (Clause 16(1)(i); Section 11(wA)):* Employers may make payments to fully eliminate the post-retirement medical aid responsibility, not only for retired employees but also for current employees. For example, an employer may provide this benefit for employees who are about to retire. The proposal should therefore provide the employer with an immediate deduction in these latter situations.

*Response: Noted.* This concern is noted but cannot be addressed at this stage. The concern overlaps with the social security reform project and possibly with the proposed medical health insurance that are currently under way. Any amendment to address this concern would therefore be premature and could only be addressed at a later stage.

*Comment (Clause 16(1)(i); Section 11(wA)):* Situations might arise where the insurer reimburses the employer so the employer can pay the retired employee's medical scheme contribution. This form of payout avoids involvement of the employee while covering the employer's risk for these costs. The proposal to

immediately deduct post-medical aid expense should be extended to cover these circumstances.

*Response:* Accepted. It is acknowledged that issues of practicality dictate that reimbursements directly to the employer may be the most viable option. Hence, this form of employer payout should be permissible as long as the payout is directly applied for the funding of medical scheme contributions of the retired employee.

*Comment (Clause 16(1)(i); Section 11(wA)):* The deduction should not be restricted to circumstances where the employer is fully relieved of all obligations towards the employee or the insurance company. The immediate deduction should still be available for the employer if certain risks are not transferred.

*Response:* Partially accepted. It is accepted that insurers might not be in a position to assume each and every risk associated with post-retirement medical obligations. As a practical matter, a portion of medical inflation risk may for example still vest in the employer. The insurer therefore does not need to assume all risks. However, mortality risk must be transferred in full.

*Comment (Clause 16(1)(i); Section 11(wA)):* Circumstances exist where employers have non-medical post-retirement obligations towards employees. The immediate deduction should also apply in respect of a lump sum payment to cancel these other post-retirement obligations towards employees (e.g. pension annuities).

*Response:* Not accepted. The budget proposals did not cover tax deductions for post-retirement obligations in general. Consequently, this issue falls outside the scope of the Bill. This area may warrant further research and will be considered at a later date.

*Comment (Clause 16(1)(i); Section 11(wA);):* The proposed deduction deals with the tax consequences for the employer when the amount is paid. However, the tax implications for the employee are often unclear. Provisions should therefore be introduced to exempt employees from Income Tax or the Capital Gains Tax.

*Response:* Noted. Circumstances may arise where employer transfer of post-retirement medical aid obligations could have unintended tax consequences for the retiree. At this stage, an attempt will be made to resolve these issues as they arise by means of interpretation. Further facts will be required before determining whether a legislative response is warranted.

*Comment (Clause 16(1)(i); Section 11(wA)):* New section 11(wA) does not apply to certain post-retirement medical scheme payments made by employers. In these circumstances, taxpayers should still be able to rely on pre-existing provisions to obtain relief to the extent those provisions are otherwise available.

*Response:* Accepted. The wording in the legislation will be amended to expressly allow for pre-existing relief. The explanatory memorandum will also highlight this point.

## **2.3 INCOME TAX: BUSINESS**

### **2.3.1 CERTIFIED EMISSION REDUCTIONS – TRADABLE CARBON EMISSIONS REDUCTION CREDITS (CERs)**

*Comment (Clause 28; Section 12K(2)):* The proposed amendment exempting the disposal of CERs from income is welcomed. However, concerns exist that the mere receipt (i.e. creation) of a CER constitutes a taxable event for which no comparable exemption exists.

*Response:* Comment misplaced. The mere issue of a CER should not give rise to a taxable event. Accordingly, it is not required that legislation exempting the receipt of a CER be introduced. The question arises as to why the issue is not comparable to obtaining a license or any other government certification, none of which would be taxable if directly received from government.

*Comment (Clause 28; Section 12K(2)):* To be fully effective, the exemption should also cover trading stock inclusions for year-end holdings under section 22. Without this change, the ultimate disposal will be exempt but the mere holding of CERs at the close of the financial year will inadvertently give rise to income.

*Response:* Comment misplaced. It is true that the inclusion of CERs held as trading stock at year-end does not constitute a disposal but a different form of inclusion. However, section 22 in effect only defers the deduction of an allowable expense. The cost incurred in respect of CERs will not qualify as a deduction under section 11(a) as any receipt or accrual from the eventual disposal will be exempt from normal tax. CERs are not in principle included as opening or closing stock under section 22. This issue will nonetheless be clarified in the explanatory memorandum in order to avoid any confusion.

*Comment (Clause 28; Section 12K(2)):* The exemption does not cover European funded transactions (i.e. transactions where the European parent company makes an upfront payment for the CERs and agrees to take delivery at a later date). This upfront payment is an important source of financing.

*Response:* Comment misplaced. Under the current formulation, the exemption applies to cash received from European funders before disposal to the European funder. Although the receipt occurs prior to the disposal of the CER, the payment will be “in respect of” the disposal which implicitly includes an anticipated disposal. This issue will be addressed in the explanatory memorandum for clarity.

*Comment (Clause 28; Section 12K(2)):* The distribution of CERs should be exempt from all forms of tax. In addition, profits derived from CERs should also be exempt from all forms of tax when distributed.

*Response:* Partially accepted. *In specie* distributions will be exempt from normal tax as the law currently reads. However, distributions of amounts derived from the disposal of CERs will not additionally be exempt from other taxes (e.g. STC).

*Comment:* In terms of CDM projects, two items are typically produced – energy and CERs. Most of the CDM related expenditure should be permitted as deductions since most of this expenditure is allocable to the other items produced (i.e. energy) whilst the non-deductible expenditure allocable to the creation of CERs is fairly small.

*Response:* Noted. As a practical matter, it appears that CER application costs constitute the main items allocated to CERs. Other production costs are generally attributable to taxable income-generating aspects of the project (and hence deductible). To the extent that a taxpayer seeks clarity on this matter, it may approach SARS for an advance ruling.

*Comment (Clause 28(2)):* While it is understood that the Kyoto Convention will be in place only until 2012 (unless extended), the current 2012 cut-off of the exemption for CERs disposed of after that date is too short. The expiry date should be extended to cover CERs arising from CDM projects registered on or before 31 December 2012.

*Response:* Accepted. The 2012 cut-off for the exemption will be based on CDM projects and not on the CERs themselves. Therefore, the cut-off date will be adjusted to cover all CERs derived from CDM projects beginning on or before 31 December 2012.

*Comment:* The Value-Added Tax does not contain any special relief for CERs. The law should be clarified so that the supply of CERs is zero rated.

*Response:* Comment misplaced. Specific relief from VAT is unnecessary. CERs can only be utilised in Annex 1 countries and as such will be exported. As a result, CERs would qualify for zero rating for VAT when the CERs are exported as a matter of simple interpretation. The general global view is that these CERs should be treated as the export of services.

*Comment (Clause 28; Section 12K(1)):* A verified emission reduction (VER) is similar to a certified emission reduction (CER) in that both CERs and VERs comprise an emission reduction unit. The difference between CERs and VERs lies in the fact that a VER is traded on the voluntary market (but VERs can also be used by Annex 1 countries when meeting their emission reduction obligations in line with the Kyoto Protocol). It is therefore suggested that VERs should also qualify for the exemption.

*Response:* Not accepted. The exemption will not be extended to VERs. The intention is to limit the exemption to a controlled regulatory paradigm. CERs are issued in a tightly controlled domestic and international (i.e. U.N.) regulatory paradigm. These controls do not exist for VERs.

### **2.3.2 ENERGY EFFICIENCY**

*Comment (Clause 29; Section 12L(1)):* Questions were raised relating to who should issue the energy savings certificates.

*Response:* Accepted. The certificate issuing authority will be dealt with in the regulations. (SANEDI will no longer be specified in the Act). The Minister of the Department of Energy will issue the regulations, in consultation with the Ministers of Finance and Trade and Industry.

*Comment (Clause 29; Section 12L(1)):* The legislation should clearly specify that the aim is “energy efficiency savings”, not just energy or electricity savings.

*Response:* Accepted. Consistency in the use the wording “energy efficiency savings” (including that of “energy efficiency savings” certificates), where applicable, will be effected.

*Comment (Clause 29; Section 12L(3)):* What is the lowest renewable energy feed-in-tariff (REFIT) rate in cases where changes to REFIT are made during the year of assessment?

*Response:* Accepted. The lowest REFIT rate applicable will be the lowest NERSA-specified REFIT rate at the beginning of the year of assessment.

*Comment (Clause 29; Section 12L(3)):* Extend the incentive to also include reduction in Diesel/HFO consumption and other energy savings. Also consideration should be given to measuring energy efficiency savings in joules and not kWh.

*Response:* Comment misplaced. The proposal merely refers to energy and not electricity. The measurement for ease of calculating the allowance and for uniformity will be kWh or kWh equivalent (the energy need not initially arise in that form).

*Note 1:* It should further be noted that this section of the Act will only come into effect on a date as determined by the Minister of Finance by way of a notice in the Government Gazette. This delay has become necessary given the need to ensure policy coherence amongst government departments and other stakeholders relating to efforts to promote energy efficiency savings.

*Note 2:* Given the possibility of the introduction of a “Standard Offer” to promote electricity efficiency savings, consideration will be given to limit any possible double benefits that may arise from the various initiatives to promote energy



efficiency savings. The tax incentive for energy efficiency savings will not be available if a taxpayer makes use of other concurrent benefits of a similar nature.

### **2.3.3 DIVIDENDS TAX: DEFINITIONS**

*Comment (Clause 8(1)(g); Section 1 (“contributed tax capital” definition)):* In order for a distribution to qualify as CTC under the proposal, the distributing company must communicate in writing to all shareholders that CTC is being distributed. As currently drafted, this requirement is onerous. In the very least, the legislation should clarify the forms of communication “in writing” that will be acceptable. For example, would a public announcement be sufficient, or does a shareholder need to be communicated with directly?

*Response:* Accepted. The “in-writing” requirement will be changed. Instead, the board of directors of a company will simply be required to make a resolution to utilise the contributed tax capital.

*Comment (Clause 8(1)(h); Section 1 (“dividend” definition)):* It appears that there is an overlap between the “dividend” definition and the “deemed dividend” rules. One definition or the other will have to be narrowed.

*Response:* Accepted. All distributions of cash, distributions in specie and redemptions will fall under the “dividend” definition. All other benefit transfers will be dealt with under the “deemed dividend” or value extraction rules (e.g. low interest loans, loan cancellations, amounts applied for the benefit of third parties and ceasing to be a resident). A value extraction will specifically exclude actual dividends to prevent overlap.

*Comment (Clause 8(1)(h); Section 1 “dividend” definition):* Formal share buy-backs by a company result in dividend treatment under the current Secondary Tax on Companies as well as under the new Dividends Tax. While the principle is accepted, the proposal is impractical when a company purchases its own shares on the open market. Selling shareholders often do not know that the buyback is a dividend and frequently view the transaction as any other open market sale.

*Response:* Accepted. Open market share buy-backs by companies on the JSE pursuant to rule 5.67 of the JSE Listing Requirements will be excluded from dividend treatment. These transactions will be treated like any other sale.

*Comment:* The amendments to section 1 of the Act do not address the issue of what constitutes a foreign dividend, which was left unattended to last year. The foreign dividend definition is of critical importance and must be addressed.

*Response:* Noted. The importance of the definition is well understood. The issue has been deferred until the 2010 legislative cycle because dedicated research and consultation will be required before the best solution can be found. At this stage, time still exists because the “foreign

dividend” definition will only be necessary once the new Dividends Tax comes into effect (which is still at least a year away).

*Comment (Clause 8(1)(l); Section 1 (“listed share” definition)):* The “listed share” and “share” definitions need to clarify that these terms include “depository receipts.” The law is unclear on this point, thereby giving rise to unnecessary uncertainty.

*Response:* Noted. For now this issue is best addressed through interpretation. A depository receipt is merely a certificate representing a beneficial ownership of a share and should be treated as such. The legislation in this respect will be further clarified more explicitly when changes to the Income Tax Act are made to conform with company law reform.

#### **2.3.4 DIVIDENDS TAX: PRE-SALE DIVIDENDS/DIVIDENDS STRIPPING**

*Comment (Clauses 35 and 88; Section 22B(2) and paragraph 43A(2) of the 8th Schedule):* The proposal seeks to eliminate the advantage arising under the new Dividends Tax from pre-sale dividends to company shareholders that are directly or indirectly funded by purchasers. If form governs, these pre-sale dividends are tax-free; whereas, the sale of shares by a company shareholder gives rise to taxable ordinary or capital gain. To eliminate this arbitrage, the proposal potentially converts dividends two years before sale of the dividend-paying shares into capital gains. It is argued that the two-year period is excessive and should be reduced to six months.

*Response:* Partially accepted. The period will be reduced to 18 months in line with the anti-avoidance rules for company re-organisations. A consequential change will also be effected to paragraph 19 of the 8th Schedule (another anti-dividend stripping rule) so as to reduce the period in that provision to 18 months.

*Comment (Clauses 35 and 88; Section 22B(2) and paragraph 43A(2) of the 8th Schedule):* There is a risk that the proposed anti-dividend stripping provisions could have unintended consequences. For example, if any lender lends funds to the target company in the ordinary course of business within the two-year period contemplated and the lender (or a connected person) subsequently acquires the shares in the target company, the dividends previously paid to the selling shareholder will trigger ordinary or capital gains. Under criticism is the fact that this result applies even if no causal connection exists between the dividends, the loan and the disposal of the shares. It is accordingly argued that the proposed anti-dividend stripping provisions should be applied only to situations where a three-way causal relationship exists.

*Response:* Accepted. The proposed causal connection will become a required trigger. More specifically, the loan/guarantee rules will be limited so that the impermissible loans/guarantees will be limited to those amounts occurring by “reason of” or “in consequence of” the acquisition.

*Comment (Clauses 35 and 88; Section 22B(2) and Paragraph 43A(2) of the 8th Schedule):* The proposal not only targets loans and guarantees between the target company and the purchaser but also purchaser loans and guarantees incurred by connected persons in relation to the target company. The inclusion of connected persons is too wide and unfounded.

*Response:* Partially accepted. The connected person test will be narrowed. Only more than 50 per cent controlled subsidiaries of target companies will be within the ambit of the provision. The main purpose of this rule is to prevent the target company from having one of its subsidiaries borrowing funds from the purchaser in relation to the acquisition, followed by the indirect distribution of the loan proceeds back to the selling company shareholders.

### **2.3.5 DIVIDENDS TAX: WITHHOLDING REFINEMENTS**

*Comment (Clause 60; Section 64K(2)):* The proposed legislation requires dividend paying companies or regulated intermediaries to submit to SARS all exempt declarations by beneficial owners. This requirement is onerous and should be deleted.

*Response:* Partially accepted. The proposed submissions to SARS will be narrowed. Only the submission of treaty reduction declarations in respect of foreign shareholders/beneficial owners will be required.

*Comment (Clauses 57 and 58; Sections 64G(2) and 64H(2)):* When enacted in 2008, a special three-year declaration rule was proposed, which generally allowed paying companies and intermediaries to rely on exemption and treaty reduction claims for a three year period. Although it is understood that the three-year declaration rules were designed to ease compliance, this three-year rule actually adds to compliance costs. Paying companies and regulated intermediaries will have an easier time complying with a rule that requires a shareholder declaration for each dividend paid.

*Response:* Accepted. The three-year rule was designed to simplify compliance. If a “per dividend” is easier for compliance purposes, this rule is preferred from a policy point of view due to its greater accuracy. This change to a “per dividend” rule will apply for purposes of both exemption and treaty claims.

*Comment (Clauses 57 and 58; Sections 64G and 64H):* Sometimes regulated intermediaries hold certificated shares due to historical reasons or because of certain practical restrictions associated with foreign shares listed on the JSE. In these cases, despite the certificated nature of these shares, the regulated intermediary should conduct the withholding – and not the company paying the dividend – because the regulated intermediary has greater access to information about the shareholding.

*Response:* Accepted. The focus of the withholding rules will be changed. Certificated and uncertificated shares will no longer be the distinguishing feature for withholding purposes. Instead, any payment (whether in

respect of certificated or uncertificated shares) by a company to a regulated intermediary will result in the regulated intermediary assuming the withholding responsibility. Any payment by a company to a party other than an unregulated intermediary will result in a withholding obligation for the company payor.

*Comment (Clause 62; Section 64M(2)):* Concerns exist as to the source of refunds stemming from company dividends, especially when regulated intermediaries conduct the withholding. If an exempt shareholder receives a dividend and seeks a refund of Dividends Tax withheld due to a late declaration for exemption, the proposal requires the exempt shareholder to obtain that refund solely from the regulated intermediary (over a three-year period) out of dividend taxes otherwise due arising from subsequent dividends. Refunds from SARS are no longer permissible. This rule is problematic because it may not be possible for the exempt shareholder to obtain a refund if no further dividends are declared by the company giving rise to the dividend received by the exempt shareholder.

*Response:* Comment misplaced. Shareholders seeking refunds from regulated intermediaries need not trace the source of the refund to a subsequent dividend distributed by the same company as the company previously distributing the dividend associated with the refund. For instance, if an exempt shareholder receives a dividend via a regulated intermediary from Company A and that shareholder is subject to Dividends Tax withholding due to a late exemption declaration, the shareholder can receive a refund from the regulated intermediary whenever the intermediary withholds dividends tax from any dividend of any other company. The source of the refund need not be linked to another Company A dividend. In other words, the provision is not limited to a particular distributing company; refunds can come from a dividend declared by any other person. This will be clarified in the explanatory memorandum.

### **2.3.6 DISTRIBUTION OF SHARES AND SHARE RIGHTS**

*Comment (Clause 67; Section 64R):* The proposed amendment generally imposes the new Dividends Tax when a company distributes its own shares to pre-existing shareholders (i.e. distributes capitalisation shares). The proposed amendment is extremely problematic and reverses the current exemption established under the Secondary Tax on Companies. Companies often distribute shares (in lieu of cash or with cash as an option only upon a specific shareholder election) in order to preserve company cash flows. The proposed charge would undermine this practice.

*Response:* Accepted. The proposed taxation of share distributions of a company's own shares will be withdrawn for further consideration. While this charge has theoretical support and is in line with international practice, the imposition of Dividends Tax gives rise to practical problems in terms of withholding and valuation. Tax-free share distributions should also generally be subject to deferred tax because the shares will be deemed to have a zero tax cost, thereby giving rise to future capital gains (or ordinary revenue). However, a limited set of avoidance transactions

remain of concern where the share distribution can change proportional shareholder interests, followed by transfers of newly issued shares between shareholders that are untaxed at the shareholder level. These avoidance transactions will be the subject of further review.

### **2.3.7 DIVIDENDS TAX: IN SPECIE VALUATION**

*Comment (Clause 55; Section 64E(3)):* The proposal seeks to establish a uniform value for *in specie* dividends so that the Dividends Tax can be firmly fixed before distribution. However, the valuation procedure for *in specie* dividends needs to be clarified. First, the valuation procedure should apply to other aspects of the Income Tax, not just the Dividends Tax. The elective nature of the system also creates uncertainty as to what happens if the elective procedure is not chosen.

*Response: Accepted.* The date of board of directors approval for the *in specie* dividend will be the date of valuation for those assets distributed. This date will apply for all Dividends Tax valuation purposes, in respect of listed companies. Unlisted company dividend valuations will be synchronised with the capital gains tax rules. Other integration issues between various aspects of the Income Tax Act will be clarified in the next legislative cycle.

*Comment:* *In specie* dividends not only give rise to valuation problems but also cash-flow problems. Cash must exist to pay the tax in respect of the *in specie* dividend. This lack of cash is especially problematic for regulated intermediaries. Surely, the regulated intermediary is not expected to raise the cash to pay the tax on the *in specie* dividend distributed by another company?

*Response: Noted.* Rules to resolve this issue are still under review. Under one option, if a company distributes a dividend with more than 90 per cent of the value constituting an *in specie* dividend, the company would be liable to withhold the cash required by the new Dividends Tax from the realisation of a portion of the assets (even if the payment is made to a regulated intermediary). If the distributing company over-withholds because dividends are subsequently determined to be exempt, such as a dividend paid to a pension fund that provides a late exemption declaration, the pension fund would then be able to claim a refund. That said, the viability of this option requires further consultation.

### **2.3.8 NEW DIVIDENDS TAX: DEEMED DIVIDENDS**

*Comment (Clause 64; General Principles - Section 64O):* The deemed dividend rules are problematic for insurers/collective investment schemes (CIS) and other regulated intermediaries because any intermediary withholding is impractical. Regulated intermediaries are typically not a party to the transaction giving rise to the deemed dividend and lack the cash to cover a transaction outside the intermediary's control.

*Response: Accepted.* The new rules will impose tax obligations on the company payor so as to eliminate the withholding liability on regulated

intermediaries. The company payor and not the shareholder/connected person will be the taxpayer liable for any taxes ultimately due. This finality will prevent tax-on-tax circularity which would otherwise arise (with the shareholder being required to bear tax on deemed dividends for tax arising out of the deemed dividend). However, this finality will not alter the exemptions normally associated with the new Dividends Tax. For instance, if a company makes a deemed dividend (e.g. loan) to a party exempt from the new Dividends Tax (e.g. a pension fund), the deemed dividend will be exempt.

*Comment (Clause 64; General Principles - Section 64O):* The deemed dividend rule should more closely track the path of the deemed dividend that leads to the recipient. The charge should not apply as if paid directly to the recipient as suggested by the proposed amendment. For instance, assume Company A and Company B are owned by a single individual shareholder. Also assume that Company A makes an impermissible loan to Company B. Under these circumstances, the loan should be viewed as taxable deemed dividend to the individual, followed by a tax-free contribution to Company B. The transaction should not be viewed as a deemed dividend directly to Company B. Similarly, assume individual owns all the shares of Parent Company with Parent Company owning all the shares of Subsidiary, and also assume that Subsidiary makes an impermissible loan to Individual. The transaction should be viewed as a dividend to Parent Company, followed by a dividend to Individual. The transaction should not be viewed as a deemed dividend directly to Individual.

*Response:* Not accepted. The proposed rules for value extraction are based on a simplifying assumption. The value extraction is deemed paid directly to the recipient. Intervening shareholders are ignored (i.e. one does not trace the path). This simplifying assumption has both positive and negatives for taxpayers but greatly simplifies enforcement and compliance.

*Comment (Clause 64; General Principles - Section 64O):* No provision is made for the repayment of a loan that was previously taxed as a deemed dividend. A scenario of this nature could result in the levying of a double Dividends Tax. A similar scenario applies with regard to a loan that constituted a deemed dividend which is then waived. Deemed dividends should accordingly increase CTC or some other method should be used to prevent double taxation of the company.

*Response:* Accepted. The rules will be adjusted so that loans do not give rise to a double charge. Only the low-interest benefit of a loan to a connected person will be taxed.

*Comment (Clause 64; General Principles - Section 64O):* Contributed tax capital is available to reduce the Dividends Tax in respect of future dividends. CTC should also be available to reduce the tax on deemed dividends.

*Response:* Not accepted. The use of CTC to reduce the taxable amount in respect of deemed dividends will effectively allow contributed tax capital to be allocated to specific parties. This concept was generally rejected for actual dividends, which require a share class allocation.

*Comment (Clause 65; General Principles – Section 64P):* The deemed dividend rules should contain an overall limitation. There should be an exemption in respect of amounts that could not otherwise have been declared as a dividend.

*Response:* Not accepted. The suggestion is essentially seeking a profit limitation. This profit limitation has been removed from the actual dividends calculation so no reason exists for placing the limitation on deemed dividends. The current profit limitation in terms of the section 64C deemed dividend rules under the STC also gives rise to practical difficulties. These practical difficulties were part of the reason why the profit limitation is being abandoned in the new Dividends Tax. As a more conceptual matter, the concept of profit is also an outdated concept under company law that will be eliminated in the new Companies Act.

*Comment (Clause 65; Loans – Section 64P):* The dual interest rate thresholds are too burdensome. If a company makes a loan in the ordinary course of business (e.g. as a vendor loan) or the company is a money lender, these facts should be sufficient to avoid the deemed dividend charge. The additional requirement that the terms not be “more favourable than to a member of the general public in similar circumstances” is unnecessary. This additional requirement is also very difficult to determine, especially with regards to moneylenders such as banks which charge various levels of interest depending on the risk involved. Comparing risks between members of the public also gives rise to further difficulties.

*Response:* Accepted. The dual interest rate thresholds will be eliminated in favour of an objective market related interest benefit concept.

*Comment (Clause 65; Loans – Section 64P(c)):* Under the proposal, loans will not give rise to deemed dividends as a general matter as long as these loans exceed paragraph (b) of the “prescribed rate” definition in section 1. This rate is too high. An arm’s length threshold should be used or at least a more appropriate commercial rate (such as the repo rate or inter-bank rate). This problem also exists under the deemed dividends rules under the STC.

*Response:* Accepted. The benchmark rate for loans to individuals and trusts will be the same as the “official rate as outlined under the employee fringe benefit rules. Loans between companies will be based on the central bank repurchase rate plus 100 basis points).

*Comment (Clause 65; Loans – Section 64P):* In determining whether a loan equals or exceeds the benchmark rate, it is not clear whether the rate should be determined at the time of the initial loan, on a daily basis or in accordance with some other method. As a matter of administrative simplicity, the comparison should be determined on the date on which the loan first attracts interest.

*Response:* Partially accepted. A mere upfront determination is problematic because the rate can then be changed subsequently. The interest benefit will instead be based on an overall average per annum.

*Comment (Clause 65; Loans – Section 64P):* An exemption from tax on deemed dividends should apply in respect of loans to employee share incentive trusts.

*Response: Accepted.* Employer loans to employee trusts typically qualify as financial assistance between connected persons because the employer is a beneficiary in the trust. The need for relief is accordingly accepted, and the exemption regime under section 64C will be utilised.

*Comment (Clause 65; Loans – Section 64P):* Downward loans to domestic and foreign subsidiaries should be exempt from deemed dividend treatment. For instance, if a parent company lends funds to a wholly-owned foreign subsidiary, the loan is at most a non-taxable capital contribution. Loans between brother-sister companies can also inadvertently give rise to a deemed dividend even though the ultimate beneficiary is a group subsidiary. Request is therefore made to provide relief in both circumstances.

*Response: Accepted.* Relief will be provided so that downward loans will not give rise to deemed dividends. This relief will require that the lending company directly or indirectly own at least 20 per cent of the equity share capital of the recipient company and the recipient company does not hold any equity shares in the parent company or any group company. This issue will be addressed in both the new Dividends Tax as well as the current STC.

*Comment (Clause 64; Arm's Length – Section 64O(2)):* A number of problems exist with the proposed treatment of section 31 non-arm's length cross-border transactions as a deemed dividend. Firstly, the rules overlap with the loan rules in many cases. Arm's length rules are also absent from domestic transactions as previously existed under the deemed dividend regime for STC (i.e. transfers by a company to a domestic taxpayer below arm's length). Moreover, if a loan is subject to arm's length section 31, the loan should not be penalised again as a deemed dividend.

*Response: Accepted.* The section 31 rules and the overall arm's length principal in relation to deemed dividends are withdrawn for reconsideration. The impact of these rules needs to be reconsidered in light of other arm's length provisions in the Act (such as the cross-border arm's length standard of section 31 and the market value standard of paragraph 38 of the 8th Schedule). However, it should be noted that the withdrawal of funds from a company for no (or less than market value) consideration generally raises two fundamental considerations – first whether the item was appropriately taxed at a 28 per cent rate in the company's hands and second whether the item was appropriately taxed again when ultimately distributed outside of domestic company ownership.

*Comment (Clause 64; Redomicile – Section 64O(2)):* If a company ceases to be a tax resident by shifting its effective management abroad, there is no justification for the dividends tax to be imposed on the company's pre-existing CTC. The formula should accordingly be reduced for available CTC.



*Response: Accepted.* While CTC cannot be taken into account for deemed dividends as a general matter because of concerns about per recipient allocation, this concern does not exist in the case of redomicile deemed dividends. CTC can therefore be used as a subtraction when this form of deemed dividend arises.

*Comment (Clause 65; Redomicile – Section 64O(4)):* In the case of a company ceasing to be a tax resident, the company is also subject to a capital gains charge as an exit charge for leaving South African taxing jurisdiction. This exit charge should be taken into account to reduce the deemed dividend (because these amounts are owed to the government and cannot be distributed to shareholders).

*Response: Accepted.* The issue of “liability” as a matter of interpretation should include a tax liability. The tax liability envisaged should run up to the date immediately before cessation of residence. This form of liability would implicitly include the capital gains tax triggered as a result of the cessation of resident status.

*Comment (Clause 65(1); Redomicile – Section 64O(5)):* In the case of a company ceasing to be a tax resident, no dividend should be deemed payable as the company has ceased to be a resident. Rather the dividend should be deemed to have been paid on the day prior to cessation of residence.

*Response: Accepted.* The date of cessation of residence will be shifted to occur on the day before actual cessation of residence. This date will match the capital gains tax rule when determining the time of disposal for the cessation of residence.

*Comment (Redomicile):* If a company shifts its tax residence abroad to a country with a tax treaty, the deemed dividends resulting from the shift should receive the benefit of the reduced treaty dividend rate (if applicable). No reason exists as to why more tax should be imposed than if an actual dividend been declared.

*Response: Noted.* A number of issues exist regarding re-domiciling and effective management that still need to be considered. This matter will be further considered in 2010.

*Comment: (Clause 64; Redomicile – Section 64O(2))* The deemed dividend charge on hybrid debt instruments is penal. Interest payments are not deductible and receipt of the interest is already includible. The deemed dividend charge effectively amounts to a double charge on the receipt.

*Response: Accepted.* The deemed dividend concept in relation to hybrid debt instruments will be withdrawn. The integration of the hybrid debt and hybrid share rules in relation to the dividends tax rules is an item in need for reconsideration.

### **2.3.9 COLLECTIVE INVESTMENT SCHEMES IN SECURITIES: CONDUIT PRINCIPLES IN RESPECT OF ORDINARY DISTRIBUTIONS**

*Comment:* The redemption of shares in a foreign CIS fund (open-ended investment company) appears to be a taxable foreign dividend (because a foreign CIS is still deemed to be a company under the Income Tax, unlike the proposed shift for a domestic CIS). Several years ago, this treatment was changed so that this form of redemption will be treated as a capital gain event as opposed to dividend treatment. It is recommended that capital gain treatment be restored.

*Response:* Accepted. Redemptions by a foreign CIS should not be a dividend. Capital gain treatment will be restored in line with the pre-existing law.

*Comment:* Sometimes, a CIS fails to distribute small fractional dividends due to the small amounts involved. These amounts are held over to the next distribution. Special relief should be provided for fractional dividends retained.

*Response:* Comment misplaced. The deferral of fractional shares until the next dividend cycle does not technically give rise to taxable treatment for the CIS unless postponed for more than 12 months. Any theoretical taxation of these very small amounts can probably be disregarded at the interpretation level as a practical matter.

*Comment:* Sometimes, dividend amounts are not paid to CIS unit holders but applied against management fees. Special relief should be provided for dividends allocated to management fees.

*Response:* Noted. The same problem exists under current law and is currently being handled as a matter of practice.

*Comment:* By treating a collective investment scheme as a trust, it will be deemed to have a 28/29 February tax year-end. An amendment is needed to permit the collective investment scheme to have a year-end that coincides with its financial year (as is allowed currently).

*Response:* Accepted. The definition of year of assessment will be revised to allow the collective investment scheme to have a year-end that coincides with its financial year (as is the case for companies).

*Comment:* The tax rate for a collective investment scheme should remain at 28 per cent. The 40 per cent trust rate should not apply.

*Response:* Not accepted. The rate for trusts remains at 40 per cent because a collective investment scheme is effectively treated as a trust and has all the benefits of the conduit principle. Therefore, the CIS should also bear the attendant tax burden. As a practical matter it is noted that a CIS rarely has taxable income that should give rise to a rate being applied.

*Comment:* The proposed new Dividends Tax fails to address property unit trusts or real estate investment trusts. This oversight should be corrected.

*Response:* Noted. Issues of a CIS in relation to the property sector are being considered within the context of the ongoing project relating to the relationship between property unit trusts and real estate investment trusts.

#### **2.3.10 LONG-TERM INSURERS**

*Comment (Clause 14(1)(b); Section 9D(2)):* The deletion of the term “market related policy” in section 9D presumably stems from the deletion of this definition from the Long-Term Insurance Act, 1998. This amendment however creates a number of complications for long-term insurers settled in 2007. At that time, it was agreed that investment policies deriving their values from the underlying assets should not result in any imputation for long-term insurers due to the constantly changing ratios in the percentage holding of the participation rights that a long term insurer may have in the foreign CIS.

*Response:* Accepted. The old reference to ‘market linked policy’ should be reinstated by explicitly using the words formerly used in the Long-Term Insurance Act. The deleted reference will no longer be an issue.

*Comment:* The requirement of accrual could lead to the situation where the individual policyholder fund will be required to pay dividends tax prior to having received any amount. The timing of the new Dividends Tax is generally determined by the time the dividend is paid. A recommendation is made that the trigger for the charging of dividends tax on the individual policyholder fund should be on receipt instead of the accrual.

*Response:* Not accepted. The “payment” principle of the new Dividends Tax is based on accrual. Therefore, the taxation of insurers (like other shareholders) should also be based on accrual.

*Comment:* In respect of life insurance companies, the individual policyholder fund will have to withhold Dividends Tax in relation to an amount allocable to the individual policyholder fund. This charge is a 10 per cent charge at the shareholder level. The four-funds deduction formula should accordingly be altered to reflect this new reality.

*Response:* Noted. This issue is part of an ongoing project relating to the four-funds system. This issue will be addressed before the new Dividends Tax comes into effect.

#### **2.3.11 TELECOMMUNICATIONS LICENSE CONVERSION**

*Comment (Clauses 47 and 91; Section 40D(3) and paragraph 67D(1) of the 8th Schedule):* Under the proposal, telecommunication license conversions are treated as rollover events, except that the newly received licenses have a new start date for all Income Tax and capital gains purposes. Does this mean that telecommunications companies can amortise the cost of the new license under

section 11(gD) even though the expenditure incurred relates to a converted license acquired before 2008 (i.e. the commencement date of section 11(gD))?

*Response:* Noted. Since 2008, telecommunication companies have been allowed to amortise the new license expenditure under section 11(gD). Since the conversion rules create a new start date, the rolled-over expenditure will become eligible for the 5 per cent allowance (as if acquired after 2008).

*Comment (Clauses 47 and 91; Section 40D(3) and paragraph 67D(1) of the 8th Schedule):* Because the rules for telecommunication license conversions create a new start date for the new license, the new license does not receive the benefit of 2001 effective date time-apportionment under the capital gains rules. This result is unfair because much of the gain relates to the initial license, which appreciated prior to 2001. It is accordingly suggested that rollover be permitted in respect of the timing rules. It is also suggested that apportionment apply if a combination (or splitting) of two or more rights are involved.

*Response:* Not accepted. The new starting date simplifies administration and compliance. The new start date also has substantive benefits. It is true that the pre-2001 time apportionment relief from CGT is lost. However, as stated above, rolled-over expenditure stemming from pre-2008 licenses (i.e. the date of introduction for the depreciation of telecommunications) will become eligible for the 5 per cent amortisation allowance.

*Comment (Clause 47; Section 40D(2)):* Under the proposed amendment, the rolled-over cost of the original license is deemed to be the expenditure incurred for the new license under section 11(a). By limiting the deduction to section 11(a), roll-over relief is not achieved. It is therefore suggested that rollover-relief should apply to section 11 in its entirety or at the very least, section 11(gD) (the depreciation regime applicable to telecommunication licenses).

*Response:* Accepted. In theory, rollover relief should apply to all expenditure and not be selective. Therefore, rollover relief will apply to section 11 in its entirety, which includes section 11(gD).

### **2.3.12 INTERNATIONAL SUBMARINE TELECOMMUNICATIONS CABLES**

*Comment (Clauses 16(1)(d) and 22; Sections 11(f) and 12D(1) (“affected asset” definition)):* A deduction may be claimed under the proposed amendment for expenditure incurred to acquire electronic communication lines or cables. The proposed amendment does not address what constitutes “electronic communications”. Clarification is therefore suggested on the ambit of the term. It may be necessary to rely on the definition in the Electronic Communications and Transactions Act 2002 as a more explicit definition.

*Response:* Comment misplaced. Most items will be covered as a matter of interpretation. The issue will remain open to provide flexibility as new

technologies develop. However, clarification will be provided on this point in the explanatory memorandum.

*Comment (Clause 16(1)(d); Section 11(f)):* The industry norm as it currently stands is for IRU contracts to be entered into for a period of 15 years. However, in order to qualify for the deduction, the minimum legal term of an IRU agreement needs to be 20 years. The conditions for IRU tax deduction should accordingly be reduced to 15 years.

*Response:* Not accepted. It was accepted in our consultations with the telecommunications industry that the term would be 20 years because this term matches with the 20-year accounting period. In addition, the 20 year rule matches other comparable fixed structure rules for depreciation in the Income Tax Act.

*Comment (Clause 16(1)(d); Section 11(f)):* Under the proposed amendment, a deduction may be claimed for an IRU, the whole of which is substantially located outside the territorial waters of the Republic. The term “substantially the whole” should be defined.

*Response:* Comment misplaced. The rule is designed to ensure that cables are not disqualified merely because these cables have an onshore connection with incidental linkage on land. The proposed rule provides the necessary flexibility for industry. This issue will be further clarified in the explanatory memorandum.

### **2.3.13 DEPRECIATION ON IMPROVEMENTS**

*Comment (Clause 30(2); Section 13quat)* The effective date applicable to the Urban Development Zone (UDZ) depreciation amendments enacted in 2008 should be triggered if “brought into use” on or after the effective date. The effective date should not be limited to erections, constructions, etc. occurring on or after that date. Furthermore the effective date of the proposed 2009 UDZ improvement amendments should match the effective date of the suggested date for the 2008 UDZ amendments.

*Response:* Accepted. The effective dates will be adjusted as proposed. The currently proposed amendments will be backdated to the same date as the UDZ amendments in 2008. The “brought into use” concept will also be substituted instead of the trigger relying upon erection, extension, addition or improvement.

*Comment:* The proposed amendments clarify that depreciation explicitly covers improvements. Shouldn't these proposed amendments also be included in the wear and tear depreciation rules of section 11(e)?

*Response:* Comment misplaced. The nature of the section 11(e) allowance is different from those in other sections. The basis of section 11(e) is value, which implicitly takes improvements into account.

*Comment (Clause 24; Section 12F(2)):* The proposed amendment requires certain assets (such as port and airport related assets) to be owned. This ownership requirement creates a disadvantage for many users of port assets because many lessees of port assets erect their own improvements.

*Response:* Accepted. The proposed amendment will be withdrawn for further consideration.

*Comment:* While the proposed amendments clarify that depreciation covers improvements for many provisions, the amendments do not address toll roads under section 24G. Toll roads should also be covered.

*Response:* Comment misplaced. Toll road improvements are already covered. Improvements are implicitly addressed under the definitions of “permanent work” and within “major rehabilitation”.

#### **2.3.14 ADJUSTING RING-FENCING OF LOSSES FOR FINANCIAL LEASING**

*Comment (Clause 36; Section 23A(1)):* Under current law, certain losses associated with the financial leasing of assets are ring-fenced against the rental income. The proposed amendment permits the use of these ring-fenced losses to be offset against associated recoupment of losses associated with the disposal of leased assets. However, the proposed amendment appears to be carried out on an asset-by-asset basis; whereas, this ring-fencing should be performed on a pooling basis (i.e. all financial lease assets being part of a single pool).

*Response:* Accepted. The amendment will be modified to reflect that pooling will continue to be allowed. The pooling approach is consistent with current SARS practice.

*Comment (Clause 118):* There is uncertainty surrounding the application of the effective date for the proposed amendment. The application of the effective date should be clarified.

*Response:* Comment misplaced. The general effective date is applicable (i.e. years of assessment ending on or after 1 January 2010).

*Comment (Clause 36; Section 23A(1)):* The proposed amendment covers recoupments on the disposal of assets as an item against which ring-fenced losses can be used. However, capital gains from the same disposals appear to be missing and should be included.

*Response:* Accepted. Capital gains from the disposal of an “affected asset” will be specifically included as an item that ring-fenced losses can offset against. This approach is in line with the rules for ring-fenced trades.

*Comment (Clause 36; Section 23A(1)):* While the regime as revised will allow ring-fenced losses against “rental income” and disposal associated with the leased asset, the revised regime does not include foreign exchange gains.

Foreign exchange gains may also be associated with rental income and the disposal of leased assets. It is therefore suggested that ring-fenced losses be permitted against these exchange gains.

*Response:* Noted. The issue raised needs further consideration.

### **2.3.15 CROSS-ISSUE AVOIDANCE – REMEDYING UNINTENDED ANOMALY**

*Comment:* If two companies issue their own shares to one another (i.e. a cross-issue), section 24B(2) treats both sets of shares as having a zero expenditure. This rule has long been applied to “direct and indirect” cross-issues. As a result of a 2008 amendment, the ambit of the provision was extended beyond the concept of “direct and indirect” to include all issues of shares occurring “by reason of or in consequence of” the issue of other shares. This extension is far too wide, thereby disrupting commercial transactions and frequently causing an unintended trap for the unwary. Section 24B(2) should be reworked to eliminate these anomalies.

*Response:* Accepted. The 2008 amendment has had a much wider impact than intended. The 2008 amendment will accordingly be repealed and the overall ambit of section 24B(2) will be re-considered so that this anti-avoidance regime is more focused. Note that the 2009 amendment to prevent section 24B(2) from inadvertently impacting multiple drop-downs will remain.

*Comment (Clause 38; Section 24B(2C)):* Section 24B(2C) extends the zero expenditure principle to cover debt-for-debt cross issues as well as debt-for-share cross issues. For instance, if Group Company A acquires newly issued shares in Group Company B on loan account, the debt-for-share rule applies so that settlement of the loan results in a capital gain for Group Company B (the holder of the claim on the loan). Section 24B(2C) should be reworded to eliminate this anomaly and other traps for the unwary.

*Response:* Accepted. These types of transactions are akin to a deferred cash transfer (which would appropriately provide base cost) so the debt-for-share cross issue rule should not apply. Due to this problem and others, the rules for debt cross-issues will be repealed. Other tax rules are sufficient to cover artificial debt transactions because the cancellation of debt should generally give rise to adverse tax consequences.

### **2.3.16 LIQUIDATING, WINDING UP OR DEREGISTRATION OF EXCLUSIVE RESIDENCE COMPANIES**

*Comment (Clause 90; Paragraph 51A of the 8<sup>th</sup> Schedule):* In light of the recent annual fee levied on companies under the Companies Act, the proposed amendment provides tax relief for residential property companies so these companies can liquidate tax-free. The main reason that many of these companies came into existence is for tax reasons, which no longer apply. While the proposal is welcome, it is suggested that the proposed relief for liquidating inactive companies is too narrow and should be extended to trusts and trust shareholders. Relief should also be extended to liquidations involving the

disposal of assets in order to settle debt and to homes used for partial business use.

*Response:* Partially accepted. It is evident that the annual fee was not the underlying driver for companies seeking liquidation relief. It is clear that a number of companies and trusts failed to utilise the previous two-year window period granted during 2001-2003 for avoiding income tax and transfer duty upon liquidation. The proposal will accordingly be substituted with the restoration of the rules associated with the previous two-year window (except the new rule provides rollover relief as opposed to a market value step-up existing under the prior system of relief). The revised proposal will not extend the relief beyond that previously set because taxpayers should not be left in a better position than those who properly utilised the relief during the initial 2001-2003 period.

*Comment (Clause 90; Paragraph 51A(1) of the 8<sup>th</sup> Schedule;):* Whilst the proposed amendment provides relief for liquidating residential property companies, no reason exists to limit the proposal solely to shareholders owning these companies as at 11 February 2009. The proposed relief should apply to all parties who own or will own a residential property at any time during the two year window?

*Response:* Not accepted. The 11 February 2009 has been selected in order to coincide with the announcement in the Minister's Budget Speech. The goal is to assist those already trapped in residence companies and trusts, not to assist new entrants who were aware of the adverse implications of residence companies and trusts.

*Comment:* Although the proposed amendment has been introduced prior to the new Dividends Tax, the amendments do not address the implications under the new Dividends Tax regime which should come into effect at some point during the two-year window period. The relief should therefore also include the new Dividends Tax.

*Response:* Accepted. A new exemption will be added to the new Dividends Tax to cover the newly created liquidation period for residence companies.

### **2.3.17 SHELF-COMPANY START UPS AND SMALL BUSINESS RELIEF**

*Comment:* The proposed amendment enables micro businesses and small business corporations to qualify for relief when shareholders purchase shelf-companies without being disqualified under the anti-multiple shareholding prohibition. The proposed amendment should also cover inactive dormant companies.

*Response:* Not accepted. As a general matter, dormant companies must be discouraged because these companies raise administrative problems for both SARS and CIPRO. The current inclusion of dormant companies within the anti-shareholder prohibition encourages taxpayers to liquidate these companies.



*Comment:* Micro businesses and small business corporations should not fail to qualify for relief due to the anti-multiple shareholding prohibition if the companies at issue are in a state of pending liquidation. CIPRO usually takes time to deregister a company once the paper work is submitted, and taxpayers should not be penalised by this delay falling outside their control.

*Response:* Not accepted. The comment lies outside the scope of the Bill but needs to be considered going forward. Any proposal would need to account for technical issues, such as the acceptable stage of pending liquidation before the company can be disregarded.

### **2.3.18 OIL AND GAS INCENTIVES AND ANCILLARY TRADES**

*Comment (Clause 100; Paragraph 5(3) of the 10<sup>th</sup> Schedule):* The proposed amendment deleting paragraph 5(3) of the 10<sup>th</sup> Schedule brings about the elimination of the special rules for gas refining (i.e. ancillary trade) which prior to the amendment treated gas refining as a permissible trade. As a result, oil and gas production losses can no longer be used to offset gas refining income. No reason exists to eliminate this form of offset since the amendment was mainly designed to provide flexibility for oil and gas operators (not to limit pre-existing tax benefits).

*Response:* Accepted. The deletion of paragraph 5(3) will be withdrawn. However, income from “refining” that can be used as an offset will be limited to refining associated with amounts produced in terms of an “oil and gas right” as defined in the MPRDA (i.e. a domestic right).

### **2.3.19 ACQUISITIONS OF UDZ COMMERCIAL BUILDINGS**

*Comment (Clause 31; Section 13quin (7)):* In 2008, special rules were added so that the purchaser can depreciate a pre-existing building when purchased, but the depreciation is limited when that purchaser acquires only part of the building. The proposed amendment now covers situations where the taxpayer purchases the whole building from a developer. The proposed amendment should also clearly state that “cost” of the purchase includes all costs in acquiring the building and not only the sale consideration (e.g. commission fees and other transactional costs).

*Response:* Accepted. The proposed amendment appears to be unnecessary. The 55/30 per cent rule only applies in respect of purchases of part of a building. No special rules are required when the whole building is purchased. Therefore, the standard “cost” rules for determining the depreciation allowance will apply when whole buildings are purchased (which includes incidental acquisition costs).

### **2.3.20 DELETION OF SECTION 11(bB)**

*Comment (Clause 16(1)(a); Section 11(bB)):* Section 11(bB) allows for the deduction of certain finance charges when acquiring certain plant, machinery, aircraft, etc... The proposed deletion of this deduction is unfounded. At most, the deduction should be limited to those finance charges falling outside the ambit of section 24J.

*Response:* Not accepted. Section 11(bB) was introduced to specify the timing of the deduction of finance charges. Due to the scope of the more recently introduced timing rules in sections 23H and 24J, the isolated timing rule of section 11(bB) has become obsolete.

### **2.3.21 MINING CAPITAL EXPENDITURE**

*Comment:* Before the amendments of 2008, mining companies could depreciate all employees' housing over a ten-year period (i.e. at a 10 per cent rate per annum). Although the 2008 amendments were intended as a relief measure, the amendment actually extended the depreciation period for many forms of housing to 20 years (i.e. at 5 per cent per annum). The 2008 amendment therefore places mining companies in a less advantageous position and should accordingly be withdrawn

*Response:* Accepted. The initial amendment was intended to come with other correlative changes that would have offset these disadvantages. Therefore, all of the 2008 housing amendments applicable to mining will be withdrawn.

*Comment:* The 2008 amendment limited the deductions claimed for expenditure incurred to acquire a mining right, which would exclude expenditure incurred to maintain a mining right. These amendments did not properly account for social and labour plan costs which are incurred on an ongoing basis from the inception of the mining right. It is therefore suggested that the wording of the 2008 amendment be changed so that the deduction for social and labour plan costs match the timing of the required expenditure.

*Response:* Accepted. The amendment will be extended to cover ongoing expenditure in respect of social and labour plans, all of which will be deductible as incurred in line with financial accounting. Environmental rehabilitation costs will be specifically excluded because provision for environmental rehabilitation is specifically addressed in section 37A.

### **2.3.22 MINING TRADING STOCK**

*Comment (Clause 8(1)(zF); Section 1 ("trading stock" definition)):* The proposed amendment treating all mining extraction as part of the cost price of trading stock violates standard commercial practice and the special accounting rules for mining. The cost of extraction often reflects materials that are discarded before the first stages in which that the ore is separated and identified. It is accordingly suggested that the proposed amendment be withdrawn or narrowed to address the specific avoidance of concern. In addition, the proposed amendment treating

all mining extraction as trading stock gives rise to problems associated with stockpiles. The cost of the stockpile should be immediately deductible because the stockpile may never be sufficiently viable for eventual use.

*Response:* Noted. In order to ensure that a recent Tax Court decision cannot be argued to have unintended consequences, it is proposed that the amount reflected as mining trading stock for tax purposes not be less than the amount reflected for accounting purposes. This adjustment preserves the historic *status quo*.

## **2.4 INCOME TAX: INTERNATIONAL**

### **2.4.1 CONVERSION OF THE CONTROLLED FOREIGN COMPANY (CFC) RULING EXEMPTIONS**

*Comment (Clause 14(1)(a); Section 9D(1) “foreign business establishment” definition):* The revised definition of foreign business establishment (which is a pre-requisite for avoiding CFC imputation) is too strict. The revised test now requires the carrying on of business to operate on a “continuous” basis, which literally does not allow for temporary closures (such as closure for the weekend or for holidays).

*Response:* Accepted. The “continuous” requirement will be dropped. The remaining “carrying on business” requirement entails a sufficient level of continuity as derived from common law to prevent avoidance. Under the test as revised, *de minimis* activities (such as sporadic and intermittent services and sales) will not be sufficient to satisfy the foreign business establishment criteria.

*Comment (Clause 14(1)(a); Section 9D(1) “foreign business establishment” definition):* The revised definition of foreign business establishment wrongly specifies foreign tax savings as a negative element. Once valid non-South African tax reasons operate as the main reason for operating abroad, the exact country location of that operation should be irrelevant, even if one foreign country is chosen over another primarily for foreign tax reasons.

*Response:* Accepted. The test will be revised so that the business purpose focus solely weighs the commercial need for operating abroad (vis-à-vis South Africa) against potential South African tax reduction. Foreign tax savings will no longer be relevant to the equation.

*Comment (Clause 14(1)(a); Section 9D(1) “foreign business establishment” definition):* The revised definition of foreign business establishment for group companies is too restrictive. The revised test wrongly requires that both companies who are sharing resources need to be incorporated in the same country in which the fixed business is located. While it is understood that both companies should operate in the same tax environment, the focus should be on the country of residence as opposed to incorporation.

*Response:* Accepted. The country of incorporation requirement will be dropped. Instead, both companies must be “*subject to tax in the same*”

*country by virtue of residence, place of effective management, or other criteria of a similar nature.”* In other words, both companies must be subject to the tax jurisdiction of the same country based on residence utilising applicable foreign tax law concepts in respect of the foreign country at issue.

*Comment (Clause 14(1)(c); Section 9D(2A)):* The requirement that a CFC must be subject to tax at a statutory rate of 20 per cent in the country of incorporation as a precondition for qualifying under the acceptable rate exemption is overly restrictive. Little reason exists to have this measurement if the CFC must additionally be subject to global foreign tax at a 75 per cent level.

*Response:* Accepted. The 20 per cent threshold will be dropped. The purpose of the threshold was to establish a quick bright line test, not to act as hindering prohibition.

*Comment (Clause 14(1)(c); Section 9D(2A)):* The revised rules relating to the acceptable rate exemption rightfully allows CFCs to disregard “assessed losses” when determining whether the CFC is subject to a 75 per cent level of global tax. This aspect of the rule recognises that overall timing differences (as opposed to permanent differences) should not be viewed as a sufficient incentive for locating abroad. However, the reference to “assessed loss” may be overly restrictive because an “assessed loss” under the South African Tax Act includes only a limited pool of losses that are carried forward. Foreign tax rules often permit companies to utilise the tax losses of other companies within the same group of companies and to carry losses back from future tax years.

*Response:* Accepted. The legislation will be clarified to cover an expanded set of losses. Losses of other companies applied against CFC income and losses carried back from future years will be explicitly disregarded (i.e. not impact on the foreign tax determination).

*Comment (Clause 14(1)(c); Section 9D(2A)):* In order to qualify for an acceptable rate exemption, the revised rules require the taxpayer to perform the entire South African tax calculation first in order to determine if the taxpayer meets all the requirements for the exemption. This aspect of the test poses an administrative burden to both the taxpayer and SARS. Little time is saved if the dual country tax calculation is required in any event.

*Response:* Not accepted. While admittedly unwieldy, the dual tax calculation is the only way to provide relief without creating opportunities for utilising the exemption as a means for obtaining an unduly low global rate of tax. Simplifying proxies for determining whether foreign tax levels are suitably high in relation to South African tax invariably give rise to inequitable results. Many countries accordingly follow the proposed paradigm when employing an acceptable tax rate exemption (e.g. Sweden, the United Kingdom and the United States).

*Comment (Clause 14(1)(c); Section 9D(2A)):* In order to qualify for the acceptable rate exemption, the revised rules require the net income of the CFC

as an aggregate to be subject to a global level of tax of at least 75 per cent when compared to the tax that would have been imposed had the CFC been fully taxed in South Africa. The 75 per cent requirement should be reduced to two-thirds or at most 70 per cent.

*Response:* Not accepted. The purpose of the proposal is not to provide an incentive for operating abroad but merely to provide relief from CFC taxation if only a small amount of global tax savings is at issue. It makes little sense to impose South African tax when the net amount of that tax is marginal after foreign tax rebates are taken into account. The 75 per cent threshold chosen is in line with the threshold of the United Kingdom (one of South Africa's largest investors) and is relatively low when compared internationally to other exemptions of this nature.

#### **2.4.2 DIVIDENDS TAX: FOREIGN PORTFOLIO DIVIDENDS**

*Comment (Clause 56; Section 64F(3)):* The extension of the new Dividends Tax to foreign dividends in respect of JSE listed shares imposes an unfair burden in relation to locally listed companies. For instance, failure to exempt these foreign dividends when paid to domestic company shareholders will often result in double tax (a tax when foreign dividends are paid to South African companies and a second tax when the domestic companies eventually distribute dividends to individual or foreign shareholders).

*Response:* Accepted. Dividends from foreign shares listed on the JSE will receive the same exemptions as dividends from domestic shares listed on the JSE (with an additional exemption when foreign dividends are paid directly to foreign shareholders because these latter dividends are outside South African taxing jurisdiction).

*Comment (Clause 15(1)(i); Section 10(1)(k)):* The proposed new Dividends Tax is likely to discourage investments in foreign shares listed on a foreign exchange by retail and institutional South African investors. This rule makes little sense in the case of dual listed companies. It is proposed that foreign listed shares of a dual listed company should have the same benefits as JSE listed shares.

*Response:* Noted. Under the formulation as currently proposed, the system for taxing dividends from foreign shares will be divided into two overall groups – taxation of dividends from foreign JSE listed shares and the taxation of dividends from other foreign shares. This proposed distinction exists because no practical means appear to exist to impose the 10 per cent withholding tax on foreign shares unless those shares are listed on the JSE. That said, the benefits and burdens of the two system groupings for foreign dividends is still under review. Further analysis and discussion pertaining to foreign dividends will be required before the new Dividends Tax comes to effect.

*Comment:* Domestic taxpayers receiving dividends in respect of foreign JSE listed shares should receive the participation exemption if share ownership equals or exceeds 20 per cent. This exemption would place foreign JSE listed shares on par with other foreign shares held by domestic taxpayers.

*Response: Not accepted.* As discussed above, a dual system exists for taxing foreign dividends – one for foreign JSE listed shares and a second for the other foreign shares. The taxation of dividends from foreign JSE listed shares is designed to match the taxation of domestic JSE listed shares. The request seeks to obtain the best of both worlds for foreign JSE listed shares (e.g. domestic share dividend exemptions as well as foreign share dividend exemptions).

### **2.4.3 REPEAL OF FOREIGN LOOP EXEMPTION**

*Comment (Clause 15(1)(h); Section 10(1)(k)):* The repeal of loop relief for STC is unprincipled as long as the STC (a company level charge) remains in place. Repeal of this loop relief should only go into effect once the new Dividends Tax goes into effect.

*Response: Partially accepted.* Repeal of STC loop relief will generally be deferred until the new Dividends Tax goes into effect as suggested. However, this loop relief will require specific tracing; the special presumption for 10 per cent or greater interests will be repealed immediately. The main purpose of the special presumption is no longer of practical use and could give rise to avoidance.

## **2.5 FILM ALLOWANCE**

*Comment (Clause 39; Section 24F(1)):* The wholesale exclusion of banks, financial services and insurers from the section 24F film allowance is unwarranted. These institutions are a valuable source of funding needed to stimulate the local film industry. This aspect of the proposed amendment should accordingly be withdrawn.

*Response: Partially accepted.* All of the amendments relating to the film allowance will be withdrawn for reconsideration, including the wholesale exclusion of banks, financial services and insurers. Current law remains in place. As stated in the Budget Review, the main purpose of the amendments was to curb further avoidance (such as the assumption of debt that was unlikely to be repaid). Special concerns also existed that certain banks, financial services and insurers utilising the incentive did so mainly for tax reasons with little meaningful benefit for the industry. On the other hand, review of the sector revealed that the section 24F allowance had shortcomings, which required modification or complete revision. These shortcomings meant that section 24F was not assisting the film industry as intended. Given these concerns, it was decided that a broad-based policy review of the area is required before appropriate changes are made.

## **2.6 ESTATE DUTY**

### **2.6.1 PORTABLE SPOUSAL DEDUCTION**

*Comment (Clause 5; Section 4A(2) of the Estate Duty Act):* The proposed amendment allowing the section 4A deduction of R3.5 million to roll-over between spousal estates is too narrow by requiring all assets to be bequeathed to the surviving spouse. Estates of the predeceased spouse often transfer assets to other parties (e.g. jewellery, personal effects and immovable property). The rule should allow the estate of the predeceased spouse to freely bequeath assets with unused section 4A deductions rolling over to the estate of the surviving spouse.

*Response: Accepted.* The proposal will be amended to allow the desired flexibility. The estate of the second deceased spouse will receive a double deduction under section 4A less the section 4A deduction previously utilised by the first deceased spouse. However, as a precondition for the doubling of the section 4A amount, the executor of the estate of the second deceased spouse must provide the estate duty return associated with the predeceased spouse (as contemplated in section 7 of the Estate Duty Act). This return is required to ensure that taxpayers do not seek to misuse the section 4A deduction associated with the predeceased spouse (e.g. with the R3.5 million section 4A deduction of the predeceased spouse claimed for transferred assets to children upon the first death, followed by a second claim of the same R3.5 million section 4A deduction of the predeceased spouse when further assets are transferred to the children on the death of the second spouse). Should the value of the section 4A deduction be increased in future, the calculation of the total amount, or the remaining balance, that may be roll-over to the surviving spouse, in this context, might require further consideration.

*Comment (Clause 5; Section 4A(3) of the Estate Duty Act):* In the case of polygamous marriages under customary law, the deceased may be survived by more than one spouse. In these circumstances, the section 4A deduction should not be apportioned based on the value or amount of assets that each spouse receives.

*Response: Accepted.* If the deceased was a spouse in a polygamous marriage, the deduction will be made available to all the spouses in that marriage on a proportional basis without regard to the assets each spouse receives. The proportion will be based simply on the number of spouses in existence when the predeceased spouse dies. For instance, if the deceased upon death was married to four spouses, each deceased estate of each spouse will be entitled to an additional section 4A deduction equal to 1/4<sup>th</sup> of that amount (less 1/4<sup>th</sup> of the section 4A deduction previously utilised by the estate of the predeceased spouse).

*Comment:* A person may have been married to various pre-deceased spouses during that person's lifetime. In these circumstances, the section 4A deduction for each pre-deceased spouse should cumulatively roll over.

*Response: Not accepted.* If a deceased had many spouses during his or her lifetime, only a doubling of the section 4A deduction will be allowed. In these circumstances, an additional section 4A deduction less the

section 4A deduction utilised by the estate of one of the predeceased spouses will be available.

*Comment (Clause 5(2)):* To apply the effective date in respect of the predeceased spouse would prejudice those persons that did not use estate planners in the past. The effective date should therefore be in respect of the estate of the second deceased spouse, not the estate of the predeceased spouse.

*Response: Accepted.* The effective date of the proposal will be based on the death of the second spouse. For example, if the husband dies in 2007 and the wife dies in 2010, the proposal will fully apply because the wife will die after the effective date of the proposal.

## **2.6.2 USUFRUCTUARY SCHEME**

*Comment (Clause 6; Section 5(1) of the Estate Duty Act):* The envisaged aim of the proposal is to close down a scheme whereby testators avoid estate duty by bequeathing a usufruct to a spouse with the remainder first to a one year trust (or other one-year holder), followed by another shift to the ultimate heir. However, this proposal unfairly penalises all usufructs, many of which have valid non-tax estate planning purposes. For example, a usufruct may be created in favour of a surviving spouse and then transferred to a minor child until such time as the minor reaches majority. Conversely, the proposal can also be misused (e.g. through the use of public benefit organisations) to reduce the estate duty in an artificial way.

*Response: Accepted.* It is accepted that a usufruct created in a will can fulfil an important function in estate planning unrelated to the estate duty. In acceptance of this concern, the amendment is withdrawn for reconsideration. Nevertheless, one-year schemes remain of concern and still warrant an appropriate remedy.

## **2.7 INDIRECT TAX**

### **2.7.1 IMPACT OF VALUE-ADDED TAX ON RE-ORGANISATIONS**

*Comment (Clause 105; Section 8(25A)):* The removal of section 42 asset-for-share transactions from VAT reorganisation relief should be reconsidered. Contrary to the statement in the explanatory memorandum, section 42 transactions do in fact entail the transfer of going concerns in many circumstances.

*Response: Accepted.* The reference to section 42 transactions will be restored so that section 42 will again fall within the ambit of VAT reorganisation relief. However, this relief will only cater for section 42 going concern transactions (similar to the other reorganisations).

*Comment (Clause 105; Section 8(25)):* The proposed legislation provides SARS with the power to collect tax liabilities from a transferee in a reorganisation transaction where these liabilities were previously incurred by a transferor. No



basis exists for this rollover of tax liabilities as these transactions are unrelated to the transferee.

*Response:* Accepted. The proposed amendment will be withdrawn for reconsideration. The issue giving rise to the proposal goes beyond reorganisations (i.e. being of concern whenever assets are completely removed from a VAT paying entity to another VAT vendor).

## **2.8 TAX ADMINISTRATION**

### **2.8.1 CONFIDENTIALITY – CLAUSE 7 OF THE 2<sup>ND</sup> BILL; SECTION 4 OF THE INCOME TAX ACT**

*Comment:* The proposed amendment is a limitation on a taxpayer's right to privacy. It should specifically provide what non-financial information the Commissioner may disclose and not leave the matter open for the Commissioner to determine.

*Response:* Partly accepted. The purpose of the proposed amendment is to enable employers to use SARS data to verify their employee related information. The wording will be revised to provide more certainty as to what information the Commissioner may disclose, while retaining a degree of flexibility to cater for business and practical developments.

### **2.8.2 “PAY NOW ARGUE LATER - CLAUSE 14 OF THE 2<sup>ND</sup> BILL; SECTION 88 OF THE INCOME TAX ACT AND CLAUSE 37 OF THE 2<sup>ND</sup> BILL; SECTION 36 OF THE VAT ACT**

At the outset it is useful to recap on the threefold nature of the amendments that are proposed, since many of the commentators have lost sight of the linkages between the amendments. These amendments:

- make it clear that a disputed tax debt may be collected despite an objection to the assessment in terms of which it is raised;
- provide guidance, which is currently only to be found in a 2000 press statement by SARS, as to what factors should be considered in deciding whether to agree to a taxpayer's request to suspend payment of the debt; and
- provide for the payment of interest should an amount be collected and later refunded because the objection has been conceded. It should be noted that the interest will be paid at the same rate that SARS normally charges on outstanding debt (11.5 per cent at time of writing), which is higher than the rate paid on refunds of overpaid provisional tax (7.5 per cent at time of writing) in the income tax context.

*Comment:* The proposed amendment amounts to an extension of the “pay now argue later” principle to the assessment stage and results in a fundamental and unjustified denial of the taxpayer's right to the principle of *audi alteram partem*. This is so because the proposed amendment to these sections results in the disputed assessment becoming enforceable against the taxpayer even before the taxpayer has been granted the right to be heard on the correctness or otherwise of the disputed assessment. The formal objection to the disputed

assessment is the only right granted in terms of the Acts for the taxpayer to be heard before the payment obligation arises. It is this right to be heard, before being condemned to the payment of the disputed assessment, which the proposed amendments now seek to abolish.

*Response: Not accepted.* The Constitutional Court held in a unanimous decision in Metcash Trading Ltd v Commissioner, South African Revenue Service, and Another 2001 1 SA 1109 (CC) that the pay now argue later principle is constitutional in that it does not preclude the right of access to the courts to review SARS's decision on the underlying merits of a matter or SARS's decision not to suspend payment of the amount disputed. While it is certainly conceded that the Metcash case dealt with a VAT matter within a particular set of facts, the principles it set out cannot be so narrowly applied. That said, even if the wording of the Constitutional Court judgment is read narrowly, Kriegler J noted that; "The first significant point to note is that VAT, quite unlike income tax, does not give rise to a liability only once an assessment has been made." We would respectfully submit that the inference to be drawn is clear. The court was of the view, although not critical to the case then at hand, that the liability for an income tax debt arose on assessment. The court went on to note in a VAT context that; "Ensuring prompt payment by vendors of amounts assessed to be due by them is clearly an important public purpose... Requiring them to pay on assessment prior to disputing their liability is an essential part of this scheme. It reduces the number of frivolous objections and ensures that the fiscus is not prejudiced by the delay in obtaining finality." We would respectfully submit that this is a clear indication that the principles of the judgment are of equal force at the assessment and objection stage.

Moving abroad to another constitutional democracy Addy J held, in the Canadian case of Oneil Lambert v Her Majesty the Queen et al 75 DTC 5065, that; "The obligation to pay the tax, subject to the right of contesting the ultimate liability for same, arises from the moment the assessment is made. But again, there is nothing extraordinary in this procedure, and it has for many years been used in other taxing statutes... In the case of the *Income Tax Act* should the assets of a taxpayer be seized and it should be established at a later date that there was in fact no liability for taxes, then obviously he would be entitled to restitution. The principle of *audi alteram partem* applies to the question of final determination of liability, which is a completely different question from the temporary deprivation of assets or even from the permanent loss of assets, providing there exists a right of restitution of the assets or of compensation for their loss. The public policy behind the power in many taxing statutes to declare an amount payable before final liability for the amount has been determined and to take effective steps of securing such payment by means of seizure of assets and of sale of same if necessary, is of course founded on the principle that the tax collector must be furnished some means of preventing tax avoidance by dissipation of assets or by the taxpayer removing them from the jurisdiction."

*Comment:* The taxpayer's safeguard is to have its objection duly considered. Most comparable countries, of which Australia and New Zealand are examples, have a similar safeguard. Current law establishes a fair balance between the interests of the taxpayer and those of the *fiscus* and there is no justification for the suggested amendments.

*Response:* Not accepted. The Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2008) survey covering 43 countries confirms that Australia and another 24 countries permit collection of disputed taxes while an administrative review (i.e. an objection) is in progress. A further nine countries permit collection after administrative review while litigation is in progress. It is acknowledged both domestically and internationally that the ability to collect disputed taxes in appropriate cases is vital to society's interests. This ability to collect ensures that funds flow to government as budgeted for with minimal delay or evasion due to frivolous disputes, dissipation of assets, etc. Equally, this ability to collect must be subject to judicial review of the merits of the substantive dispute should that review be required. Full repayment of the amount incorrectly collected should also be available if the dispute is decided in the taxpayer's favour.

*Comment:* How will the Commissioner be able to consider the factor dealing with whether the taxpayer has "an arguable case" when applying for a suspension of collections when payment may be due before the taxpayer is required to object?

*Response:* Accepted. The legislation will be modified to make it clear that the question of whether a taxpayer's objection or appeal has a minimum merit will only be taken into account after it has been lodged.

*Comment:* The Commissioner's view on whether the taxpayer has "an arguable case" is irrelevant to the question of whether the payment obligation should be suspended.

*Response:* Partially accepted. This factor is required to ensure that frivolous objections are not lodged in order to defer payment of tax. The legislation will, however be modified to provide that the factor to be considered is that the objection or appeal must not be frivolous or vexatious. This is a relatively low but clear standard that can be applied before all the details of an objection or appeal are addressed.

*Comment:* The factor relating to fraud should be limited to cases where a taxpayer has been convicted of fraud in respect of which the dispute is related.

*Response* Not accepted. The decision to suspend payment must take place early in the dispute resolution process. Convictions for fraud, on the other hand, typically occur either late in the process or after it has been concluded. (Suspension is not feasible in view of the risk to the *fiscus* in these situations.)

*Comment:* Different considerations apply to the collection of administrative penalties and additional taxes levied in terms of provisions which are intended to

be penal in nature. It is inappropriate that a taxpayer should be condemned to pay penalties and additional taxes without due process. We submit that whatever justification there might be in a particular case for the immediate collection of taxes suspected to be payable, there can never be justification for the enforced payment of additional taxes and penalties without due process. The proposed amendments do not, but ought to, address this distinction.

*Response:* Not accepted. Additional taxes were at issue in the Metcash case, but the court did not draw the distinction that is being sought. Furthermore, the current legislative requirement that any payments be first set off against penalties, then interest and then tax and additional tax, which was introduced at the request of the Auditor-General with effect from 1994, would render this approach impractical.

*Comment:* "In relation to the provisions of the VAT Act, the Supreme Court of Appeal has already 'clarified' the current position. It is surprising that the author of the Explanatory Memorandum should think there is a need for further clarification. The position is that the Commissioner is obliged to 'hear' the taxpayer before the obligation to pay a disputed assessment arises. The principle of *audi alteram partem* is entrenched by various provisions in the Acts which provide that the disputed assessment will become final, notwithstanding the taxpayer's appeal to the Tax Court, after the Commissioner has considered and decided upon the taxpayer's objection to the disputed assessment. Singh v Commissioner, South African Revenue Service 2003 4 SA 520 (SCA); 65 SATC 203 at [35] 218. The similar provisions in the Income Tax Act render the ruling of the Court in Singh's case applicable to a disputed assessment issued under the Income Tax Act."

*Response:* Comment misplaced. The majority decision in the Singh case held that SARS cannot commence collection proceedings before notifying the VAT vendor concerned of the assessment, and only after the vendor concerned has failed to pay the taxes within the period specified in the assessment. Cloete JA and Heher AJA writing for the majority noted; "Section 40(5)... justifies the conclusion that the right to exact the amount reflected in the assessment flows from the assessment itself and not some subsequent event." The obligation to pay arises upon the issue and notification of the vendor of the assessment. The commentator by contrast attempts to present the *minority* judgment by a single judge as the court's binding decision.

The irresponsible nature of this particular commentator's comments, as exemplified by the above and the general tone of its submission, is particularly disappointing given that it represents a sizeable portion of the legal profession in South Africa.

*Comment:* The discretionary powers afforded to SARS should be made subject to objection and appeal.

*Response:* Not accepted. The decision in the Metcash case was that, as far as section 36 of the VAT Act was concerned, the exercise by SARS of its discretion in terms of section 36 of that Act constituted administrative

action as contemplated by section 33 of the Constitution. A refusal to accede to a request for the suspension of the obligation to pay would be reviewable before a court in terms of the principles of administrative law. Similar principles would hold true in respect of the Income Tax Act from which the relevant provisions for the VAT Act were largely drawn. Hence, no explicit provision to this effect needs to be added to the current wording of the proposed amendment.

*Comment:* The proposed amendment must contain time-frames within which the parties must perform the various acts required in terms thereof e.g. within how many days from receipt of assessment, or the outcome of an objection must the taxpayer lodge a request for suspension of payment).

*Response:* Not accepted. The relevant time-periods will be set out in a policy document to provide flexibility for taxpayers and SARS alike.

*Comment:* Where an assessment is altered and an adjustment is made, amounts short-paid by the taxpayer are recoverable with interest in terms of section 89. It is submitted to be inequitable that the Commissioner allows suspension of payment, and thereafter requires interest paid on that amount from the date of the assessment in the case where the objection/appeal is denied. Since no amount is payable during the period of suspension, no amount exists on which interest may be charged during that period. To allege that interest is chargeable is to hold that the suspension has been revoked retrospectively.

*Response:* Not accepted. The liability to pay the disputed tax arises on assessment. Although payment may be suspended, the debt itself is not. Interest must be charged to ensure that the time value of money is accounted for. Equally, where the taxpayer has paid the disputed tax and the objection is subsequently allowed, the taxpayer will be paid interest from date of payment to date of refund.

*Comment:* The effective date of the amendment should be clarified (i.e. will it apply to all existing objections or appeals or only to objections and appeals lodged after the effective date?)

*Response:* Accepted. The proposed amendments will apply to all amounts payable to or by SARS in existence on or after the effective date of the amendments. A transitional rule will ensure that suspension of payment granted under the previous legislation will carry over to the new legislation and will lapse on the earlier of the expiry date thereof or six months from the effective date.

### **2.8.3. DEFINITION OF DISPUTE – CLAUSE 15 OF THE 2<sup>ND</sup> BILL; SECTION 88A OF THE INCOME TAX ACT**

*Comment:* 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.

*Response:* Not accepted. In the case of a self-assessment process, SARS formally raises a tax liability that differs from that arrived at by a taxpayer through the issue of an assessment. Permitting settlements before this point increases the risk that settlements will not be dealt with, quantified and reported to the Auditor-General and Minister of Finance as required by legislation.

**2.8.4 COMPOUND INTEREST – CLAUSE 16 OF THE 2<sup>ND</sup> BILL; SECTION 89quin OF THE INCOME TAX ACT**

*Comment:* 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. A monthly compounding period would simplify matters and be in line with the most common commercial practice.

*Response:* Accepted. The legislation will be modified to provide that interest will be calculated on daily balances owing and compounded monthly.

**2.8.5 PERSONAL LIABILITY OF EMPLOYERS – CLAUSE 19 OF THE 2<sup>ND</sup> BILL; PARAGRAPH 5 OF THE 4<sup>TH</sup> SCHEDULE TO THE INCOME TAX ACT)**

*Comment:* The full impact of the proposed amendment is not clear. Does it mean that if the employer pays the outstanding employees' tax on behalf of the employees (i.e. if an employees' tax assessment was raised by SARS) that the SARS will regard this as the final settlement of the employees' tax or does the employer have to perform a full gross-up tax calculation on the employees' tax paid on behalf of the employee (on the basis that it is 'remuneration') and include the additional employees' tax so calculated in the payment of the outstanding employees' tax to SARS?

The 10 per cent penalty in paragraph 6(1) and interest in terms of s89bis were also not levied on this penalty. It is unclear whether the proposed amendment is intended to result in the 10 per cent penalty and interest being levied on the outstanding employees' tax.

The outstanding employees' tax that was paid as a penalty was not allowed as a deductible expense for tax purposes in the hands of the employer. Is it now intended to be allowed as a deductible expense for the employer?

*Response:* Partly accepted. Where an employer settles the outstanding employees' tax in terms of paragraph 5(1), that employer's personal liability is extinguished. The proposed insertion of paragraph (1A) makes it clear that the employer's liability (agent liability) in terms of paragraph 2(1) is extinguished by the payment made by the employer in terms of paragraph 5(1) and effectively eliminates any dual liability (i.e. ensuring that the principal liability is extinguished if the employer pays in terms of personal liability).

Hence a payment made in terms of paragraph 5(1) relates back to the principal liability in terms of par 2(1) and will carry interest from due date to date of payment. No explicit provision needs to be made in this regard.

Paragraph 5(5) will no longer be deleted and its modified wording will clarify that the payment made by the employer in terms of paragraph 5(1) is, as far as the employer is concerned, regarded to be a penalty for purposes of section 23(d) and hence not deductible by that employer.

#### **2.8.6 PROVISIONAL TAX – CLAUSE 22 OF THE 2<sup>ND</sup> BILL; PARAGRAPH 20 OF THE FOURTH SCHEDULE TO THE INCOME TAX ACT**

*Comment:* Recognition of the fact that “less sophisticated” taxpayers may not always be able to estimate their taxable income for the purposes of the second provisional tax payment and that some accommodation for them is required, serves only to emphasize the punitive implications of this provision for “larger” taxpayers. Difficulties encountered with estimates for this purpose do not arise from the level of sophistication or the size of the taxpayer but from the nature of its operations. Many large, sophisticated businesses are unable to calculate their taxable income as at the last day of the tax year for purposes of these provisions. Comparative analysis shows that the accuracy requirements in many other countries are equal to or lower than SA, examples used by SA (i.e. India and Ireland) do not charge penalties but only interest on under-estimate, however, this option has never been offered to SA taxpayers (i.e. no international precedent for the imposition of a penalty regime).

*Response:* Partly accepted. As a consequence of further interactions with stakeholders, the following two tier model is proposed for the short-to medium-term. Further discussions with stakeholders with respect to proposals for a medium-term revision of the provisional tax process to modernise it and make greater use of interest, as opposed to penalties, will take place in due course.

##### *Tier one – Smaller taxpayers*

This tier largely reverts to the pre-2008 basis whereby an estimate of taxable income for the second provisional tax payment will not attract a penalty if the estimated amount is at least equal to the lesser of the basic amount or 90 per cent of actual taxable income for the year. If the estimated amount does not reach this level an automatic penalty of 20 per cent of the shortfall is imposed. The taxpayer may approach SARS for a full or partial reduction of the penalty if the estimate was “was seriously calculated with due regard to the factors having a bearing thereon and not deliberately or negligently understated”. Although the 20 per cent penalty is higher than the other underpayment penalties of 10 per cent in the Income Tax and VAT Acts, no change is proposed in view of its long standing application and the interest discussion below.

The basic amount (for both first and second provisional tax payments) will be increased by 8 per cent a year if the basic amount is in respect of a year of assessment that closed more than a year before the provisional

tax estimate is due. This escalation replaces the non-statutory escalation of 10 per cent suggested on provisional tax forms where an assessment was two or more years out of date. The rate is reduced from 10 per cent in view of the current higher inflation but lower growth economic environment.

#### *Tier two – Larger taxpayers*

This tier retains the current basis whereby an estimate of taxable income for the second provisional tax payment will not attract a penalty if the estimated amount is at least equal to 80 per cent of actual taxable income for the year. If the estimated amount does not reach this level, SARS may impose a penalty of up to 20 per cent of the shortfall if SARS is not satisfied that the estimate was “seriously calculated with due regard to the factors having a bearing thereon or was not deliberately or negligently understated”. In other words the penalty becomes a discretionary penalty to address concerns that have been expressed about the impact of an automatic penalty on financial disclosure.

#### *Dividing provisional taxpayers between tiers*

The cap of taxable income of R1 million will place 90 per cent or more of provisional taxpayers *by volume* in the first tier, while retaining 90 per cent or more of corporate provisional taxpayers and up to half of individual provisional taxpayers *by value* in the second tier. To place provisional tax collections from individuals in context, these collections amount to approximately 10 per cent of those from companies.

Stakeholders would prefer that a taxpayer's basic amount be compared to the R1 million cap since it requires no estimation by taxpayers. We are, however, concerned that this would allow taxpayers with outdated assessments to enjoy the benefit of the basic amount safe harbour of the first tier, especially in high value cases where the taxpayer was previously in an assessed loss position or enjoyed a greater than 8 per cent per annum growth rate.

Accordingly, the taxable income for the current year will be compared to the cap. While it is true that taxpayers at the margin will have to prepare reasonably accurate estimates to determine whether they fall into the first or second tier, taxpayers with a taxable income approaching R1 million are likely to be more sophisticated taxpayers. In doing so, these taxpayers will also be able to estimate whether a payment based on the basic amount is likely to fall within the 80 per cent accuracy level required of the second tier.

#### *Charging and payment of interest*

The stakeholder proposal that the penalty on understatement be reduced but that interest be charged and paid on the shortfall or overpayment of provisional tax compared to the actual taxable income for the year is not considered feasible in the short-to-medium-term. The proposal would



require substantial systems changes and represent a major change to the provisional tax system that would require further consultation.

*Comment:* The proposed amendment provides the Commissioner with the power to prescribe a method for determining an estimate of taxable income which, if followed, will result in automatic waiver of the 20 per cent penalty. Whatever the Commissioner prescribes in terms of this policy results in an enactment of tax rules by the Commissioner in the form of the required second provisional payment which may only be departed from under pain of a possible penalty of 20 per cent. Such a procedure is unconstitutional.

*Response:* Comment misplaced. Although the comment is based on a misunderstanding that the method prescribed by the Commissioner would be mandatory (whereas a proper reading of the draft legislation would have revealed that it would only have served as a simplified alternative to the existing method) it is proposed that the legislation be modified to give effect to the two tier system.

#### **2.8.7 BIOMETRICAL INFORMATION – CLAUSE 36(a) OF THE 2<sup>ND</sup> BILL; SECTION 23(2) OF THE VALUE-ADDED TAX ACT**

*Comment:* As a result of the amendments proposed, biometrical information is now a requirement for successful VAT registration. This added requirement of biometrical information places an unfair registration burden on small business.

*Response:* Not accepted. The VAT system, which is a self-assessment system, needs to be protected from manipulation and abuse. Of great concern is the entry into the VAT system of persons (e.g. criminal syndicates) seeking to falsely claim refunds. The additional requirement of biometric information serves as a bulwark by prohibiting false entry. However, it is recognised that the operational implementation of biometric devices may take some time, and therefore, the amendment will only become effective on a date determined by the Minister (once he is satisfied that sufficient systems are in place).

Taxpayers also raised concerns that delays exist with the registration of VAT, and VAT registration is sometimes being backdated to the date of application. The backdating of registrations will only occur for persons that are compelled to be registered as required by the Act where it is clear that as a result of exceeding the threshold, such persons become liable. The operational policy of SARS is that voluntary VAT registrations are not backdated.

*Comment:* The proposed addition of biometrics raises a practical issue for non-resident entities seeking South African VAT registration. It is unclear whether a foreign representative of the non-resident entity is required to travel to South Africa to provide the required biometrical information or whether the local representative of the non-resident entity can provide the requisite information.

*Response:* Comment misplaced. The VAT Act currently requires that a non-resident entity appoint a natural person who is a resident of the

Republic to act as a representative vendor. This representative vendor is responsible for the duties imposed by the VAT Act, including VAT registration.

**2.8.8 REMISSION OF INTEREST – CLAUSE 38(b) OF THE 2<sup>ND</sup> BILL; SECTION 39(7) OF THE VALUE-ADDED TAX ACT**

*Comment :* The proposed new legislation limits the Commissioner's discretion to waive interest owed. This change should not remove the waiver for situations where the fiscus has not suffered an overall financial loss.

*Response:* Not accepted. The current "fiscus financial loss" test is based on an incorrect premise. A vendor's liability to pay interest should have no regard to whether or not the recipient vendor claimed the input tax on the same transaction. In effect, taxpayers are seeking a waiver of interest whenever one vendor fails to make payment to another. This position is tantamount to breaking the VAT chain, which would relegate the VAT system to a retail sales tax.

*Comment :* Under the revised discretionary waiver of interest, the waiver will only be permitted for "circumstances beyond the control" of the VAT vendor. This test is too narrow and subjective.

*Response:* Not accepted. The revised waiver is intended only for exceptional cases (i.e. where the vendor is not responsible for the default). An example of this circumstance is a banking system failure. As a theoretical matter, shortfalls should almost universally trigger interest (as opposed to penalties which are more discretionary).

**2.8.9 CUSTOMS AND EXCISE – CLAUSES 29 OF THE 2<sup>ND</sup> BILL; SECTION 94 OF THE CUSTOMS AND EXCISE ACT AND CLAUSE 31 OF THE 2<sup>ND</sup> BILL; SECTION 119A OF THE CUSTOMS AND EXCISE ACT**

*Comment :* The proposed amendment introducing a provision for countering schemes for the avoidance of duties is possibly not line with global trends in Customs legislation.

*Response:* Accepted. The provision was included to align the Customs and Excise Act with the VAT Act, with which it operates in tandem in respect of imports. Nonetheless, the proposed amendment will be withdrawn for further consideration to ensure that it will have the intended effect of addressing schemes prevalent in the customs environment.

*Comment :* The scope of the Commissioner's rule-making power in respect of Customs modernisation should not be stated so widely.

*Response:* Partially accepted. Subclause (1) of the provision specifies that the rules may only be issued in cases of urgency for modernisation purposes. Subclause (2) provides that the rules must be consistent with the objectives of the provisions of the Act to which they relate, thus further

limiting their scope. Subclause (3) provides that the rules lapse at the end of the next calendar year unless they are explicitly ratified by Parliament. The proposed legislation will be refined further in consultation with the State Law Advisers.